# NOTES

## Duty of Member of Protective Committee to Disclose Information Before Purchasing Stock from Non-Depositor*

Plaintiff was a stockholder in a close corporation of which the defendant was a director, executive vice-president, and general manager.[1] The defendant received an offer from outside business men to buy a prosperous subsidiary of the corporation for $15,000,000,[2] or a part thereof on the basis of this price.[3] Negotiations were conducted by the defendant which resulted in a plan for the reorganization of the subsidiary under which the outside investors would acquire a four-fifteenths interest in the subsidiary for $4,000,000.[4] To effect this reorganization a deposit agreement was drawn up. The parties to this agreement were to be the stockholders of the parent company, the stockholders of the subsidiary, and a deposit committee of which the defendant was a member.[5] A few days after he had signed the agreement, the defendant, with the assistance of third parties who concealed his identity, purchased stock of the plaintiff who, at the time of the sale, had no knowledge of the deposit agreement or of the contemplated reorganization. Five years later, having found out that it was the defendant who had bought her stock, the plaintiff brought suit to recover the amount by which the actual value of the stock at the time of the sale exceeded the price at which she had sold. The trial court gave judgment for the plaintiff

*Nichol v. Sensenbrenner, 220 Wis. 165, 263 N. W. 650 (1935).

1. The corporation, the Kimberly-Clark Company, had only fifty-four stockholders, most of whom lived within a radius of twenty-five miles of the home office in Wisconsin and were connected with the management. The stock of the corporation was not listed on an exchange.

2. The subsidiary, the Kotex Company, had 3000 shares of stock outstanding of which the parent company owned 2685. The remaining 315 shares were owned by six individuals, all connected with the parent company. Although the value of the parent's interest in the subsidiary was carried on the books at only $268,500, the profits of the subsidiary for the years 1924, 1925, and 1926, amounted to $2,599,912.19. The earnings of the subsidiary were not shown on the books of the parent company nor was any information in regard to these earnings given to the plaintiff or other stockholders of the parent company.

3. It is interesting to note that the acceptance or rejection of such an important offer lay almost entirely within the discretion of a single individual, the defendant.

4. The alleged purpose of the reorganization plan was to avoid payment of an income tax. See Sage v. Commissioner of Internal Revenue, 83 F. (2d) 221 (C.C.A. 2d, 1936); Brief for Respondent 23, Nichol v. Sensenbrenner, 220 Wis. 165, 263 N. W. 650 (1935); *cf.* Comment (1935) 45 Yale L. J. 134.

5. Under the reorganization plan the parent corporation was to declare a dividend of the stock which it held in the subsidiary. This stock was to be delivered to the deposit committee and exchanged by them for preferred and common stock in the new, reorganized Kotex Company. The deposit committee was also authorized to provide for the issuance in the new company of not more than $4,000,000 of second preferred stock with a provision to make it convertible into common stock.

on the ground that the defendant, as a director and officer of the corporation, owed a duty of affirmative good faith towards the plaintiff when purchasing her stock.[6] On appeal the judgment was affirmed,[7] the court holding, however, that "under the special circumstances here existing, the deposit agreement created a trust relationship between the members of the committee of which defendant was a member and all the stockholders of the Kotex Company and the Kimberly-Clark Company," and that the defendant, therefore, was under a duty to disclose to the plaintiff all the material facts relating to the reorganization plan before purchasing her stock.[8]

The courts, partly because of differences in the deposit agreements involved in individual cases, have shown a striking lack of unanimity in their attempts to define the precise relationship between members of protective committees and security holders who have either deposited or in some other way become parties to the deposit agreements.[9] Thus, in various situations, the relationship has been defined as one of agency,[10] assignment,[11] bailment,[12] power coupled with an interest,[13] or trust[14]. Despite their disagreement as to

6. In its opinion the trial court stated "that a director and principal officer of a corporation, having an intimate knowledge of facts bearing directly upon the value of its stock, cannot purchase the stock of another stockholder known to be ignorant of such facts and by active concealment of such facts take an unfair advantage of such ignorance, but that he owes to such stockholder the active duty of making an honest disclosure of such facts materially affecting the value of the stock which he is trying to buy." See Nichol v. Sensenbrenner, 220 Wis. 165, 168, 263 N. W. 650, 651 (1935).

7. The judgment of the trial court was also modified in that the plaintiff was allowed interest from the date of the sale, November 6, 1926, rather than, as the trial court had held, from the date of the verdict which was rendered June 29, 1934.

8. Nichol v. Sensenbrenner, 220 Wis. 165, 181, 263 N. W. 650, 656 (1935). One conceivable interpretation of the case is that it held the defendant's membership on the deposit committee to be only one of the "special circumstances" which resulted in a trust relationship arising between the defendant as an officer-director of the corporation and the plaintiff stockholder. *Cf.* Comment on principal case in (1936) 11 WIS. L. REV. 547. Such an interpretation, however, would do violence to the precise words of the court's holding quoted above.

9. See generally 15 FLETCHER, CORPORATIONS (Perm. ed. 1932) §7248; Carey and Brabner-Smith, *Studies in Realty Mortgage Foreclosures* (1933) 28 ILL. L. REV. 1; Douglas, *Protective Committees in Railroad Reorganizations* (1934) 47 HARV. L. REV. 565; Foster, *Conflicting Ideals for Reorganization* (1935) 44 YALE L. J. 923; Rodgers, *Rights and Duties of the Committee in Bondholders' Reorganizations* (1929) 42 HARV. L. REV. 899; Rohrlich, *Protective Committees* (1932) 80 U. OF PA. L. REV. 670.

10. See Industrial & General Trust, Ltd. v. Tod, 180 N. Y. 215, 230, 73 N. E. 7, 11 (1905); Miller v. Dodge, 28 Misc. 640, 643, 59 N. Y. Supp. 1070, 1072 (Sup. Ct., 1899).

11. Mines Management Co. v. Close, 186 App. Div. 23, 174 N. Y. Supp. 80 (1st Dep't, 1919).

12. See Industrial & General Trust, Ltd. v. Tod, 180 N. Y. 215, 230, 73 N. E. 7, 11 (1905).

13. Unger v. Newlin Haines Co., 94 N. J. Eq. 458, 120 Atl. 331 (1923).

14. Bullard v. Cisco, 290 U. S. 179 (1933); United Waterworks Co. v. Stone, 127 Fed. 587 (C.C.D. Mass. 1904); Cushman v. Bonfield, 139 Ill. 219, 28 N. E. 937 (1891);

terminology, however, courts are generally agreed that members of protective committees are fiduciaries,[15] at least as far as depositors are concerned.[16]

The principal case, however, goes further than previous cases in deciding that under special circumstances a committee member may owe fiduciary obligations to a security holder who does not even know that the committee exists. In terms of technical trust relationships the imposition of such a duty may be difficult, for the non-depositor has entrusted nothing to the committee member; there is no res upon which the trust may operate. This lack of conformity to the typical trust concept is not decisive, however, since fiduciary relationships are discovered far outside the technical boundaries of trust doctrine, and protective committees are in a position, by virtue of their power over deposited securities, to affect drastically the rights of non-depositors.[17] The technical weakness of the fiduciary argument, moreover, was alleviated to a considerable extent in the instant case by the unusual combination of facts surrounding the transaction: the terms of the planned reorganization, including the anticipated sale, the purposeful concealment, and especially the fact that the defendant committee member was also an officer-director of the corporation and, for that reason, was probably under a discrete fiduciary obligation to the individual stockholders. It may have been the cumulative effect of all these elements and not alone the circumstances of the reorganization plan, which moved the court in the *Sensenbrenner* case to impose fiduciary consequences upon the relation between the protective committee member and the non-depositor. Thus the case might be regarded as an application of the so-called "special circumstance" doctrine which has acquired considerable significance in the field of law involving the relationship between officers and directors of corporations and their stockholders.[18] It has there been held by courts which had not adopted

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Cowell v. City Water Supply Co., 130 Iowa 671, 105 N. W. 1016 (1906); American Trust Co. v. Holtsinger, 226 Mass. 30, 114 N. E. 956 (1917); Monticello Bldg. Corp. v. Monticello Inv. Co., 330 Mo. 1128, 52 S. W. (2d) 545 (1932); Cassagne v. Marvin, 143 N. Y. 292, 38 N. E. 285 (1894); Bray v. Jones, 190 Wis. 578, 209 N. W. 675 (1926); *cf.* Peoria & E. Ry. Co. v. Coster, 97 Fed. 519 (C.C.S.D.N.Y. 1899).

15. Parker v. New England Oil Corp., 13 F. (2d) 158 (D. Mass. 1926), *rev'd on other grounds*, 19 F. (2d) 903 (C. C. A. 1st, 1927); Carter v. Nat. Bank of Pocahontas, 128 Md. 581, 98 Atl. 77 (1916); Cox v. Stokes, 156 N. Y. 491, 51 N. E. 316 (1898); Mawhinney v. Converse, 117 App. Div. 255, 102 N. Y. Supp. 279 (1st Dep't 1907); Clinton Trust Co. v. 142-144 Joralemon Street Corp., 237 App. Div. 789, 263 N. Y. Supp. 359 (2d Dep't 1933); Bergelt v. Roberts, 144 Misc. 832, 258 N. Y. Supp. 905 (Sup. Ct. 1932), *aff'd*, 236 App. Div. 777, 258 N. Y. Supp. 1086 (1st Dep't 1932); *cf.* Robertson v. First Nat. Bank, 35 Idaho 363, 206 Pac. 689 (1922).

16. *Cf.* Bound v. South Carolina R. Co., 78 Fed. 49 (C.C.A. 4th, 1897).

17. S. E. C., REPORT ON THE STUDY AND INVESTIGATION OF THE WORK, ACTIVITIES, PERSONNEL AND FUNCTIONS OF PROTECTIVE AND REORGANIZATION COMMITTEES (1936) Part IV, at 98-102, Part VI, at 205-214. Moreover, as in the principal case, trading on the basis of inside information may be consummated before the deposit agreements are made known to the security holders. S. E. C., *supra*, Part III, at 135.

18. See generally Berle, *Publicity of Accounts and Directors' Purchases of Stock* (1927) 25 MICH. L. REV. 827; Laylin, *The Duty of a Director Purchasing Shares of*

the full fiduciary rule,[19] and yet which did not like to see corporate officials unfairly profit by the use of inside information,[20] that special circumstances within the peculiar knowledge of directors, such as prospective mergers,[21] assured sales of corporate assets,[22] agreements with third parties to buy the stock at a higher price,[23] and the impending declaration of dividends,[24] give rise to a fiduciary relationship between the officers of a corporation and individual stockholders.[25] Whether or not liability in the principal case

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*Stock* (1918) 27 YALE L. J. 731; Smith, *Purchase of Shares of a Corporation by a Director from a Shareholder* (1921) 19 MICH. L. REV. 698; Walker, *The Duty of Disclosure by a Director Purchasing Stock from his Stockholders* (1923) 32 YALE L. J. 637; Wilgus, *Purchase of Shares of Corporation by a Director from a Shareholder* (1910) 8 MICH. L. REV. 267.

19. For cases supporting the view that there is always a fiduciary relationship existing between corporate officials and individual stockholders insofar as the latters' stock is concerned, see Westwood v. Continental Can Co., 80 F. (2d) 494 (C.C.A. 5th, 1935); Oliver v. Oliver, 118 Ga. 362, 45 S. E. 232 (1903); Wood v. MacLean Drug Co., 266 Ill. App. 5 (1932); Dawson v. Nat. Life Ins. Co., 176 Iowa 362, 157 N. W. 929 (1916); Stewart v. Harris, 69 Kan. 498, 77 Pac. 277 (1904); Jacquith v. Mason, 99 Neb. 509, 156 N. W. 1041 (1916); Saville v. Sweet, 234 App. Div. 236, 254 N. Y. Supp. 768 (1st Dep't, 1932).

20. The older view is that an officer may deal with an individual stockholder as with a stranger. Carpenter v. Danforth, 52 Barb. 581 (N.Y. 1868); Tippecanoe County v. Reynolds, 44 Ind. 509, 15 Am. Rep. 245 (1873); 3 FLETCHER, *op. cit. supra* note 9, §1168; Note (1933) 84 A. L. R. 615. Consequently, when purchasing stock, the officer is under no duty to disclose information which he possesses as to the value of the stock. Goodwin v. Agassiz, 283 Mass. 358, 186 N. E. 659 (1933) (ore discovery); Crowell v. Jackson, 53 N. J. Law 656, 23 Atl. 426 (1891) (sale of corporate property); Connolly v. Shannon, 105 N. J. Eq. 155, 147 Atl. 234 (1929) (prospective merger).

21. McMynn v. Richardson-Phenix Co., 186 Wis. 442, 201 N. W. 272 (1924), noted in (1925) 10 CORN. L. Q. 509.

22. Gammon v. Dain, 238 Mich. 30, 212 N. W. 957 (1927); *cf.* Commonwealth Title Ins. & T. Co. v. Seltzer, 227 Pa. 410, 76 Atl. 77 (1910).

23. Stanton v. Hample, 272 Fed. 424 (C.C.A. 9th, 1921); *cf.* Dunnett v. Arn, 71 F. (2d) 912 (C.C.A. 10th, 1934), noted in (1934) 20 CORN. L. Q. 101. But *cf.* Haverland v. Lane, 89 Wash. 557, 154 Pac. 1118 (1916).

24. Hotchkiss v. Fischer, 136 Kan. 530, 16 P. (2d) 531 (1932), noted in (1933) 46 HARV. L. REV. 847.

25. Strong v. Repide, 213 U. S. 419 (1909), the leading case on this doctrine; *cf.* Backus v. Kirsch, 264 Mich. 339, 249 N. W. 872 (1933); Poole v. Camden, 79 W. Va. 310, 92 S. E. 454 (1917); 3 FLETCHER, *op. cit. supra* note 9, §1171. In some cases there is no need to spell out a special relationship between an officer and an individual stockholder, *per se*, in order to hold the officer liable. For instance, in cases of actual fraud on the part of the officer, such as misrepresentations as to the value of the stock, the courts uniformly hold that the stockholder may, as any other defrauded party, either rescind the sale and recover the stock or affirm the transaction and sue for damages. Bollstrom v. Duplex Power Car Co., 208 Mich. 15, 175 N. W. 492 (1919); Hume v. Steele, 59 S. W. 812 (Tex. Civ. App. 1900); Morrison v. Snow, 26 Utah 247, 72 Pac. 924 (1903); *cf.* Pellio v. Bulls Head Coal Co., 224 Pa. 379, 73 Atl. 451 (1909); Barber v. Kilbourn, 16 Wis. 485 (1863). But *cf.* Boddy v. Henry, 113 Iowa 462, 85 N. W. 771 (1901). Moreover, where the court can find a *bona fide* agency

would have been imposed in the absence of any of the special circumstances which there existed, is, of course, impossible to determine. It is unlikely that magic significance is attached to any particular series of elements or events, but it is not inconceivable that, because of the gravity and the highly confidential nature of protective committee services, the courts will be willing, upon slight provocation, to declare protective committee members liable for non-disclosure to non-depositors when purchasing their securities.[26]

As a practical matter, however, committee members frequently are able to capitalize on inside information, in violation of the rules governing the conduct of fiduciaries.[27] In fact, it is not uncommon for deposit agreements expressly to permit committee members and their affiliates to buy and sell the securities and certificates of deposit covered by the agreement and to become financially interested in the property which is being reorganized.[28] As a result of these provisions, or indeed even without benefit of authorization of this sort, protective committees, as revealed in a recent investigation, have developed trading on the basis of inside information concerning reorganizations into a large-scale enterprise.[29] Thus, a well-known bond house not only organized a great number of hand-picked protective committees to handle securities which the house had formerly underwritten, but in addition had an elaborate system by which inside information was conveyed from the committee members to the department of the bond house which traded in securities.[30] Naturally, under such an arrangement, the bond house could trade most profitably at the expense of the security holders whose interests the committee members were supposedly protecting. Furthermore, it is

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relationship, the officer may be held liable irrespective of the fact that the parties are officer and stockholder. In re Parker's Estate, 189 Iowa 1131, 179 N. W. 525 (1920); Mulvane v. O'Brien, 58 Kan. 463, 49 Pac. 607 (1897); Fisher v. Budlong, 10 R. I. 525 (1873).

26. This result follows especially since it has been held that the duties of protective committee members "are in the highest degree of a fiduciary nature, far more so than the directors of a corporation." upon whom the courts have repeatedly shown a willingness to impose liability for unfairly profiting at the expense of individual stockholders. Carter v. Nat. Bank of Pocahontas, 128 Md. 581, 590, 98 Atl. 77, 80 (1916); *cf.* Holmes v. McDonald, 226 Ill. 169, 80 N. E. 714 (1907).

27. See generally S. E. C., *op. cit. supra* note 17, Parts III, IV, VI. Some committees, indeed, have gone so far as to insert in the deposit agreements provisions intended to free committee members from all the duties usually imposed upon fiduciaries. S. E. C., *supra*, Part III, at 58. Many agreements contain various exculpatory clauses designed to free committee members, as long as they act in good faith, from personal liability for failure to exercise proper diligence in protecting the interests of security holders. S. E. C., *supra*, Part III, at 59.

28. S. E. C., *op. cit. supra* note 17, Part III, at 59, Part IV, at 97-98. In Part III, page 195, of the Report it is stated: "The question of whether or not an immunity clause in the deposit agreement is effective to waive or modify the equitable principle that a trustee may not profit from his trust has seldom been litigated and consequently never been definitely determined." *Cf.* Miller v. Dodge, 28 Misc. 640, 59 N. Y. Supp. 1070 (Sup. Ct. 1899).

29. S. E. C., *op. cit. supra* note 17, Part III, at 132-152.

30. *Id.* at 134 *et seq.*

exceedingly improbable that a committee member will ever be called to account for such misuse of inside information. The use of inside information and the fact that it motivated or influenced the purchase is generally difficult to prove. The security holder is rarely in a position to get the facts upon which to base an action, and the expenses and hazards of such litigation are too great for the usual small security holder to bear.[31] In addition, where the securities are sold on the exchange or even over-the-counter, it may be impossible for the seller to trace his stock into the hands of a member of the committee. In this situation, the interests of the vast majority of security holders who become parties to deposit agreements would be insufficiently protected even though all courts were as willing to hold committee members liable for the misuse of inside information as was the court in the principal case. For, under the rule of the principal case, a committee member may always trade in the securities subject to his trust provided he makes an honest disclosure of the material facts concerning the value of the securities. "Honest disclosures" of "material facts," however, may be made and oppression still practiced. Superior knowledge may so guide the manner of making "honest disclosures" and the emphasis so placed upon "material facts" that a frank and an accurate impression of the value of the securities may not be conveyed to the seller.[32] If the security holder is to be protected adequately it would seem essential that committee members be prohibited altogether from trading in the securities and certificates of deposit which are subject to their trust.[33] This is the rule which has prevailed for years in the field of personal trusts,[34] and there seems to be no sound reason why it would not work as well when applied to protective committees.

## State Jurisdiction to Tax Income of Resident Derived from Foreign Realty*

The recent case of *Senior v. Braden*,[1] against the background of the Supreme Court's conspicuous opposition to multiple state taxation of the same economic interest,[2] has clouded the constitutional future of state income taxes. In *Senior v. Braden* an Ohio "property" tax "measured by

31. *Cf. id.* at 61.

32. *Cf. id.* at 139–140.

33. See S. E. C., *op. cit. supra* note 17, Part III, at 151, Part IV, at 98; *cf.* Section 16 of the Securities Exchange Act of 1934, 48 Stat. 896, 15 U. S. C. § 78(p) 1934.

34. 3 Bogert, Trusts and Trustees (1935) §§481, 489, 490, 543.

*People *ex rel.* Cohn v. Graves, 271 N.Y. 353, 3 N.E. (2d) 508 (1936), *reversing* 246 App. Div. 335, 286 N.Y. Supp. 485 (3d Dep't, 1936).

1. 295 U.S. 422 (1935), (1935) 24 Calif. L. Rev. 200; (1935), 35 Col. L. Rev. 1151; (1935) 21 Corn L. Q. 151; (1935) 4 Fordham L. Rev. 526; (1935) 49 Harv. L. Rev. 159; (1935) 21 Iowa L. Rev. 147; (1935) 20 Minn. L. Rev. 99; (1935) 14 N. C. L. Rev. 106; (1935) 14 Tex. L. Rev. 242; 11 Wis. L. Rev. 305.

2. Farmers' Loan and Trust Co. v. Minnesota, 280 U.S. 204, 209 (1930); First National Bank v. Maine, 284 U.S. 312 (1932).

income"[3] was held constitutionally inapplicable to transferable trust certificates representing interests in land outside the state.[4] While the difference between a tax professedly "on" income and one "on" property but measured by the income from it seems verbal,[5] it is enough of a difference to allow the Supreme Court to uphold a state income tax on income drawn from foreign realty if it wants to; the court has depended before on conveyancers' distinctions in tax cases.[6] But there is no reason to suspect that the present Supreme Court is reluctant to limit the taxing power of the states, and *Senior v. Braden,* nominally a case on property taxation, may become the leading case on state jurisdiction to tax income.[7]

Ignoring these portents, the New York Court of Appeals has recently held,[8] three judges dissenting,[9] that income of a resident of New York derived from rents and mortgage interest from New Jersey realty was subject to the New York income tax.[10]

*Pollock v. The Farmers' Loan and Trust Co.*[11] is the most direct authority for interpreting *Senior v. Braden* against the validity of the New York tax in the *Graves* case. In the *Pollock* case, in finding the federal tax on income from realty to be "direct" within the constitutional prohibition against unapportioned direct taxes,[12] the Court held that a tax on income is equivalent to a tax on the source of that income. If the case is revived in all its apparent bluntness, as *Senior v. Braden* hints, the Supreme Court will treat income taxes as indistinguishable for all purposes from taxes on the property from

3. The Court seems so to treat the tax. The majority opinion distinguishes Maguire v. Trefry, 253 U. S. 12 (1920) partially on the ground that it was an income tax. Senior v. Braden, 295 U. S. 422, 431 (1935). In the dissent Mr. Justice Stone calls it a property tax measured by income, *id.* at 436. The Ohio Supreme Court calls it a tax "on" the income. Senior v. Braden, 128 Ohio St. 597, 610, 193 N. E. 614, 619 (1934).

4. The Court relied on Brown v. Fletcher, 235 U. S. 589 (1915), which held that for procedural purposes that an assignee of an equitable interest had an interest in the trust *res.* The case seems particularly inadequate in view of the fact that in Brown v. Fletcher it was not a business trust, but a testimentary one, and also that the cestui had an absolute right to the corpus in the future, while in Senior v. Braden no such right existed.

5. See Underwood Typewriter Co. v. Chamberlain, 254 U. S. 113, 120 (1920).

6. Compare Klein v. United States, 283 U. S. 231 (1931) with Helvering v. St. Louis Union Trust Co., 296 U. S. 39 (1935).

7. Lowndes, *Rate and Measure in Jurisdiction to Tax—Aftermath of Maxwell v. Bugbee,* (1935) 49 HARV. L. REV. 756, 769.

8. People *ex rel.* Cohn v. Graves, 271 N. Y. 353, 3 N. E. (2d) 508 (1936) *reversing* 246 App. Div. 335, 286 N. Y. Supp. 485 (3d Dep't, 1936).

9. The case is directly *contra* to an earlier New York decision. Pierson v. Lynch, 237 App. Div. 763, 263 N. Y. Supp. 259 (3d Dep't 1933), *aff'd without opinion,* 263 N. Y. 533, 189 N. E. 684 (1933), *writ of certiorari dismissed as improvidently granted,* 293 U. S. 52 (1934), note (1933) 43 YALE L. J. 851. The New Hampshire court has also reached a conclusion *contra* to that of the instant case. *In re* Opinion of the Justices, 84 N. H. 559, 573, 149 Atl. 321, 328-329 (1930).

10. N. Y. TAX LAW § 359, as amended by New York Laws 1935, ch. 933.

11. 157 U. S. 429 (1895), *On rehearing,* 158 U. S. 601 (1895).

12. U. S. CONST. Art. 1, §§ 2, 9.

which income is derived; and the constitutional rules of jurisdiction to tax property will be imported bodily into the law of state income taxation. But the proposition which the *Pollock* case is supposed to represent is by no means inevitably embedded in constitutional law. In *Brushaber v. Union Pacific R. R.*,[13] Chief Justice White specifically denied that the *Pollock* case was authority for the holding so often attributed to it; subsequent cases have impliedly denied the ruling by upholding taxes inconsistent with it.[14] Thus, in *Maguire v. Trefry*,[15] New York was permitted to tax its resident on income from a Pennsylvania trust; in *Lawrence v. State Tax Commission*[16] a Mississippi tax on income earned by its resident in Tennessee was upheld; in *Peck & Co. v. Lowe* the federal tax on income drawn from an exporting business was declared constitutional;[17] the net income of a corporation engaged in interstate commerce may be taxed by the state of corporate domicile;[18] a federal excise tax was upheld even though it was measured by income coming partly from non-taxable bonds.[19]

If, however, the doctrine that a tax on income is equivalent to a tax on its source is to be revived by extending *Senior v. Braden* to state income taxes, the tax at issue in the *Graves* case would seem clearly invalid when applied to rents from New Jersey land. The tax would then be considered a tax on the taxpayer's interest in New Jersey realty, here a legal life estate,[20] which is much more tangibly a "real" interest, taxable only at the state of its situs, than the vague equitable interest in *Senior v. Braden.*

This putative invalidity of a state income tax applied to rents, under the combined doctrine of the *Pollock* case and *Senior v. Braden,* would not be conclusive as to a state income tax on mortgage interest. Mortgage interest is consideration for a loan, to which the realty is merely collateral. The Supreme Court has held both that the state of the mortgagee's domicile may impose a property tax on a mortgage on foreign lands,[21] and that the interest of a non-resident mortgagee is liable to a property tax in the state where the land is situated.[22] The trend away from multiple taxation of the same

13. 240 U. S. 1 (1916).

14. However, see National Life Insurance Co. v. United States, 277 U. S. 508 (1928); Gillespie v. Oklahoma, 257 U. S. 501 (1922).

15. 253 U. S. 12 (1920). There is considerable doubt as to whether this case has been overruled by Senior v. Braden, 295 U. S. 422 (1935). The dissent in the Graves case believes it has; Mr. Justice Stone in his dissent doesn't know whether it is overruled or merely "discredited". A strong argument could be made that it is only distinguished.

16. 286 U. S. 276 (1932).

17. Despite U. S. CONST. Art. 1, § 9, 247 U. S. 165 (1918).

18. U. S. Glue Corp. v. Oak Creek, 247 U. S. 321 (1918).

19. Flint v. Stone Tracy Co., 220 U. S. 107 (1910).

20. Relator was beneficiary under the will of her husband of a life estate in the rents and mortgages. There were three executors, two living in New Jersey and managing the estate there, and relator.

21. Kirtland v. Hotchkiss, 100 U. S. 491 (1879).

22. Savings and Loan Society v. Multnomah County, 169 U. S. 421 (1898) (Oregon property tax on non-resident mortgagee's interest in mortgage upheld as an interest

economic interests has not yet been extended to the problem of mortgages; it may be that the Supreme Court will restrict all taxation of the scattered property rights embodied in mortgages to either the state of the mortgagee's domicile or the state in which the land is located, despite the fact that both states protect part of the mortgagee's divided property in the mortgage.

The mortgage tax might also be invalidated by a contraction of the vaguely defined[23] doctrine of business situs. The recent single-tax cases[24] in the Supreme Court on jurisdiction to tax have not so far explicitly chosen as between the acknowledged power of the state of business situs[25] and the equally acknowledged power of the state of the creditor's domicile;[26] but the dissent in the *Graves* case argued that as the documents were located and the investments managed in New Jersey, they had acquired a taxable situs there, a fact which was thought to be conclusive of unconstitutionality. But the conclusion seems premature; the business situs rule has been used to uphold property taxes by the state of situs, not yet to invalidate either property or income taxes by the domicilary state.

The *Graves* case illustrates dramatically how ineffective action by the Supreme Court, under the Fourteenth Amendment, must be to resolve the sharp conflict of equities which underlies the problem of state jurisdiction to tax. As there is no method of apportioning taxation to benefits received,[27] it is felt that each state is entitled to tax in full interests which it protects in part. On the other hand, haphazard and overlapping taxes, penalizing interstate interests, suggest that the size of the economic interest rather than the fortuitous position of state lines should determine the total of taxation to which property should be subjected.

Several legislative solutions of the problem have been suggested. One plan proposes the surrender of state taxation of intangibles to the federal

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in land); Bristol v. Washington County, 177 U. S. 133 (1900) (Minnesota property tax on credits secured by mortgages on Minnesota land and handled there for New York owner upheld). *Cf.* New Orleans v. Stemple, 175 U. S. 309 (1899).

23. Actual presence of the documents in the taxing state does not seem to be essential to establish business situs. Liverpool & London & Globe Insurance Co. v. Board of Assessors, 221 U. S. 346 (1911) (unevidenced credits); Metropolitan Life Insurance Co. of New York v. New Orleans, 205 U. S. 395 (1907) (notes kept outside taxing state till due).

24. Farmers' Loan and Trust Co. v. Minnesota, 280 U. S. 204 (1930); Baldwin v. Missouri, 281 U. S. 586 (1930); Beidler v. South Carolina Tax Commission, 282 U. S. 1 (1930); First National Bank v. Maine, 284 U. S. 312 (1932); Safe Deposit and Trust Co. v. Virginia, 280 U. S. 83 (1929); Senior v. Braden, 295 U. S. 422 (1935).

25. New Orleans v. Stemple, 175 U. S. 309 (1899); State Board of Assessors v. Comptoir National D'Escompte, 191 U. S. 388 (1903); Metropolitan Life Insurance Co. of New York v. New Orleans, 205 U. S. 395 (1907); Liverpool & London & Globe Insurance Co. v. Board of Assessors, 221 U. S. 346 (1911).

26. See State Tax on Foreign Held Bonds, 15 Wall. 300, 319-320 (U. S. 1872).

27. There is of course allocation of corporate income taxes where a corporation does business in more than one state. Underwood Typewriter Co. v. Chamberlain, 254 U. S. 113 (1920); Hans Rees' Sons v. North Carolina, 283 U. S. 123 (1931).

government, with an allocation of proceeds to the states,[28] but the practical difficulties in the adoption of state and federal legislation and the objections which the Supreme Court is likely to find in the Constitution[29] seem impassable barriers. Another suggested solution is the adoption by the states of uniform reciprocal exemption statutes.[30] But the unanimity and uniformity necessary to the success of this scheme make it politically improbable. Comity clauses present the same difficulty. While a few steps have been taken in this direction, it does not seem as if a legislative program were immediately obtainable.

Judicial efforts to solve the problem by denying the constitutionality of more than one tax on the same interest have thoroughly confused the law and practice of state taxation and have piled up onerous precedents enlarging the scope of judicial review under the Fourteenth Amendment. The development has been resisted by bitter dissents[31] and the almost unanimous opposition of commentators;[32] but there has been no evidence yet that the Supreme Court will compromise. The *Graves* case gives the Court an occasion to extend its jurisdiction doctrines radically beyond the field of inheritance and property taxes, where they have so far been confined, by declaring finally whether or not income taxes are taxes "on" the property from which income is derived, and to illustrate the chaos which constant litigation as to the source of income will involve, if the answer to the question is written in the mood of *Senior v. Braden.*

## Effect of the Death of the Surety on a Depository Bond for an Indefinite Term *

In 1924 the president of a bank as surety executed a bond, in accordance with the provisions of the National Bankruptcy Act,[1] to secure the repayment of funds deposited in the bank by trustees in bankruptcy. The surety died in 1926. In 1930 the trustee of a bankrupt estate opened an account with the bank and made deposits therein until 1931 when the bank, having

28. Haig, *Federal Tax Collection with Allocation of Share of Proceeds to the States* (1933) 11 Tax Mag. 95; Rodell, *A Primer on Interstate Taxation* (1934) 44 Yale L. J. 1166, 1181.

29. *Cf.* United States v. Butler, 297 U. S. 1 (1936).

30. *Report of National Committee on Inheritance Taxation,* New Orleans, November 10, 1925, pp. 40–48, 77; *Proceedings of the Second National Conference on Inheritance and Estate Taxation,* New Orleans, November 10, 1925, pp. 17–26; Brady, *Statutory Solutions of Multiple Death Taxation,* (1927) 13 Am. B. A. J. 147; for a contrary discussion and the statutes, see Legis. (1930) 43 Harv. L. Rev. 641. Beuscher, *Overlapping State Income Tax Laws* (1932) 8 Wis. L. Rev. 320.

31. Mr. Justice Holmes in Farmers' Loan and Trust Co. v. Minnesota, 280 U. S. 204, 216 (1930); Mr. Justice Stone in First National Bank v. Maine, 284 U. S. 312, 331 (1932) and in Senior v. Braden, 295 U. S. 422 (1935).

32. The best periodical literature is cited by Merrill, *Jurisdiction to Tax—Another Word,* (1934) 44 Yale L. J. 582, n. 2. See also notes cited note 2, *supra.*

*Chain v. Wilhelm, 84 F. (2d) 138 (C. C. A. 4th, 1936).

1. 30 Stat. 558, 562 (1898), 11 U. S. C. §§ 78(h), 101 (1934).

become insolvent, closed its doors. The trustee in bankruptcy brought suit on the bond against the executrix of the deceased surety to recover the balance in the account. The Circuit Court of Appeals denied recovery on the ground that, because more than a reasonable time had elapsed since the execution of the surety contract, the liability under it had terminated before the trustee made his first deposit.[2]

In determining the effect of the death of the surety on the liability of his estate under depository bonds of the instant type, most courts rely either on cases involving ordinary continuing guaranties or on decisions relating to official bonds, depending upon the category in which they find the closer analogy.[3] It may be pointed out, however, that significant differences are to be found between depository bonds and either of the other two types. The usual continuing guaranty, where no present consideration is given in exchange,[4] is a continuing offer of a promise to stand security for advances made to the principal, and this promise does not become a binding contract until accepted by the act of the obligee in advancing credit on the strength of the guaranty; those offers which had not been previously accepted are terminated by the death of the offeror.[5] The orthodox view is that death of itself ends the relationship,[6] while a few jurisdictions require notice, actual or constructive, to relieve from liability.[7] Even where a seal or nominal consideration is present, the courts for the most part hold the continuing guaranty to be a revocable offer, without careful analysis of the consideration given for it.[8] If, however, the obligation is for a definite time or involves

2. Chain v. Wilhelm, 84 F. (2d) 138 (C. C. A. 4th, 1936) (Parker, J., dissented).

3. In the instant case, the majority, on the basis of the analogy to a continuing guaranty, termed the bond a continuing offer, which because of the attached seal was itself a contract. In accordance with RESTATEMENT, CONTRACTS (1932) § 46, it was then held that such an offer, where no time is fixed in the offer itself, cannot be terminated within a reasonable time either by revocation or by the offeror's death, the problem then becoming what was a reasonable time. The dissent saw no difference in principle between the depository bond and an official bond. *Cf.* Continental Casualty Co. v. United States, 68 F. (2d) 577 (C. C. A. 7th, 1934); United States v. Robson, 9 F. Supp. 446 (S. D. W. Va. 1935).

4. The effect of consideration would be to make the offer irrevocable for the time fixed in the offer, or if no such time is fixed, for a reasonable time. See *supra* note 3.

5. RESTATEMENT, CONTRACTS (1932) §§ 44, 48; 2 WILLISTON, CONTRACTS (1920) § 1253; see cases cited *infra* notes 6 and 7.

6. Aitken v. Lang's Adm'r., 106 Ky. 652, 51 S. W. 154 (1899); Jordan v. Dobbins, 122 Mass. 168 (1877); American Chain Co. v. Arrow Grip Mfg. Co., 134 Misc. 321, 235 N. Y. Supp. 228 (Sup. Ct. 1929); *cf. In re* Kelley's Estate, 173 Mich. 492, 139 N. W. 250 (1913); *In re* Lorch's Estate, 284 Pa. 500, 131 Atl. 381 (1925).

7. Gay v. Ward, 67 Conn. 147, 34 Atl. 1025 (1895); Buckeye Cotton Oil Co., v. Amrhein, 168 La. 139, 121 So. 602 (1929); Menard v. Scudder, 7 La. Ann. 385 (1852). The general rule is that the death of the offeror revokes an offer, but if the offeree, acting in ignorance of the death, performs the act which the offer called for, the application of this rule works an obvious hardship on the offeree; these cases represent an attempt by the courts to prevent this hardship.

8. Aitken v. Lang's Adm'r., 106 Ky. 652, 51 S. W. 154 (1899); Jordan v. Dobbins, 122 Mass. 168 (1877); Hyland v. Habich, 150 Mass. 112, 22 N. E. 765 (1889); American Chain Co. v. Arrow Grip Mfg. Co., 134 Misc. 321, 235 N. Y. Supp. 228

the performance of a particular contract or office, and the actual consideration for the surety's promise is given at the outset, the surety, having obtained the benefit of his bargain, cannot withdraw nor will his death relieve his estate.[9] Thus, the term of a bond required as a condition precedent to the creation of an official status is held to be co-extensive with the term of office of the principal[10] and survives the death of the surety.[11] This rule applies even where the acts guaranteed may cover a long or indefinite period of time.[12]

The bond in the instant case differs from a continuing guaranty mainly in that it is an indivisible contract whereby the surety promises the United States that he will make good any defalcation on the part of the bank in respect of its duties as authorized depository of bankruptcy funds, the trustees in bankruptcy being the beneficiaries of such promise.[13] Accordingly, it is held that the surety cannot terminate his liability for future deposits under the bond simply by giving notice to the court and the bank, as can be done in the case of a continuing guaranty by giving notice to the obligee,[14] but must secure a court order to terminate his liability on the obligation.[15] Important differences between a depository bond and an official bond appear not only in the character of the principals, but also in the fact that in the case of official bonds, the surety has obtained the full benefit of his bargain once the principal takes office, whereas in the case of depository bonds, the surety is interested in the deposits themselves, with the status of authorized depository only a means to that end.

Due to these differences, it is submitted that these depository bonds deserve separate classification, and therefore that precedent from cases involving continuing guaranties or official bonds is not controlling. And in determining the effect of the death of the surety on a depository bond the court should consider the particular facts underlying such bonds rather than abstract principles of contract law. Since the main purpose of the appointment of the trustee in bankruptcy is to safeguard the funds of a bankrupt estate, it does not seem unreasonable to require the trustee to investigate the security

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(Sup. Ct. 1929). This attitude on the part of some courts has been criticized as an added source of confusion. See 2 WILLISTON, CONTRACTS (1920) § 1253.

9. Hecht v. Weaver, 34 Fed. 111 (C. C. D. Ore. 1888); United States v. Keiver, 56 Fed. 422 (C. C. W. D. Wis. 1893); Fewlass v. Keeshan, 88 Fed. 573 (C. C. A. 6th, 1898); Lloyd's v. Harper, 16 Ch. Div. 290 (1880).

10. Westervelt v. Mohrenstecher, 76 Fed. 118 (C. C. A. 8th, 1896); Exeter Bank v. Rogers, 7 N. H. 21 (1834).

11. Pond v. United States, 111 Fed. 989 (C. C. A. 9th, 1901); Moore v. Wallis, 18 Ala. 458 (1850); Hecht v. Skaggs, 53 Ark. 291, 13 S. W. 930 (1890); Mowbray v. State, 88 Ind. 324 (1882); Snyder v. State, 5 Wyo. 318, 40 P. 441 (1895).

12. Estate of Rapp v. Phoenix Ins. Co., 113 Ill. 390 (1885); Royal Life Insurance Co. v. Davies, 40 Ia. 469 (1875); Green v. Young, 8 Greenl. 14 (Me. 1831); Shackamaxon Bank v. Yard, 150 Pa. 351, 24 Atl. 635 (1892); 2 WILLISTON, CONTRACTS (1920) § 1253; *cf.* cases cited *supra* note 10.

13. See Illinois Surety Co. v. United States, 226 Fed. 665, 668 (C. C. A. 7th, 1915); Bosler v. United States, 26 F. (2d) 4, 8, 9 (C. C. A. 8th, 1928).

14. See cases *supra* notes 6 and 7.

15. Continental Casualty Co. v. United States, 68 F. (2d) 577 (C. C. A. 7th, 1934).

of the bond of a contemplated depository. On the other hand, the bond provides that the obligation is to be of full force and effect unless the bank faithfully discharges and performs all the duties pertaining to it as such depository. The surety has knowingly assumed such liability for an indefinite period in a formal document purporting to bind his heirs, executors, and successors; and, moreover, death will not ordinarily terminate a contract which does not require the personal services of the deceased. Furthermore, there are mitigating factors in the possible hardship upon the surety since upon either a petition to the court praying for the termination of liability under the bond,[16] or upon notice of the death of the surety,[17] the court will require the depository to furnish a new bond and discharge the surety from future liability under the old one. Thus, if the surety does not wish to be bound for the full duration of the term of the depository, he can petition the court to relieve him from future liability under the bond, or make some anticipatory provision that notice of his death should reach the court as soon thereafter as possible.

It may be suggested that in executing the bond the surety contemplated that the court, in its periodic examination of these bonds,[18] would arrange for termination of liability for future deposits where the surety has died. However, the trustee in bankruptcy is equally justified in relying on this investigation, and if both prefer to substitute the inquiries of the court for their own precautionary measures, neither can complain when liability is imposed. As a final consideration, it seems unreasonable to give a construction to the bond which makes it possible for liability thereunder to be terminated, without action by the court, while the official status of the bank as depository, which was dependent upon that liability, is permitted to continue.

It is submitted that the possible delinquency of the trustee in bankruptcy in failing to investigate the security of the bond is more than offset by practical reasons for holding the surety to the literal terms of his contract, and consequently, that the liability under such bonds should not be terminated unless by express court order. Furthermore, it seems desirable that the courts establish a definite rule on the effect of the death of the surety on his liability under such bond, rather than holding, as in the instant case, that a depository bond is effective for only a reasonable time after execution. Such holding makes inevitable resort to the courts in every case to determine what is a reasonable length of time in the light of the particular circumstances of each case, one of which would be the death of the surety.

16. Such petitions are practically never refused, thus giving the surety what amounts to a power of revocation upon reasonable notice. *Cf.* Continental Casualty Co. v. United States, 68 F. (2d) 577 (C. C. A. 7th, 1934).

17. Communications to the YALE LAW JOURNAL from the Clerks of the United States District Courts for the Southern District of New York (September 23, 1936) and the Northern District of West Virginia (September 23, 1936).

18. The bonds are checked over by examiners of the Department of Justice who investigate into all phases of the security every two years. They are also checked up at irregular intervals by Clerks of the court. In addition, the Referees have been required to keep track of the banks in which Trustees appointed by them made deposits. Since the decision in the instant case, the Referees have again been admonished to be unusually careful in this respect. See note 17, *supra*.

## ALTERNATIVE REMEDIES UNDER THE COMMERCE ACT AND THE ANTI-TRUST LAWS*

THE PURPOSE of the anti-trust laws is the maintenance of business rivalry in industry generally, and the enforcement machinery consists of the Department of Justice, the Federal Trade Commission and the courts. The purpose of the Interstate Commerce Act, on the other hand, is the comprehensive regulation of the railroad industry specifically, with the maintenance of competition and the encouragement of cooperation as coordinate aims, and its enforcement is centered in the Interstate Commerce Commission.[1] As a result, whenever some issue seems referable to both statutory schemes, a choice must be made between the procedure prescribed by the anti-trust laws and the remedies under the Commerce Act. In such cases the tendency in both Congress and the courts has been toward the achievement of a unitary system of regulation by concentrating jurisdiction over railroads in the Interstate Commerce Commission,[2] subject, of course, to the usual inhibitions of judicial review, at the expense of limiting the application of the anti-trust laws. The Clayton Act, which gave individuals the right to restrain violations of the anti-trust laws, expressly provided that carriers subject to the provisions of the Commerce Act could be enjoined only by the government.[3] Then the *Keogh* case denied the right of private persons to recover damages under the anti-trust laws where the subjects of complaint were rates and practices within the jurisdiction of the Interstate Commerce Commission.[4] And in the *Cunard* case the Shipping Act was held to have superseded the right of a private suitor to an injunction under the Clayton Act and its remedy held exclusive to the extent of transactions within its range, so that the plaintiff, in the interests of uniformity, must seek redress before the Shipping Board—this despite the fact that the exception in the Clayton Act with respect to carriers subject to the Commerce Commission does not apply in terms to wrongs within the jurisdiction of any other board.[5]

A recent case in the Supreme Court of the United States continues this development. A railroad had contracted to pay a warehouse, *A*, for certain services rendered in the receipt and delivery of freight and also to make no

*Terminal Warehouse Co. v. Pa. R. R., 297 U. S. 500 (1936).

1. PARSONS, THE RAILWAYS, THE TRUSTS AND THE PEOPLE (1906) 494; Hotchkiss, *The Interstate Commerce Commission and its Work* (1932) 2 DETROIT L. REV. 1; Comment (1923) 36 HARV. L. REV. 456; (1934) 11 N. Y. U. L. Q. REV. 478.

2. A preliminary order from the Commission was early held a prerequisite to judicial action in all cases where the complaint involved administrative matters, principally rates. Texas & Pac. Ry. v. Abilene Cotton Oil Co., 204 U. S. 426 (1907).

3. 38 STAT. 737 (1914), 15 U. S. C. § 26 (1934).

4. Keogh v. Chicago & N. W. Ry., 260 U. S. 156 (1922); Central Transfer Co. v. Terminal Ass'n, 61 F. (2d) 546 (C. C. A. 8th, 1932), *aff'd*, 288 U. S. 469 (1933); *cf.* Glenn Coal Co. v. Dickinson Fuel Co., 72 F. (2d) 885 (C. C. A. 4th, 1934). *Contra:* Meeker v. Lehigh Valley R. R., 183 Fed. 548 (C. C. A. 2d, 1910); Gulf & S. I. R. R. v. Buddendorft, 110 Miss. 752, 70 So. 704 (1916).

5. U. S. Navigation Co. v. Cunard S. S. Co., 284 U. S. 474 (1932); see Comment (1931) 44 HARV. L. REV. 955; *cf.* Wisconsin & Mich. Transportation Co. v. Pere Marquette Line Steamers, 210 Wis. 391, 245 N. W. 671 (1932).

similar allowances for such services to any other warehouse in the city of Philadelphia. The warehouse was to give the railroad in return a preference over other lines in the use of its facilities. This practice was clearly approved under a line of decisions of the Interstate Commerce Commission until 1928, when the Commission overruled one of them, and announced that a warehouse doing business under such a contract was a consignor or consignee, acting on its own behalf and not as agent for the carrier.[6] A competing warehouse, *B*, was quick to petition the Commission for a restraining order against the carrier and for reparation based on past loss of profits. The Commission declared the contract unduly discriminatory, but refused to grant any reparation on the ground that the plaintiff's showing of damage was too vague.[7] Upon suit brought by the carrier, together with warehouse *A* and other warehouse companies interveners in the proceeding before the Commission, this order to cease and desist was sustained by a statutory three-judge court,[8] whose decision was affirmed by the Supreme Court.[9] Warehouse *B* could, of course, take no appeal from the negative order denying reparation.[10] Instead it brought an action under the Sherman and Clayton Acts,[11] seeking to charge both warehouse *A* and the carrier with treble damages. This time warehouse *B* achieved temporary success on the ground that the causes of action provided by the anti-trust laws were wholly distinct from those under the Commerce Act, although admittedly both suits were based simply on the carrier's preferential treatment of a competitor.[12] The Circuit Court of Appeals for the Third Circuit reversed, however, holding that, while warehouse *B* might have sued under the anti-trust acts in the first instance, the proceedings before the Commission constituted an election which barred any further action against either the carrier or ware-

6. McCormick Warehouse Co. v. Pa. R. R., 148 I. C. C. 299 (1928); 24 STAT. 380 (1887), 49 U. S. C. § 3 (1934).

7. Gallagher v. Pa. R. R., 160 I. C. C. 563 (1929). As to what the plaintiff must prove in order to recover, see Fletcher, *The Interstate Commerce Commission* in GROWTH OF AMERICAN ADMINISTRATIVE LAW (1923) 59.

8. Merchants' Warehouse Co. v. United States, 44 F. (2d) 379 (E. D. Pa. 1930) (one judge dissenting as to restraining order). It appears from the District Court's opinion that the carrier took no part in this suit. *Id.* at 382.

9. Merchants' Warehouse Co. v. United States, 283 U. S. 501 (1931).

10. Proctor & Gamble Co. v. United States, 225 U. S. 282 (1912); Interstate Commerce Comm. v. United States, 289 U. S. 385 (1933); 2 SCHARFMAN, THE INTERSTATE COMMERCE COMMISSION (1931) 406–417; WYMAN, RAILROAD RATE REGULATION (2d ed. 1915) 68; see Watkins, *Has a Shipper Who has been Denied Relief by the Interstate Commerce Commission Any Remedy?* (1917) 17 COL. L. REV. 34; Comment (1934) 34 *id.* 908; (1933) 1 GEO. WASH. L. REV. 274. The courts do, however, review orders which are negative merely in form, but not in effect. United States v. New River Co., 265 U. S. 533 (1924); Alton R. R. v. United States, 287 U. S. 229 (1932).

11. 26 STAT. 209 (1890), 15 U. S. C. §§ 1, 2 (1934); 38 STAT. 731 (1914), 15 U. S. C. § 15 (1934).

12. Terminal Warehouse Co. v. Pa. R. R., 7 F. Supp. 484 (E. D. Pa. 1934), (1935) 35 COL. L. REV. 129, (1935) 48 HARV. L. REV. 520; *cf.* Meeker v. Lehigh Valley R. R., 183 Fed. 548 (C. C. A. 2d, 1910).

house *A*.[13] The Supreme Court affirmed, but on the ground apparently that, since the Commerce Act gave a complete remedy against all persons procuring the allowance of a forbidden preference as well as against the carrier itself,[14] the discrimination complained of did not constitute a restraint of trade remediable even in the first instance under the anti-trust laws.[15]

The equities of the case, in view of the Commission's recent abrupt change of position with respect to the practice involved, were clearly with the carrier.[16] But, in any event, that a plaintiff should have an additional remedy under the anti-trust laws for preferences declared illegal by the Commerce Act would destroy, as Mr. Justice Cardozo observes, the unity and effectiveness of a "remedial system that is complete and self-contained".[17] Other practical considerations support the result. Judicial action under the anti-trust laws would preclude uniform treatment; for the amount of damages recovered might operate, like a rebate, to give the plaintiff a preference over his competitors, and the measure of relief granted by the several juries and courts would inevitably vary.[18] Such action, moreover, would not only detract from the finality which should be accorded the determination of a technical question by a specially equipped body with all the parties and all the questions and evidence before it,[19] but might also be considered, with respect to the parties defendant before the Commission, a collateral attack on its negative order denying reparation.[20]

At the same time the decision proceeds toward a solution of the many questions of conflicting power that are likely to arise with the continued regulation of business practices, by statute and commission. Since the Court is evidently willing to accept the fact that a particular issue of restraint of trade comes within the effective reach of the Interstate Commerce Commis-

13. Pa. R. R. v. Terminal Warehouse Co., 78 F. (2d) 591 (C. C. A. 3d, 1935).

14. 24 STAT. 382 (1887), 49 U. S. C. § 8 (1934); 24 STAT. 382 (1887), 49 U. S. C. § 10 (4) (1934).

15. Terminal Warehouse Co. v. Pa. R. R., 297 U. S. 500 (1936). The Circuit Court of Appeals, in holding that the election applied to the defendant warehouse as well as the carrier, apparently believed that the former, since it had intervened in the proceedings before the Commission, had subjected itself to its jurisdiction. The Supreme Court, however, disagreed, stating that the Commission's holding applied only to the carrier. The election in the Commerce Act, furthermore, is between a proceeding for damages before the Commission and a similar action in a District Court, and not between a suit under the Commerce Act and one under the anti-trust laws. 24 STAT. 382 (1887), 49 U. S. C. § 9 (1934). The Supreme Court did not decide whether the Commission would have had jurisdiction over the warehouse had the plaintiff demanded relief against it as well as the carrier. *Cf.* 34 STAT. 590 (1910), 49 U. S. C. § 16 (1) (1934); 32 STAT. 848 (1903), 49 U. S. C. § 42 (1934).

16. The Court has held that damages cannot be granted in cases where the Commission has declared rates illegal which it had formerly approved. Arizona Grocery Co. v. Atchison Ry., 284 U. S. 370 (1932); *cf.* Great No. Ry. v. Sunburst Oil & Refining Co., 287 U. S. 358 (1932), (1933) 42 YALE L. J. 779.

17. Terminal Warehouse Co. v. Pa. R. R., 297 U. S. 500, 514 (1936).

18. Keogh v. Chicago & N. W. Ry., 260 U. S. 156, 163 (1922).

19. Illinois Cent. R. R. v. Interstate Commerce Comm., 206 U. S. 441, 454 (1907).

20. See notes 10, 16, *supra*.

sion as adequate assurance to competitors that the rates or practices complained of will not effect a restraint, it will apparently continue to be difficult to attack administered prices generally under the anti-trust laws.[21] This does not mean that common carriers in interstate commerce are wholly removed from the scope of the anti-trust laws. Combinations for the establishment of uniform rates may be enjoined by the government, although the rates themselves have been approved as reasonable by the Commission.[22] And carriers who knowingly ally themselves with a conspiracy in restraint of trade[23] or who attempt to monopolize the sale or production of some commodity[24] are still undoubtedly liable under the anti-trust laws, at the hands either of the government or of a private person. The holding must be limited, as the Court was careful to observe, to cases where there is no evidence of any wrong irremediable under the Commerce Act.[25] The Court, however, does not indicate how many elements of restraint other than the allegedly discriminatory character of the rates or practices within the Commission's reach are necessary before a separate attack can be entertained.

## CONCLUSIVENESS OF JURISDICTIONAL DECISIONS*

THE DEFENDANT, a Maryland corporation, operated a steamship line between Baltimore, Norfolk and foreign ports. An employee injured aboard one of its vessels in Norfolk harbor brought an action for damages in New York, where he had become a resident, by attaching the company's funds in a local bank and serving it personally without the state. The defendant, appearing specially, moved to dismiss the action, contending that its entertainment in a state where the defendant's ships did not touch would impose an unconstitutional burden on interstate commerce. Upon denial of the motion by the Supreme Court and affirmance by the Appellate Division,[1] whose ruling on interlocutory orders is not subject to further review,[2] the defendant moved in that court, on the same ground, for a writ of prohibition against further proceedings in the original action. The denial of this motion was reversed by the Court of Appeals, which held that the exercise of jurisdiction in such an action would unreasonably burden interstate commerce,

21. It is uncertain whether or not the ROBINSON-PATMAN ACT, Pub. L. No. 692, 74th Cong., 2d Sess. (June 19, 1936), applies to administered rates.

22. See Keogh v. Chicago & N. W. Ry., 260 U. S. 156, 161 (1922); FLETCHER, *supra* note 7, at 68-69. The individual must, however, seek his remedy under the Commerce Act. Keogh v. Chicago & N. W. Ry., *supra*.

23. *Cf.* Swift & Co. v. United States, 196 U. S. 375 (1905).

24. United States v. Lehigh Valley R. R., 254 U. S. 255 (1920); United States v. Southern Pacific Co., 259 U. S. 214 (1922); *cf.* Thomsen v. Union Castle Mail S. S. Co., 166 Fed. 251 (C. C. A. 2d, 1908).

25. See Terminal Warehouse Co. v. Pa. R. R., 297 U. S. 500, 516 (1936).

*Baltimore Mail S. S. Co. v. Fawcett, 269 N. Y. 379, 199 N. E. 628 (1936).

1. Madsen v. Baltimore Mail S. S. Co., 244 App. Div. 809, 279 N. Y. Supp. 766 (2d Dep't 1935).

2. N. Y. CIV. PRAC. ACT § 611.

and that the defendant was not precluded by the decision upon the motion to dismiss from raising the same objection of want of jurisdiction over the subject matter in a petition for a writ of prohibition, since "a defendant may raise and reiterate the objection of want of jurisdiction at any stage".[3]

The principle that a court without jurisdiction cannot acquire it by its own decision, that its judgment is "void" and therefore always open to attack, is an ancient one which has been so often repeated as to be generally given the force of maxim.[4] For some time, however, a trend has been clearly discernible toward the opposing doctrine that an issue once judicially decided should not be relitigated in another, independent proceeding. The presumption in favor of the validity of the judgment of a court of general jurisdiction is an old one.[5] Carried over to the federal courts, it has been extended so far that a federal judgment has been held immune from collateral attack for want of diversity jurisdiction notwithstanding the showing of a complete lack of diversity on the face of the record.[6] Further evidence of the trend is apparent in the evolution of a large group of "quasi-jurisdictional" facts —such as the ownership of land in the distribution of a decedent's estate,[7] or the existence and amount of the petitioning creditor's debt in an involuntary proceeding in bankruptcy[8]—whose sanctity is lost on collateral attack.[9] The doctrine of estoppel has been applied against the assertion of lack of jurisdiction by a party who has either invoked the court's jurisdiction himself or accepted the fruits of its exercise.[10] And finally, jurisdictional findings

3. Baltimore Mail S. S. Co. v. Fawcett, 269 N.Y. 379, 388, 199 N.E. 628, 632 (1936). The court disposed of the argument that prohibition is a discretionary remedy and its denial not subject to review [People *ex rel.* Cuvillier v. Hagarty, 238 N.Y. 621, 144 N.E. 917 (1924)] by holding the writ issuable as of right when it is the only remedy available: the defendant had exhausted every remedy by appeal open to it under the laws of the state and was not required to seek a review of the interlocutory order by the Supreme Court of the United States before petitioning for prohibition. Prohibition, however, would seem never properly issuable except when it is the only remedy available. People *ex rel.* Livingston v. Wyatt, 186 N.Y. 383, 79 N.E. 330 (1906); People *ex rel.* Cuvillier v. Hagarty, *supra.*

4. Thompson v. Whitman, 18 Wall. 457 (U.S. 1873); Andrews v. Andrews, 188 U.S. 14 (1903); see Hanna v. Stedman, 230 N.Y. 326, 336, 130 N.E. 566, 569 (1921); 1 FREEMAN, JUDGMENTS (5th ed. 1925) § 333.

5. Grignon's Lessee v. Astor, 2 How. 319 (U.S. 1844); see Evers v. Watson, 156 U.S. 527, 532 (1895).

6. Des Moines Navigation & R. R. v. Iowa Homestead Co., 123 U.S. 552, 557 (1887). The presumption of a finding of diversity applies *a fortiori* where the lack of diversity is not apparent on the face of the record. McCormick v. Sullivant, 10 Wheat. 192 (U.S. 1825); Dowell v. Applegate, 152 U.S. 327 (1894); Windholz v. Everett, 74 F. (2d) 834 (C.C.A. 4th, 1935).

7. Morgan v. Big Woods Lumber Co., 198 Ky. 88, 249 S.W. 329 (1923).

8. Michaels v. Post, 21 Wall. 398 (U.S. 1874).

9. Thompson v. Tolmie, 2 Pet. 157 (U.S. 1829); Florentine v. Barton, 2 Wall. 210 (U.S. 1864); Comstock v. Crawford, 3 Wall. 396 (U.S. 1865); see Noble v. Union River Logging R. R., 147 U.S. 165, 173 (1893).

10. Bledsoe v. Seaman, 77 Kan. 679, 95 Pac. 576 (1908); Langewald v. Langewald, 234 Mass. 269, 125 N.E. 566 (1920); Dyckman v. New York, 5 N.Y. 434 (1851); see Grasselli Chemical Co. v. Simon, 84 Ind. App. 327, 328, 150 N.E. 617, 618 (1925);

have been held binding when the result of statutory construction by the courts of sister states.[11] In comparatively recent years many courts have dispensed with these special formulas in favor of the general rule that the principle of res judicata applies to decisions on jurisdictional questions equally with other issues,[12] saving them from collateral attack in the same state or in any other so long as the defendant has appeared, either generally, or specially to contest jurisdiction, and the court has purported to render a judgment against him. In 1916 the Supreme Court established the constitutionality of the rule under the due process clause,[13] and fourteen years later it was unequivocally adopted by the Court in *Baldwin v. Iowa State Traveling Men's Association.*[14]

The conclusiveness of rulings on personal jurisdiction has been rationalized on the theory that a special appearance to contest jurisdiction is a submission to the "limited jurisdiction" of the court to determine its "ultimate jurisdiction" over the parties.[15] The application of res judicata to decisions with respect to jurisdiction over the subject matter is a more difficult question conceptually; for it is said to be elementary that jurisdiction over the subject

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1 FREEMAN, JUDGMENTS (5th ed. 1925) §320; 3 *id.* §1438. But see Grubb v. Public Utilities Comm. of Ohio, 281 U.S. 470, 475 (1930); *cf.* Hollingshead v. Hollingshead, 91 N.J. Eq. 261, 110 Atl. 19 (Ch. 1920) (exception in divorce cases).

11. Amer. Ry. Exp. Co. v. Royster Guano Co., 273 U.S. 274 (1927); Grubb v. Public Utilities Comm. of Ohio, 281 U.S. 470 (1930).

12. Moch v. Va. Fire Ins. Co., 10 Fed. 696 (C.C.E.D.Va. 1882); Phelps v. Mutual Reserve Fund Life Ass'n, 112 Fed. 453 (C.C.A. 6th, 1901); Chinn v. Foster-Milburn Co., 195 Fed. 158 (W.D.N.Y. 1912); Valentine v. Police Court of San Francisco, 141 Cal. 615, 75 Pac. 336 (1904); Chicago Title & Trust Co. v. National Storage Co., 260 Ill. 485, 103 N.E. 227 (1913); Hall v. Wilder Mfg. Co., 316 Mo. 812, 293 S.W. 760 (1927); Simmons Co. v. Sloan, 104 N.J.L. 612, 142 Atl. 15 (1928); see Medina, *Conclusiveness of Rulings on Jurisdiction* (1931) 31 COL. L. REV. 238; Comments (1928) 41 HARV. L. REV. 1055, (1931) 26 ILL. L. REV. 432; *cf.* (1936) 45 YALE L. J. 1499 (faulty cause of action as ground for collateral attack). But see Farrier, *Full Faith and Credit of Adjudication of Jurisdictional Facts* (1935) 2 U. OF CHI. L. REV. 552.

13. Chicago Life Ins. Co. v. Cherry, 244 U.S. 25 (1917).

14. 283 U.S. 522 (1931); American Surety Co. v. Baldwin, 287 U.S. 156 (1932), (1932) 42 YALE L. J. 427, (1934) 12 N.C.L. REV. 250; RESTATEMENT, CONFLICT OF LAWS (1934) §451; Napa Valley Electric Co. v. Railroad Comm. of Cal., 251 U.S. 366 (1920) *semble; cf.* Jaster v. Currie, 198 U.S. 144 (1905). The Restatement provides that the defendant shall also have "participated in the proceedings". This is suggested by earlier cases. *Cf.* Reynolds v. Stockton, 140 U.S. 254 (1891); see Cherry v. Chicago Life Ins. Co., 190 Ill. App. 70, 73 (1914), *aff'd*, Chicago Life Ins. Co. v. Cherry, 244 U.S. 25 (1917). But the rule is not so limited in the two *Baldwin* cases, *supra.* Nor would it seem necessary that the jurisdictional question should have been expressly raised; a final ruling on the merits carries with it by implication a ruling on jurisdiction. Windholz v. Everett, 74 F. (2d) 834 (C.C.A. 4th, 1935); Valentine v. Police Court of San Francisco, 141 Cal. 615, 75 Pac. 336 (1904). But see National Exchange Bank of Tiffin v. Wiley, 195 U.S. 257, 269 (1904).

15. See Stevirmac Oil & Gas Co. v. Dittman, 245 U.S. 210, 214 (1917); Comment (1928) 41 HARV. L. REV. 1055.

matter cannot be "waived".[16] Acceptance of the doctrine, however, would not mean that jurisdiction over the subject matter could be "waived" just as a party, by a general appearance, consents to the jurisdiction over his person: regardless of the type of his appearance the defendant would be able to raise the question of jurisdiction over the subject matter at any time before final judgment *in the same proceeding*. By entering an appearance, whether special or general, with an opportunity to litigate the question of jurisdiction over the subject matter, the defendant would simply subject himself, like a defendant on a special appearance to contest the court's jurisdiction over his person, to the "limited jurisdiction" of the court. The practical reasons for putting an end to litigation with respect to the one type of jurisdiction are as compelling as they are with respect to the other. And, while the doubt which has been expressed as to the applicability of the doctrine of res judicata to questions of jurisdiction over the subject matter[17] will not be completely dispelled until the Supreme Court definitely rules on the question, authority does exist for the proposition that rulings on such questions are final. The older formulas did not discriminate between subject matter and person, and in addition to an apparently forgotten decision of the Supreme Court in 1897[18] several recent federal cases offer support.[19] The New York Court in the instant case, in permitting a collateral attack based on lack of jurisdiction over the subject matter after the question had been considered by two courts in the original proceeding, seems to have ignored this entire development.[20]

The application of res judicata to rulings on jurisdiction may prove embarrassing to the defendant in those states where an exception properly taken to an adverse ruling on an objection to the jurisdiction is held to be waived by a subsequent plea in bar and defense on the merits and where, at the same time, no interlocutory appeal is permitted from such a ruling.[21] If

16. Southern Pac. Ry. v. Denton, 146 U. S. 202 (1892); Jackson & Sons v. Lumbermen's Mutual Casualty Co., 86 N. H. 341, 168 Atl. 895 (1933). But *cf.* Grasselli Chemical Co. v. Simon, 84 Ind. App. 327, 150 N. E. 617 (1925) (jurisdiction of administrative board).

17. RESTATEMENT, CONFLICT OF LAWS (1934) § 451, Caveat; see Medina, *supra* note 12.

18. Forsyth v. Hammond, 166 U. S. 506 (1897).

19. Hamilton Gas Co. v. Watters, 79 F. (2d) 438 (C. C. A. 4th, 1935); *cf.* Catholic Soc. of Religious & Literary Education v. Madison County, 74 F. (2d) 848, 850 (C. C. A. 4th, 1935) (finding of *lack* of jurisdiction). See Gavit, *Jurisdiction of the Subject Matter and Res Judicata* (1932) 80 U. OF PA. L. REV. 386.

20. It is not clear, indeed, whether the commerce clause *is* a limitation on the existence of jurisdiction over the subject matter or whether such jurisdiction exists, but simply cannot be exercised in such a way as to burden interstate commerce. The entire injection of the commerce clause into the problem of interstate selection of forums is comparatively recent. For a discussion of the cases that have arisen under the commerce clause, see Comment (1936) 45 YALE L. J. 1100, especially 1114, n. 75.

21. Morris v. Miller, 4 Idaho 454, 40 Pac. 60 (1895); McCullough v. Railway Mail Ass'n, 225 Pa. 118, 73 Atl. 1007 (1909); Corbett v. Physicians' Casualty Ass'n, 135 Wis. 505, 115 N. W. 365 (1908); see Sunderland, *Preserving a Special Appearance* (1911) 9 MICH. L. REV. 396.

he does defend on the merits, he waives his objection to the court's jurisdiction over his person; and if he lets the action go to final judgment on the overruling of his plea to the jurisdiction and appeals, he risks everything on his one more or less doubtful defense to the jurisdiction, sacrificing any defense he may have had on the merits if the judgment is affirmed. He can, of course, enter no appearance at all and let judgment go by default, thus preserving his right to attack it collaterally, by resisting an action thereon or by enjoining its execution; but these tactics may again deprive him completely of his defense on the merits if his attack is unsuccessful. In such states the defendant cannot, if res judicata be applied, obtain an appellate ruling on both his defenses, to the jurisdiction over his person and on the merits.[22]

Constitutionally, however, this procedure can be no more objectionable than the rule in some states which allows no special appearance whatever and thus confines a defense on jurisdiction over the person to collateral attack.[23] The latter rule, the Supreme Court has held, is not a deprivation of due process.[24] And if it be considered undesirable on considerations of policy that the defendant should be thus compelled unalterably to select one defense, his predicament can be solved very simply, either by these states' adopting the present federal rule, which does allow a reservation of the jurisdictional question on a plea in bar,[25] or by their permitting an interlocutory appeal, as New York and other states now do, from the overruling of the objection to the jurisdiction.[26] In the former case, if the defendant fails in his objection to the jurisdiction over his person and also, after reserving an exception, in his defense on the merits, he may appeal by assigning error to the disposition of both questions.[27] In the latter case he may secure an

22. An escape might be based on the argument that res judicata does not apply to summary interlocutory rulings in general from which no appeal is possible. Bishop v. Smith, 66 Kan. 621, 72 Pac. 220 (1903); Heidel v. Benedict, 61 Minn. 170, 63 N.W. 490 (1895). But it has been held applicable [Naigle v. First Nat. Bank of Omaha, 57 Neb. 552, 77 N.W. 1074 (1899)], at least where there has been a full hearing [Dwight v. St. John, 25 N.Y. 203 (1862); Rogers v. McCord-Collins Mercantile Co., 19 Okla. 115, 91 Pac. 864 (1907)]. See 2 FREEMAN, JUDGMENTS (5th ed. 1925) §717. The dilemma does not apply at all to jurisdiction over the subject matter; for it is, of course, not waived by a defense on the merits. See note 16, *supra*.

23. York v. Texas, 73 Tex. 651, 11 S.W. 869 (1889), *aff'd*, 137 U.S. 15 (1890); Teller v. Equitable Mutual Life Ass'n, 108 Iowa 17, 78 N.W. 674 (1899). Federal courts sitting in these states have refused to follow the rule. Southern Pac. Ry. v. Denton, 146 U.S. 202 (1892) (Texas statute).

24. York v. Texas, 137 U.S. 15 (1890).

25. Harkness v. Hyde, 98 U.S. 476 (1878); James-Dickinson Farm Mortgage Co. v. Harry, 273 U.S. 119 (1927). This practice is common to about half the states. Chandler v. Citizens' Nat. Bank, 149 Ind. 601, 49 N.E. 579 (1898); Fisher v. Crowley, 57 W.Va. 312, 50 S.E. 422 (1905); see Sunderland, *supra* note 21, at 405.

26. Townsend v. Hendricks, 40 How. Pr. 143 (N.Y. 1870); Skinner v. Carter, 108 N.C. 106, 12 S.E. 908 (1891); see note 2, *supra*.

27. The court in the instant case argued that this procedure, while it may guarantee the defendant due process, is not adequate protection where the objection to jurisdiction is based rather on the commerce clause, in which case a trial on the merits is the very

appellate ruling on both defenses seriatim. It is, therefore, not essential to a fair presentation of the defendant's case that he be permitted to attack a jurisdictional ruling, whether of person or of subject matter, at his discretion, when no practical reason any longer exists for considering an erroneous decision of this sort any more "a denial of constitutional rights" and any less the result of "the imperfection of man"[28] than an erroneous decision on any other question.

## PRIORITY OF CITY'S CLAIM FOR SALES TAXES COLLECTED BY BANKRUPT VENDOR *

THE CITY of New York filed a claim in the bankruptcy of a merchant, demanding priority for sales taxes collected by the bankrupt and not paid over to the city.[1] The city relied on two sections of the Bankruptcy Act, one allowing priority to claims for taxes, and the other giving priority to persons entitled thereto under state law.[2] The court allowed the claim, but refused to grant it priority, holding that the funds, having been collected by the bankrupt, were no longer a tax but a debt, and that the city was not entitled to priority under state law.[3]

The court's refusal to allow the claim priority as a claim for taxes seems orthodox. According to the decided weight of authority, a tax collector's liability to the taxing body is similar to that of any agent who has received

burden which is unconstitutional. Baltimore Mail S. S. Co. v. Fawcett, 269 N.Y. 379, 389, 199 N.E. 628, 632 (1936); Michigan C. R. R. v. Mix, 278 U.S. 492 (1929) *semble;* Denver & R. G. W. R. R. v. Terte, 284 U.S. 284 (1932) *semble.*

28. Chicago Life Ins. Co. v. Cherry, 244 U.S. 25, 30 (1917) (Holmes, J.).

*Matter of Lazaroff, City of New York v. Goldstein, 84 F. (2d) 982 (C.C.A. 2d, 1936).

1. The right of priority in this type of case is of considerable importance as it appears that at the present time the City is creditor for such taxes in over four hundred bankruptcies in the Southern District of New York alone. Petition for writ of certiorari, September 4, 1936, p. 13, Matter of Lazaroff, City of New York v. Goldstein, 84 F. (2d) 982 (C.C.A. 2d, 1936).

2. 44 STAT. 666 (1926), 11 U.S.C. § 104 (1934). The term "person" is defined in the statute as including corporations. This includes municipal corporations. City of Lincoln v. Ricketts, 297 U.S. 373 (1936).

3. Matter of Lazaroff, City of New York v. Goldstein, 84 F. (2d) 982 (C.C.A. 2d, 1936). The same result on the first question has been reached by a district court. *In re* Goldstein, 13 F. Supp. 991 (S.D.N.Y. 1935). The lower New York courts are divided on the question. Priority granted: Matter of Lichtman Clothes, Inc., N. Y. L. J., January 4, 1936, p. 58, col. 2; *In re* Shapiro, N. Y. L. J., December 17, 1935, p. 2472, col. 1; *In re* Rich Frocks, Inc., N. Y. L. J., January 14, 1936, p. 240, col. 1; Matter of La Chic Shops, Inc., N. Y. L. J., January 29, 1936, p. 529, col. 6; *In re* Fordon, N. Y. L. J., September 2, 1936, p. 577, col. 1. Priority denied: Matter of Relkin, N. Y. L. J., September 22, 1936, p. 792, col. 2; Wellworth Sales, Inc. v. Goldstein, N. Y. L. J., September 22, 1936, p. 792, col. 3; Matter of Kaplan, N. Y. L. J., September 30, 1936, p. 935, col. 1; *In re* Itkin, N. Y. L. J., September 11, 1936, p. 652, col. 2; *In re* Terman, N. Y. L. J., September 11, 1936, p. 652, col. 3.

money on his principal's account, and therefore, once the taxpayer has paid the collector, the distinguishing title of "tax" disappears.[4] Moreover, an individual may be a collector within this rule even though he is compelled to pay over the money as an incident of carrying on some business, such as selling tickets or gasoline, provided that he is not intended to bear the ultimate tax burden, but is to pass the tax on to others.[5] Accordingly, since it seems evident from the provisions of the New York City Sales Tax Law that the ultimate tax burden is intended to fall on the purchaser rather than on the merchant,[6] the city's claim in the principal case might properly be called the debt of a collector, rather than a tax.

In regard to the city's right to priority under state law, a possible argument is suggested by a decision holding that money collected as in the instant case is held in trust for the taxing authority.[7] But to receive a preference under this doctrine, the trust *res* would have to be traceable into the hands of the trustee in bankruptcy,[8] something which was here precluded, since the money from the sales taxes was concededly never turned over to the trustee.[9]

However, the court might well have allowed the city priority on the ground of sovereignty. Under English law the crown is entitled to priority of payment over general creditors of an insolvent.[10] It has usually been held that this is an attribute of sovereignty and a part of the common law adopted by the states in blanket form after the Revolution.[11] In some cases the priority

4. *In re* Waller, 142 Fed. 883 (D. Md. 1905); Bent v. Inhabitants of Hubbardston, 138 Mass. 99 (1884); Matter of Niederstein, 154 App. Div. 238, 138 N. Y. Supp. 952 (2d Dep't 1912).

5. Nolte et al. v. Hudson Navigation Co., 8 F. (2d) 859 (C. C. A. 2d, 1925); *In re* Wyoming Valley Ice Co., 145 Fed. 267 (M. D. Pa. 1906); Pennsylvania v. York Silk Manufacturing Co., 192 Fed. 81 (C. C. A. 3d, 1911); *In re* Martin, 75 F. (2d) 618 (C. C. A. 7th, 1935); Pennsylvania v. Stocker, 70 F. (2d) 453 (C. C. A. 3d, 1934). *Contra:* Missouri v. Ross, 80 F. (2d) 329 (C. C. A. 8th, 1935).

6. Local Law No. 25, 1934. This act is cited in several opinions as Local Law No. 24, 1934. It provides, in part, that the tax "shall be paid by the purchaser to the vendor, for and on account of the City of New York" (§ 2), that the property of both vendor and purchaser is liable for nonpayment (§ 8), and that refund applications should be by the purchaser, or vendor only if he has repaid the purchaser (§ 10). While the provisions of § 8 provide ground for an argument that the vendor is more than a mere agent, it would seem equally plausible to construe the provision as merely providing a special security for the vendor's liability as agent. But see interpretation of the New York motor fuel tax in *In re* Riemer, 82 F. (2d) 162 (C. C. A. 2d, 1936).

7. Shipe v. Consumers' Service Co., 28 F. (2d) 53 (N. D. Ind. 1928); State v. Canfield Oil Co., 34 Ohio App. 267, 171 N. E. 111, *aff'd*, 122 Ohio St. 175, 171 N. E. 33 (1930).

8. Matter of Cavin v. Gleason, 105 N. Y. 256, 11 N. E. 504 (1887); Matter of Hicks, 170 N. Y. 195, 63 N. E. 276 (1902); see BOGERT, TRUSTS AND TRUSTEES (1st ed. 1935) § 866; Comment (1931) 30 MICH. L. REV. 441.

9. Brief for appellee, p. 24, Matter of Lazaroff, 84 F. (2d) 982 (C. C. A. 2d, 1936).

10. *In re* Henley & Co., 9 Ch. D. 469 (1878); 1 COOLEY'S BLACKSTONE (2d ed. 1872) 154.

11. Marshall v. New York, 254 U. S. 380 (1920); Pennsylvania v. Stocker, 70 F. (2d) 453 (C. C. A. 3d, 1934); *In re* Martin, 75 F. (2d) 619 (C. C. A. 7th, 1935); Seay v. Bank of Rome, 66 Ga. 609 (1881); State of Maryland v. Bank of Maryland,

is expressly declared by statute.[12] Although it is usually said not to extend to the political subdivisions of the states,[13] it may be so enlarged by statute.[14]

In New York the state is entitled to priority for debts and taxes;[15] the political subdivisions of the state enjoy a similar preference for unpaid taxes owing by the debtor on his personal account,[16] on the theory that when exercising the delegated power to tax, the city is functioning in a sovereign capacity and is entitled to the appendant prerogative.[17] It can therefore be argued that although the collection of the city's claim was not the collection of a tax, it was nevertheless the exercise of a sovereign function which had

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6 Gill & J. 205 (Md. 1834); Aetna Accident and Liability Co. v. Miller, 54 Mont. 377, 170 Pac. 760 (1918); Matter of Carnegie Trust Co., 206 N.Y. 390, 99 N.E. 1096 (1912); U.S. Fidelity & Guaranty Co. v. Rainey, 120 Tenn. 357, 113 S.W. 397 (1908). *Contra:* Potter v. Fidelity and Deposit Co., 101 Miss. 823, 58 So. 713 (1912); Middlesex County v. State Bank, 2 Stew. 268 (N.J. Eq. 1878); North Carolina Corp. Com. v. Citizens' Bank & Trust Co., 193 N.C. 513, 137 S.E. 587, 51 A.L.R. 1355 (1927); State v. Harris, 2 Bail. Eq. 598 (S.C. 1831) (the Court said at p. 599: "It cannot be, that the incidents of royalty are to adhere to the vestal of republicanism, when she has trod the diadem of kings under her feet, and broken the scepter of power.") *Cf. In re* Devlin, 180 Fed. 170 (D. Kan. 1910). The state may waive the prerogative. Maryland Casualty Co. v. Rainwater, 173 Ark. 103, 291 S.W. 1003, 51 A.L.R. 1336 (1927). It has been held that there is no subrogation to the priority. U.S. Fidelity & Guaranty Co. v. McFerson, 78 Colo. 338, 241 Pac. 728 (1925). *Contra:* Orem v. Wrightson, 51 Md. 34 (1878); U.S. Fidelity & Guaranty Co. v. Bramwell, 108 Ore. 261, 217 Pac. 332 (1923), 32 A.L.R. 846 (1924).

12. Minnesota v. Bell, 64 Minn. 400, 67 N.W. 212 (1896). Priority is granted to debts due the United States by REV. STAT. § 3466, 31 U.S.C. § 191 (1934).

13. Aetna Casualty & Surety Co. v. Bramwell, 12 F. (2d) 307 (D. Ore. 1926); County of Glynn v. Brunswick Terminal Co., 101 Ga. 244, 28 S.E. 604 (1897); People *ex rel.* Nelson v. Home State Bank, 338 Ill. 179, 170 N.E. 205 (1930); Bignell v. Cummins, 69 Mont. 294, 222 Pac. 797 (1923), 36 A.L.R. 640 (1925); Boone County v. Cantley, 330 Mo. 911, 51 S.W. (2d) 56 (1932); Matter of Northern Bank of New York, 85 Misc. 594, 148 N.Y. Supp. 70 (Sup. Ct. 1914), *aff'd on opinion below,* 163 App. Div. 974, *aff'd,* 212 N.Y. 608, 106 N.E. 749 (1914); City of Sturgis v. Meade County Bank, 38 S.D. 317, 161 N.W. 327 (1917); U.S. Fidelity & Guaranty Co. v. Rainey, 120 Tenn. 357, 113 S.W. 397 (1908). *Contra:* City and County of Denver v. Stenger, 295 Fed. 809 (C.C.A. 8th, 1924).

14. *In re* Marathon Savings Bank, 198 Iowa 692, 196 N.W. 729, 200 N.W. 199 (1924); Bent v. Inhabitants of Hubbardston, 138 Mass. 99 (1884); Insurance Commission v. Commercial Mutual Insurance Co., 20 R.I. 7, 36 Atl. 930 (1897).

15. Marshall v. New York, 254 U.S. 380 (1920); Matter of Carnegie Trust Co., 206 N.Y. 390, 99 N.E. 1096 (1912); Matter of Niederstein, 154 App. Div. 238, 138 N.Y. Supp. 952 (2d Dep't 1912).

16. *In re* Ginsburg, 27 Misc. 745, 59 N.Y. Supp. 656 (Sup. Ct. 1899); Mixter v. Mohawk Clothing Co., 155 N.Y. Supp. 647 (Sup. Ct. 1915); Matter of Atlas Iron Construction Co., 19 App. Div. 415, 46 N.Y. Supp. 467 (1st Dep't 1897).

17. See Matter of Northern Bank of New York, 85 Misc. 594, 148 N.Y. Supp. 70 (Sup. Ct. 1914), *aff'd on opinion below,* 163 App. Div. 974, *aff'd,* 212 N.Y. 608, 106 N.E. 749. That this is the *ratio decidendi* of these cases is evident from the fact that several of the cases cited in Mixter v. Mohawk Clothing Co., 155 N.Y. Supp. 647 (Sup. Ct. 1915) in support of the result are cases where *state* taxes were accorded the priority of sovereignty.

not ceased merely because the city's agent had received the funds. In *Matter of Northern Bank of New York*,[18] where the city had deposited funds from tax collections in a bank which subsequently failed, it was held that when the money had been paid to the city officials, the sovereign function had ceased, and priority was therefore denied. Two distinctions are discernable. First, the money in that case had actually passed through the hands of city officials, and had been deposited to the city's account. Neither of these facts was present in the instant case. On the contrary, the city was still in a position where it had to take action to collect the money. It would seem that the sovereign function should extend at least to the collection of debts arising from its exercise. Second, in *Matter of Northern Bank of New York*, the money was part of the general municipal funds; in the instant case the sales tax receipts are required by the enabling act[19] to be earmarked for unemployment relief. In upholding the enabling act over the constitutional complaint that it concerned a locality and had not been properly passed,[20] the Court of Appeals held in unmistakeable language that unemployment relief was a state purpose, and that the city was only the agent of the state.[21] It would seem reasonable to argue that when the city is thus engaged in a state undertaking, the sovereign prerogative is attached to the money from the time of its payment by the purchaser until its final disbursement in pursuance of the sovereign objective. As the result of the decision would seem to make money paid by the taxpayers for unemployment relief available to the bankrupt personally so as to preserve assets in his estate for the benefit of his creditors, priority might well have been allowed.

## Liability of Telephone Company for Special Damages Arising from Failure of Service*

The duty of telephone and telegraph companies to use due care in the transmission of messages may arise either from statutory or common law obligations of the company as a public service corporation, or from contracts with subscribers;[1] and liability, at least for nominal damages, or the amount

18. 85 Misc. 594, 148 N.Y. Supp. 70 (Sup. Ct. 1914), *aff'd on opinion below*, 163 App. Div. 974, *aff'd*, 212 N.Y. 608, 106 N.E. 749.

19. N. Y. Laws 1933, c. 815; N. Y. Laws 1934, c. 873.

20. The act involved was N. Y. Laws 1933, c. 815. Article XII, Sec. 2 of the New York Constitution provides that the Legislature shall not pass any law relating to the cities which is either special or local in terms or effect except on an emergency message from the governor and a two-thirds vote in each house. The act in issue was not so passed.

21. New York Steam Corp. v. City of New York, 268 N.Y. 137, 197 N.E. 172 (1935).

*Emery v. Rochester Telephone Corp., 271 N. Y. 306, 3 N. E. (2d) 434 (1936).

1. See Vinson v. Southern Bell Tel. & Tel. Co., 188 Ala. 292, 301, 66 So. 100, 102 (1914); Mentzer v. New England Tel. & Tel. Co., 276 Mass. 478, 483, 177 N.E. 549, 551 (1931); Weld v. Postal Telegraph-Cable Co., 199 N.Y. 88, 98, 92 N.E. 415, 418 (1910).

paid for the service, will generally result from its breach.[2] Where recovery is sought for special damages, however, as for physical injury[3] or business loss,[4] the courts have encountered difficulty in determining the limits to which such liability ought to extend.[5] In a few jurisdictions, recovery is said to depend on the form of the action brought by the injured party.[6] Thus, if the action is in contract, the rule of *Hadley v. Baxendale*[7] applies, so that, unless the parties had notice of the particular risks involved, only nominal damages will be allowed;[8] but the liability in tort is deemed broader, and special damages may be recovered for all injuries proximately caused by defendant's wrongful act, irrespective of notice or contemplation of the parties.[9] The present weight of authority seems to be opposed to a distinction based on the form of the action,[10] and the measure of damages is generally held to be the same in tort and in contract.[11] It is said that since the obligation in tort invariably rises out of a contract, or rather a relationship created by contract, the two theories of action are "inextricably interwoven", and the

2. Western Union Tel. Co. v. Hall, 124 U. S. 444 (1888).

3. Southern Tel. Co. v. King, 103 Ark. 160, 146 S. W. 489 (1912); Glawson v. Southern Bell Tel. & Tel. Co., 9 Ga. App. 450, 71 S. E. 747 (1911); Cumberland Tel. & Tel. Co. v. Jackson, 95 Miss. 79, 48 So. 614 (1909).

4. Southwestern Bell Tel. Co. v. Carter, 181 Ark. 209, 25 S. W. (2d) 448 (1930); Hamel v. Western Union Tel. Co., 233 App. Div. 77, 251 N. Y. Supp. 559 (3d Dep't 1931).

5. See Leonard v. The New York, Albany & Buffalo Electro-Magnetic Tel. Co., 41 N. Y. 544, 566; 1 Am. Rep. 446, 452 (1870).

6. Western Union Tel. Co. v. Green, 153 Tenn. 59, 281 S. W. 778 (1926), 48 A. L. R. 318 (1927).

7. 9 Ex. 341 (1854).

8. Primrose v. Western Union Tel. Co., 154 U. S. 1 (1893); McBride v. Sunset Tel. Co., 96 Fed. 81 (C. C. W. D. Wash. 1899); Barrett v. New England Tel. & Tel. Co., 80 N. H. 354, 117 Atl. 264 (1922).

9. Since the tort duty usually arises from a statute providing for a civil right of action against telephone and telegraph companies, the courts have occasionally followed the exact wording of these statutes and permitted recovery for all damages caused by the failure of service, requiring merely that such damage be the proximate result of the wrongful act. Mentzer v. Western Union Tel. Co., 93 Iowa 752, 62 N. W. 1 (1895); Western Union Tel. Co. v. Green, 153 Tenn. 59, 281 S. W. 778 (1926); Parker v. Western Union Tel. Co., 134 Wis. 147, 114 N. W. 439 (1908). New York has not adopted this broad interpretation of the statutory duty. See Kerr Steamship Co. v. Radio Corp., 245 N. Y. 284, 157 N. E. 140 (1927), *cert. denied*, 275 U. S. 557 (1927).

10. The courts have so held, notwithstanding the presence of a statute conferring a civil right of action on subscribers. Western Union Tel. Co. v. Taylor, 94 Fla. 841, 114 So. 529 (1927); Western Union Tel. Co. v. Redding, 100 Fla. 495, 129 So. 743 (1930); Kerr Steamship Co. v. Radio Corp., 245 N. Y. 284, 157 N. E. 140 (1927); *cf.* Pollock v. New England Tel. & Tel. Co., 289 Mass. 255, 194 N. E. 133 (1935).

11. Western Union Tel. Co v. Merritt, 55 Fla. 462, 46 So. 1024 (1908); Kerr Steamship Co. v. Radio Corp., 245 N. Y. 284, 157 N. E. 140 (1927), (1927) 41 HARV. L. REV. 256; see (1933) 33 COL. L. REV. 759 (1931) 65 U. S. L. REV. 396, 398. *Contra:* Cowan v. Western Union Tel. Co., 122 Iowa 379, 98 N. W. 281 (1904).

contract must, therefore, "define and limit" the tort.[12] In such a cause of action, sounding in contract and in tort, special damages may not be recovered, by the weight of authority, unless both the elements of notice and proximate cause are present.[13]

Dealing with the precise problem for the first time, the New York Court of Appeals recently adopted the prevailing point of view. The father of a sick child, attempting to telephone for a doctor, was unable to obtain a response from the operator, and it was alleged that the child died as a result of the consequent delay in securing medical attention. The father, as administrator, brought an action against the telephone company under the New York Wrongful Death Statute,[14] and, as a defense, the company relied on a limitation of liability in its contract with plaintiff as a subscriber. The lower court struck out this defense as against public policy. Upon appeal, the Court of Appeals refused to consider the legality of the defense, but held instead, with three judges dissenting, that the complaint should be dismissed because it failed to state a cause of action under the death statute.[15] The reasoning of the court appears to have been that, since the telephone company was unaware of the illness of plaintiff's child, it could not have foreseen the consequences of its wrongful failure to act. If there had been notice, plaintiff might have recovered,[16] provided he could have established the failure of service as the proximate cause of his child's death.[17] Under the circumstances, such proof would have been difficult. The courts have been quick to point out the presence of independent and intervening agencies, and where failure of service has prevented the calling of a fire

12. Edd v. Western Union Tel. Co., 127 Ore. 500, 272 Pac. 895 (1928).

13. Southern Tel. Co. v. King, 103 Ark. 160, 146 S. W. 489 (1912); Southwestern Bell Tel. Co. v. Hodges, 146 Ark. 585, 228 S. W. 731 (1921); see Comment (1933) 28 ILL. L. REV. 105. If either notice or proximate cause is lacking, no recovery for special damages will be allowed. Southwestern Bell Tel. Co. v. Carter, 181 Ark. 209, 25 S. W. (2d) 448 (1930); Seifert v. Western Union Tel. Co., 129 Ga. 181, 58 S. E. 699 (1907).

14. N. Y. Decedent Estate Law § 130, providing for an action by an executor or administrator for the recovery of pecuniary losses suffered by decedent's next of kin as a result of his death against one "who would have been liable to an action in favor of the decedent by reason thereof had death not ensued" Although the court seems to have intimated that plaintiff should have expressly alleged a cause of action in decedent had she lived, such an allegation has never been required before in New York and has been held unnecessary in Philadelphia, W. & B. R. R. v. State of Md. *use of* Sarah Bitzer, 58 Md. 372 (1882). *Cf.* Brown v. Buffalo State Line R. R., 22 N. Y. 191 (1860); McCahill v. New York Transp. Co., 201 N. Y. 221, 94 N. E. 616 (1911); *In re* Brennan's Account 160 App. Div. 401, 145 N. Y. Supp. 440 (2d Dep't 1914).

15. Emery v. Rochester Tel. Corp., 271 N. Y. 306, 3 N. E. (2d) 434 (1936).

16. *Cf.* Southwestern Bell Tel. Co. v. Hodges, 146 Ark. 585, 228 S. W. 731 (1921); Cumberland Tel. & Tel. Co. v. Sutton, 156 Ky. 191, 160 S. W. 949 (1913); Carter v. Western Union Tel. Co., 141 N. C. 374, 54 S. E. 274 (1906); Chesapeake & Potomac Tel. Co. v. Carless, 127 Va. 5, 102 S. E. 569 (1920).

17. *Cf.* Western Union Tel. Co. v. Ford, 10 Ga. App. 606, 74 S. E. 70 (1912); Southwestern Tel. & Tel. Co. v. Allen, 146 S. W. 1066 (Tex. Civ. App. 1912).

department,[18] or a veterinary,[19] or a doctor,[20] and damage has ensued, it has been held that the element of causation was too remote to support an action.[21] In the principal case, however, in spite of obvious problems of causation, the court appears to have conceded this element arguendo, and to have relied, instead, on the absence of notice of special risk.

In selecting this particular ground for its decision,[22] the Court of Appeals conferred upon telephone companies virtual immunity from liability for negligence. The requirement of notice of special risk was first developed in the telegraph cases where it has practical application, since telegraph messages are always read by an operator. But telephone companies can seldom have knowledge of the special needs of individual subscribers. Where the failure of service on which the complaint is based is the subscriber's inability to reach the operator, it is obviously also impossible for him, in most cases, to inform the company of the risk. For this reason, the requirement of actual notice in telephone cases may seem an unreasonable bar to recovery. Being unable to obtain a legal remedy, subscribers are left virtually unprotected from the hazards of faulty service. Although telegrams may be insured by "repeating" at a slight extra cost, insurance can have no practical application to telephone calls, nor has it ever been suggested. In view of the fact that telephone companies advertise their availability for emergency calls,[23] and that telephones are part of the normal emergency equipment of a community, it might be argued that such companies ought

18. Volquardsen v. Iowa Tel. Co., 148 Iowa 77, 126 N. W. 928 (1910); Lebanon, Louisville & Lexington Tel. Co. v. Lanham Lumber Co., 131 Ky. 718, 115 S. W. 824 (1909); Whitehead v. Carolina Tel. & Tel. Co., 190 N. C. 197, 129 S. E. 602 (1925).

19. Central Union Tel. Co. v. Swoveland, 14 Ind. App. 341, 42 N. E. 1035 (1896); Duncan v. Western Union Tel. Co., 87 Wis. 173, 58 N. W. 75 (1894). But *cf.* Peterson v. Monroe Independent Tel. Co., 106 Neb. 181, 182 N. W. 1017 (1921).

20. Where failure of service has resulted in physical injury through the delayed attendance of a physician, the courts have held the evidence of causal relationship too remote to go to the jury. Seifert v. Western Union Tel. Co. 129 Ga. 181, 58 S. E. 699 (1907); Southern Bell Tel. & Tel. Co. v. Reynolds, 139 Ga. 385, 77 S. E. 388 (1913); Evans' Adm'r v. Cumberland Tel. & Tel. Co., 135 Ky. 66, 121 S. W. 959 (1909); Southwestern Tel. & Tel. Co. v. Solomon, 54 Tex. Civ. App. 306, 117 S. W. 214 (1909); Deweese v. Southwestern Tel. & Tel. Co., 144 S. W. 732 (Tex. Civ. App. 1912). *Contra:* Glawson v. Southern Bell Tel. & Tel. Co., 9 Ga. App. 450, 71 S. E. 747 (1911), overruled by Southern Bell Tel. & Tel. Co. v. Reynolds, *supra*. *Cf.* cases cited notes 16 and 17, *supra*.

21. See Clay, *The Liability of a Telephone Company for its Negligent Failure to Furnish Promptly Service for Summoning a Physician in Case of Sickness* (1914) 1 VA. L. REV. 337.

22. Although some reference was made in the opinion to the absence of physical contact, it is doubtful whether this could have been relied on for the decision. Mitchell v. Rochester Ry., 151 N. Y. 107, 45 N. E. 354 (1896) relates solely to injuries resulting from fright. There is no such element in this case, and, furthermore, the requirement of physical contact has been liberally construed to permit recovery. Comstock v. Wilson, 257 N. Y. 231, 177 N. E. 431 (1931); Sider v. Reid Ice Cream Co., 125 Misc. 835, 211 N. Y. Supp. 582 (2d Dep't 1925).

23. See N. Y. L. J., September 30, 1936, p. 922, col. 3.

not to require special notice of risks, with the general nature of which they are already aware. Although courts have never permitted recovery on the basis of implied notice alone, such a rule would not place upon telephone companies an undue burden of liability. Since New York does not recognize mental anguish in telephone and telegraph cases,[24] there could be no such deluge of litigation as has flooded the courts of Texas and some of the other southern states,[25] and in any event the requirement of proximate cause would afford protection to the telephone companies and would permit the courts flexibility in granting or denying recovery. To the extent that injured subscribers would benefit thereby, such a rule would seem to be in accord with the purpose of the various statutes in New York[26] and other states[27] which provide for a civil right of action against telephone companies.

Although cogent arguments may be advanced for the elimination of notice as a prerequisite of recovery, the sounder rule would seem to be that adopted in the principal case. By requiring notice, the courts can avoid the confused issue of proximate cause. If this were made the sole basis of the action, liability would be haphazard and unsatisfactory, and, because the connection between faulty service and injury is inevitably tenuous in telephone cases,[28] it is doubtful whether subscribers would derive any appreciable benefit from the alternate rule, even conceding the possibility of more frequent recoveries. Certainly, it would be impossible under it to establish any clear-cut rule of liability. Since Public Service Commissions would merely be forced to raise rates in order to meet such increased obligations, the imposition of liability in cases like the present one would involve no actual loss to the telephone company, and would provide the management little incentive to guard against mistakes which may be either unavoidable or else completely unexplained, as in the principal case. And one may doubt the justification for transferring the loss for such accidents to the public at large in the form of higher rates. The damages for which a telephone company could conceivably be held liable are unlimited, especially in cases involving business loss, and in this respect they differ from those of a common carrier, which can normally be held responsible only for the value of the goods shipped. For

24. Curtin v. Western Union Tel. Co., 13 App. Div. 253, 42 N. Y. Supp. 1109 (1st Dep't 1897).

25. See Note (1914) 49 L. R. A. (N. S.) 206.

26. N. Y. Pub. Serv. Comm. Law § 93, providing that where a telephone company shall fail in the performance of its statutory obligations as a public service corporation, it "shall be liable to the person or corporation affected thereby for all loss, damage or injury caused thereby or resulting therefrom". Although the New York courts have virtually nullified the effect of this statute by requiring actual notice to the telegraph company, see Kerr Steamship Co. v. Radio Corp. 245 N. Y. 284, 157 N. E. 140 (1927), such a narrow construction is supported in other jurisdictions having similar statutes, see note 10, *supra*.

27. FLA. COMP. GEN. LAWS ANN. (Skillman, 1927) § 6347; GA. CODE (1933) c. 104, § 206; TENN. CODE ANN. (Williams, 1934) § 3102; WIS. STAT. (1927) c. 180, § 19. Even in those states permitting a liberal interpretation of such statutes it has been held that damages are restricted to injuries proximately caused by the failure of service. Fisher v. Western Union Tel. Co., 119 Wis. 146, 96 N. W. 545 (1903).

28. See cases cited *supra* note 20.

this reason, it would be impossible to estimate the exact amount of the loss, and in order to guard against eventualities, rates might have to be raised to an extent which would seem to be out of all proportion to the benefit to be obtained.

## Depreciation Allowances Under Long Term Leases*

A railroad and its subsidiaries leased all their property to two other roads for 999 years. The lease provided for the payment by the lessees of money rental and other stipulated expenses of the lessors; in addition the lessees agreed to repair and replace the leased property at their own expense, and on termination of the lease to return it in substantially as good condition as when received. Under the uniform system of accounts prescribed by the Interstate Commerce Commission, depreciation on the original leased equipment from the effective date of the lease, was currently accrued on the books of the lessees. The Commissioner of Internal Revenue, however, in computing taxable net income for the years 1928-30 inclusive, refused to allow the deduction of the depreciation thus charged off. On consolidated appeals by one of the lessees[1] and the lessor, the Board of Tax Appeals held that neither the lessor nor the lessee was entitled to a depreciation allowance, but permitted the lessees to deduct in the year of retirement[2] the value of leased property retired but not replaced. The Circuit Court of Appeals for the Fourth Circuit, affirming the Board's decision, held, with Judge Parker concurring specially, that neither the lessor nor lessee railroad was entitled to a reduction of gross income for depreciation of the original leased property,[3] since the lessor had sustained no loss and the lessee had made no capital investment.[4]

*Atlantic Coast Line R. R. v. Commissioner, 81 F. (2d) 309 (C. C. A. 4th, 1936).

1. The Louisville and Nashville R. R., joint lessee with the Atlantic line, on whose books one-half of the claimed depreciation on the leased property was charged off, did not appeal from the Commissioner's ruling.

2. When the lessee failed to replace original leased property on retirement, he credited the lessor with value at date of lease and offset such credits against charges to the lessor in the value of additions and betterments, for which the lessee was entitled, under the lease, to reimbursement in bonds from the lessor. On a showing that the lessee received bonds only for the difference between such charges and credits, the Board permitted him to deduct the value of the retired leased property, as of the date of the lease, less salvage and prior permitted depreciation, as rental payments. 31 B. T. A. 730, 738–740 (1934). This was not contested on appeal to the Circuit Court.

3. When, however, the lessee invests capital in replacements, he is entitled to depreciation deductions over the useful life or the remaining term of the lease, whichever is shorter. See Atlantic Coast Line R. R. v. Comm'r of Int. Rev., 31 B. T. A. 730, 738 (1934); Gen. Coun. Memo. 11933, XII–2 Cum. Bull. 52 (1933). He is not entitled to depreciate additions and betterments, however, since he receives reimbursement for these expenditures from the lessor. *Id.* at 736; see note 9, *infra.*

4. Atlantic Coast Line R. R. v. Comm'r of Int. Rev., 81 F. (2d) 309 (C. C. A. 4th, 1936), *cert. denied,* 80 Sup. Ct. (L. Ed.) 673 (April 6, 1936), *rehearing denied,* 80 Sup. Ct. (L. Ed.) 787 (May 4, 1936).

The depreciation deduction from gross income uniformly permitted by the Revenue Acts since 1913[5] is an allowance for the consumption of capital during the year, through the wear and tear of capital assets in excess of ordinary repairs and maintenance.[6] The deduction thus represents a contribution of capital to offset a loss of capital,[7] which is not taxable under the 16th Amendment.[8] Accordingly, when the investor is subsequently to receive a complete capital reimbursement for all loss suffered through depreciation of his property, he is considered not to be entitled also to a tax-free increase of capital via a statutory deduction.[9] On this principle, the decisions have uniformly denied the lessor a depreciation deduction where, as in the present case,[10] the lessee has contracted to replace the leased property or to restore its equivalent on termination of the lease.[11] Under such circumstances, property depreciation does not diminish the lessor's capital investment, and denial of the deduction by the principal court seems clearly justified.

On the other hand, the courts have been equally firm in denying a depreciation allowance to a lessee who has made no capital investment,[12] even where the long-term lease was regarded under state law as a conveyance

5. Also permitted under the Corporation Tax Law of 1909, 36 STAT. 113.

6. See United States v. Ludey, 274 U.S. 295, 300 (1927); Lindheimer v. Illinois Bell Telephone Co., 292 U.S. 151, 167 (1934).

7. See City of Knoxville v. Knoxville Water Co., 212 U.S. 1, 13 (1909); U.S. Treas. Reg. 86, Art. 23(1)—1.

8. See United States v. Blow and Chatfield-Taylor, 77 F. (2d) 141, 143 (C.C.A. 7th, 1935). But *cf.* Horne, *The Accrual Method of Calculating Taxable Net Income* (1931) 9 TAX MAG. 9, 12.

9. On the principle that the element of reimbursement defeats any deduction for losses or expenses. Glendinning, McLeish & Co. v. Comm'r of Int. Rev., 61 F. (2d) 950 (C.C.A. 2d, 1932); *cf.* New York, C. & St. L. R. R. v. Helvering, 71 F. (2d) 956, 959 (App. D. C. 1934).

10. The actual obligation of the lessee was to return the leased property at the end of the lease "in good order and condition, ordinary wear and tear excepted." The covenant was interpreted by the Board, and apparently by the lessee also, as an obligation to restore property actually equivalent in value. See Atlantic Coast Line R. R. v. Comm'r of Int. Rev., 31 B.T.A. 730, 735 (1934); but *cf.* Terminal Realty Corp. v. Comm'r of Int. Rev., 32 B.T.A. 623 (1935).

11. Comm'r of Int. Rev. v. Terre Haute Electric Co., 67 F. (2d) 697 (C.C.A. 7th, 1933), *cert. denied,* 292 U.S. 624 (1934); Georgia Ry. & Electric Co. v. Comm'r of Int. Rev., 77 F. (2d) 897 (C.C.A. 5th, 1935), *cert. denied,* 296 U.S. 601 (1935); A. Wilhelm Co., 6 B.T.A. 1 (1927). But where the lessee is not under obligation to restore the equivalent of the leased property, the lessor is entitled to depreciation deductions. Richmond Belt Ry. v. Comm'r of Int. Rev., 13 B.T.A. 1291 (1928).

12. Weiss v. Wiener, 279 U.S. 333 (1929); Brevoort Hotel Co. v. Reinecke, 36 F. (2d) 51 (C.C.A. 7th, 1929); Belt Ry. of Chicago v. Comm'r of Int. Rev., 36 F. (2d) 541 (App. D. C. 1929), *cert. denied,* 281 U.S. 742 (1930); Tunnel R. R. of St. L. v. Comm'r of Int. Rev., 61 F. (2d) 166 (C.C.A. 8th, 1932), *cert. denied,* 288 U.S. 604 (1933); New York Central R. R. v. Comm'r of Int. Rev., 79 F. (2d) 247 (C.C.A. 2d, 1935), *cert. denied,* 296 U.S. 653 (1935); William J. Ostheimer, 1 B.T.A. 18 (1924); Ohio Cloverleaf Dairy Co. v. Comm'r of Int. Rev., 13 B.T.A. 1320 (1928); *aff'd without opinion,* 34 F. (2d) 1022 (C.C.A. 6th, 1929).

of the fee.[13] If the premise is accepted that the principal function of the deduction is to maintain the integrity of the taxpayer's original investment,[14] the lessee is refused the allowance under the theory that his capital is not diminished by depreciation of the leased property. Likewise, if emphasis is shifted to the view that the depreciation charge is incurred as an operating expense for the primary purpose of determining the correct cost of operations,[15] the lessee is still not granted the allowance, on the ground that exhaustion of the lessor's capital in leased property does not represent an "actually sustained" expense of operation to the lessee. The existence of an obligation to restore the equivalent of the leased property on termination of the lease is held not to alter the situation—for the expenditure is considered at most a future one, and the statutory deduction has been interpreted to require an "actual and present" loss.[16] Only where the lessee actually invests capital[17] in improvements[18] or replacements,[19] or where he makes a separable purchase of depreciable property on the land leased,[20] is he thereafter allowed

13. See Weiss v. Wiener, 279 U. S. 333, 337 (1929).

14. This has been termed the "engineering" viewpoint on depreciation as distinguished from that of the "accountant," where stress is laid on the necessity of the deduction to determine true cost of production. 2 KESTER, ACCOUNTING THEORY AND PRACTICE (3d ed. 1933) 245–246. The two standpoints represent a difference in emphasis rather than a conflict of views.

15. See note 14, *supra*. For an exposition of the "accountant's" theory of depreciation, see HATFIELD, ACCOUNTING (1928) 131, 133–135; Brandeis J., dissenting, in United Railways v. West, 280 U. S. 234, 260 *et seq.* (1930).

16. Weiss v. Wiener, 279 U. S. 333 (1929).

17. While the courts have consistently demanded an initial capital outlay before conceding a deduction for depreciation, [*cf.* Rose v. Grant, 39 F. (2d) 338 (C. C. A. 5th, 1930) (right of a life tenant to deduct depreciation, distinguishable because of the freehold interest)] a capital investment in the same sense has not been required in cases involving depletion, although the function of the allowance in each case is identical. United States v. Ludey, 274 U. S. 295 (1927); Pugh v. Comm'r of Int. Rev., 49 F. (2d) 76 (C. C. A. 5th, 1931), *cert. denied*, 284 U. S. 642 (1931). For a general discussion of the depletion allowance, see Beveridge, *Depletion of Oil and Gas Properties* (1936) 14 TAX MAG. 67; 2 PAUL & MERTENS, THE LAW OF INCOME TAXATION (1934) 682 *et seq.* In permitting the non-investing lessees of mineral property to deduct depletion allowances, the courts have apparently felt that the holders of mineral leases were entitled to special treatment, in view of the fact that with the removal of each mineral unit the operating right and business existence of the lessee under the lease is correspondingly diminished. Lynch v. Alworth-Stephens Co., 267 U. S. 364 (1925); see Weiss v. Wiener, 279 U. S. 333, 336 (1929); 2 PAUL AND MERTENS, *op. cit. supra*, at 688. Depletion deductions are apportioned between lessor and lessee under the Revenue Acts since 1918 inclusive.

18. Duffy v. Central R. R. of N. J., 268 U. S. 55 (1925); Gladding Dry Goods Co., 2 B. T. A. 336 (1925). Even a tenant at will may deduct depreciation on improvements. Simons Brick Co. v. Comm'r of Int. Rev., 45 F. (2d) 57 (C. C. A. 9th, 1930), *cert. denied*, 283 U. S. 834 (1931).

19. See note 3, *supra*.

20. Cogar v. Comm'r of Int. Rev., 44 F. (2d) 554 (C. C. A. 6th, 1930); G. S. Stewart Co., 2 B. T. A. 1016 (1925).

a deduction for depreciation.[21] Similarly, where the court believes that the lease is merely a device in aid of a borrowing scheme and that the technical lessee remains in effect an owner-mortgagor, the lessee may charge off depreciation on the leased property.[22]

Although the depreciation deduction, under similar circumstances, has been denied particular lessees[23] and also particular lessors,[24] the issues, in the instant case, are dramatized by the fact that the decision of the court is the first in which the allowance has been refused both lessor and lessee under the same lease.[25] In the light of the flat statutory provisions for the deduction, hortatory in form,[26] the result reached appears to be paradoxical. Under pertinent Treasury regulations, however, neither party is penalized in the amount of the deductions to which he will potentially be entitled. Upon expiration of 999 years, the lessor will be permitted to depreciate the value of the leased property, as of the date of the lease, over the remaining useful life of equivalent property returned to him;[27] and the lessee will be entitled to deduct accelerated depreciation in the closing years of the lease.[28]

Although both the lessor and the lessee can thus take their deductions, postponement of the lessee's allowance until the closing years of the lease seems to work hardship upon him. The dictates of correct accounting, as recognized by the Interstate Commerce Commission,[29] call for a readjustment of the timing and basis of the lessee's depreciation deductions. By permitting the lessee immediately to accrue depreciation of the originally leased property over the remainder of its useful life, in place of taking accelerated depreciation on replacements made in the closing years of the lease, the net income of the lessee during the early and the closing years of the lease would be

21. For a general discussion of the allowance to lessees, see Lavery, *Some Phases of the Deduction for Depreciation under Long Term Leases* (1929) 3 U. OF CIN. L. REV. 444.

22. Comm'r of Int. Rev. v. H. F. Neighbors Realty Co., 81 F. (2d) 173 (C. C. A. 6th, 1936); F. and R. Lazarus & Co., 32 B. T. A. 633 (1935). But *cf.* City Nat. Bank Bldg. Co. v. Comm'r of Int. Rev., 34 B. T. A., March 10, 1936.

23. See note 12, *supra.*

24. See note 11, *supra.*

25. But such a situation was discussed *arguendo* in New York Central R. R. v. Comm'r of Int. Rev., 79 F. (2d) 247 (C. C. A. 2d, 1935), *cert. denied,* 296 U. S. 653 (1935), although the case only involved the rights of a lessee.

26. "In computing net income there shall be allowed as deductions . . . a reasonable allowance for the exhaustion, wear and tear of property used in the trade or business, including a reasonable allowance for obsolescence." Revenue Act of 1928, 45 STAT. 799, 800, 26 U. S. C. § 23 (1934).

27. GEN. COUN. MEMO. 11933, XII-2 CUM. BULL. 52 (1933); see 2 PAUL AND MERTENS, THE LAW OF FEDERAL INCOME TAXATION (1934) 626.

28. See note 3, *supra.* The accelerated depreciation is granted the lessee in lieu of depreciation deductions denied on the originally leased property. However, an exact equivalent is not substituted insofar as retirement without replacements are made during the lease for which the lessee is obligated to reimburse the lessor and entitled to take deductions. See note 32, *infra.*

29. See Atlantic Coast Line R. R. v. Comm'r of Int. Rev., 81 F. (2d) 309, 310 (C. C. A. 4th, 1936).

more accurately reflected than under the legally accepted scheme whereby such net income is swelled in the early period and contracted in the later. It is true that the lessee made no present investment in the property acquired from the lessor in the sense of an outright purchase, and that title to this property remains in the lessor. Nevertheless, realistically viewed, it is the lessee's property,[30] he must replace it when worn out, and its depreciation during useful life is incurred in producing the income upon which he is taxed.[31] In substance, the transaction amounts to a purchase of the property upon deferred credit in the form of an obligation to return to the lessor equivalent property upon termination of the lease.[32] The fact that this payment is delayed[33] and indirect, does not alter the fundamental accounting requirement that depreciation must be accrued over the useful life of purchased capital assets in order truly to reflect the income of that period.[34] While a determination of what is good accounting does not always solve the question of what the taxing statutes permit,[35] the stipulation of the Revenue Act that the taxpayer's method of accounting shall "clearly reflect income" must be given due weight.[36] The court's refusal, therefore, to permit the depreciation deductions during useful life can be attributed only to reluctance to deviate from cash-receipts-and-disbursements accounting in the direction of the accrual system, and to an adherence to the technical concepts of the law of property with its emphasis on the situs of title instead of the practical indicia of ownership.

However, if the lease is to be literally construed as conferring on the lessee merely the interest of a holder for years, he should still be entitled from both legal and accounting standpoints to anticipate his future liability by yearly deductions for a restoration reserve[37] over the useful life of the

30. See note 22, *supra*, for cases in which the court looked through the form to the substance of a leasing transaction in holding that the technical lessee was the real owner for purposes of depreciation.

31. See Judge Parker concurring specially in Atlantic Coast Line R. R. v. Comm'r of Int. Rev., 81 F. (2d) 309, 312 (C. C. A. 4th, 1936).

32. This obligation is reduced to the extent that the lessee reimburses the lessor for retirements without subsequent replacement (including retirements of originally leased property, of additions and betterments, and of all replacements of either); and is increased to the extent that the lessor reimburses the lessee for additions and betterments.

33. The Board held that the lessor's bonds, which amounted to mere promises to pay at termination of the lease, and then without interest, were a present capital reimbursement for additions and betterments. See note 3, *supra*. Consistency would appear to require an analogous construction of the lessee's promise to restore equivalent property after 999 years as amounting to an effective, present capital reimbursement for the original leased property.

34. HATFIELD, ACCOUNTING (1928) 130 *et seq.*

35. See Weiss v. Wiener, 279 U. S. 333, 335 (1929); 1 PAUL AND MERTENS, THE LAW OF FEDERAL INCOME TAXATION (1934) 576; 2 *id.* at 622–623.

36. 45 STAT. 805 (1928), 26 U. S. C. § 41 (1934).

37. Hatfield argues that the use of the term "reserve" in referring to a liability is terminologically incorrect. "Instead of representing something held in reserve (from surplus) it represents something that is nonexistent". HATFIELD, ACCOUNTING (1928)

property acquired under the lease.[38] In view of the lessee's obligation to replace and restore the leased property, the annual wear and tear of equipment should still be considered an operating expense properly attributable to the earnings of the taxable period, under the accounting requirement of including related items of income and expense in the same fiscal period.[39] It may be true that reserves are not favored by the courts or the Treasury,[40] but reserves for the amortization of bond discounts, a future liability of contractual origin, have been held proper and necessary in order clearly to reflect the taxpayer's income.[41] The lessee's liability under his covenant seems definite enough,[42] and even if he were able to escape his obligation, the government is normally in a position to recoup, merely by adding to its taxable income for the ensuing year the amount of the deductions for depreciation or restoration reserve previously allowed.[43] If such annual allowances are not permitted in one form or the other, the distortion of the lessee's income under the plan approved by the court creates the possibility of injustice to the taxpayer in the contingency that accelerated depreciation in the closing years of the lease should exceed taxable income. With the elimination of the net loss provision of the Revenue Acts[44] and the increasingly heavy corporate taxes now in effect, such overpayments may severely penalize a leased road.

298–302. But see 2 KESTER, ACCOUNTING THEORY AND PRACTICE (3d ed. 1933) 571–578.

38. See Roberts, *Depreciation Allowances to Lessees* (1929) 7 TAX MAG. 221. The Interstate Commerce Commission requires deductions in order adequately to reflect earnings for rate making purposes.

39. United States v. Anderson, 269 U.S. 422 (1926); see Gaskill, *Accounting Methods and the Income Tax* (1930) 8 TAX MAG. 365.

40. Gude Brothers. Kiefer and Co., 2 B. T. A. 1029 (1925); see 1 PAUL AND MERTENS, THE LAW OF FEDERAL INCOME TAXATION (1934) 583.

41. Helvering v. Union Pac. R. R., 293 U.S. 282 (1934), noted (1935) 9 ST. JOHN'S L. REV. 437; New York Central R. R. v. Comm'r of Int. Rev., 79 F. (2d) 247 (C.C.A. 2d, 1935), *cert. denied*, 296 U.S. 653 (1935). Furthermore, reserves have been permitted in anticipation of an admitted liability to respond in damages for breach of contract, even where the amount and date of the liability were uncertain. Fraser Brick Co., 10 B.T.A. 1252 (1928).

42. Assignment of the lease does not discharge the lessee's obligation, although his liability, of course, might be voided by agreement with the lessor. The Court held the lessee's covenant and liability absolute in order to bar deduction by the lessor, but viewed it as contingent to deny the allowance to the lessee!

43. The Treasury has provided for such procedure in the case of depletion deductions allowed a lessor on an advance bonus payment. "In such case, if there is no production from the leased premises, the taxpayer must restore the amount of deductions to his income as of the year of termination of the lease." GEN. COUN. MEMO. 14448, XIV–17–7383, p. 4 (1935).

44. This provision was repealed June 16, 1933. 48 STAT. 209 (1933), 26 U.S.C. § 23 (1934).

## BANKER'S RIGHT TO SET OFF DEPOSIT AGAINST UNMATURED NOTE OF INSOLVENT CUSTOMER*

THE MAJORITY of states either by statute[1] or judicial decision[2] permit a bank, upon learning that its depositor has become insolvent, to apply deposits against unmatured obligations of the insolvent depositor. Since under this rule the bank determines the insolvency of the customer,[3] a number of states, fearing to give so much discretion to the bank, do not permit the set-off until there has been an adjudication of insolvency.[4] The majority rule seems sounder, for it permits the bank to protect itself more expeditiously, but does not unduly prejudice other creditors over whom the bank is preferred under either rule;[5] and the depositor who is not in fact insolvent has an adequate remedy for an arbitrary or unreasonable set-off by the bank.[6]

In those states which do not permit the set-off before an adjudication of insolvency, special circumstances are usually excepted from the force of the rule. Thus, if the depositor failed to disclose his true financial condition and was insolvent when the obligation was created, a finding of fraud seems unavoidable.[7] This would permit the bank to rescind the transaction immediately upon discovery of the fraud and set off the unmatured obligation against the deposit[8] even without notice to the depositor.[9]

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*Harding v. Broadway National Bank, 200 N. E. 386 (Mass. 1936).

1. N. Y. DEBTOR AND CREDITOR LAW § 151; see Updike v. Manufacturers' Trust Co., 243 App. Div. 15, 16, 275 N. Y. Supp. 716, 717 (1st Dep't 1934), *aff'd*, 267 N. Y. 528, 196 N. E. 563 (1935).

2. United States v. Bank of Shelby, 68 F. (2d) 538 (C. C. A. 5th, 1934); Kane v. First National Bank of El Paso, 56 F. (2d) 534 (C. C. A. 5th, 1932); Minge v. First National Bank of Birmingham, 191 Ala. 271, 68 So. 141 (1915); Parker v. First National Bank of Muldrow, 96 Okla. 70, 220 Pac. 39 (1923); 7 ZOLLMAN, BANKS AND BANKING (1936) § 4471; notes (1926) 43 A. L. R. 1325, (1927) 51 A. L. R. 1477.

3. Insolvency in this connection means that the depositor cannot pay his debts as they fall due. Parker v. First National Bank of Muldrow, 96 Okla. 70, 220 Pac. 39 (1923). The same court suggested that this rule may be too rigorous. Zollinger v. First National Bank of Oklahoma City, 126 Okla. 182, 259 Pac. 141 (1926).

4. Sullivan v. The Merchants National Bank, 108 Conn. 497, 144 Atl. 34 (1928); Wiley v. Bunker Hill National Bank, 183 Mass. 495, 67 N. E. 655 (1902); Rogosin v. City Trust Co. of Passaic, 107 N. J. Eq. 79, 151 Atl. 834 (Ch. 1930); Kurtz v. County National Bank of Clearfield, 288 Pa. 472, 136 Atl. 789 (1927).

5. Thus under the Federal Bankruptcy Act the bank may set off before the petition is filed. Studley v. Boylston National Bank, 229 U. S. 523 (1913). Because the bank would receive a preference over other creditors, a set-off is not allowed even after the appointment of a receiver. Blum Bros. v. Girard National Bank, 248 Pa. 148, 93 Atl. 940 (1915).

6. Monier v. Guaranty Trust Co. of New York, 82 F. (2d) 252 (C. C. A. 2d, 1936).

7. *In re* K. Marks & Co., 218 Fed. 453 (C. C. A. 2d, 1914); (1935) 44 YALE L. J. 690, 692.

8. Bradley v. Seaboard National Bank, 167 N. Y. 427, 60 N. E. 771 (1901); Andrews v. The Artisans' Bank, 26 N. Y. 298 (1860); Paoli v. East River National Bank, 92 Misc. 153, 155 N. Y. Supp. 245 (Sup. Ct. 1915); Mann v. Franklin Trust Co., 158 App. Div. 491, 143 N. Y. Supp. 660 (2d Dep't 1913).

9. Wolf v. National City Bank of New York, 170 App. Div. 565, 156 N. Y. Supp. 575 (1st Dep't 1915).

Furthermore, in states which adhere to the minority rule, the bank may protect itself by specific agreement with the depositor.[10] Such agreements are usually found in the provisions of the credit statement which the bank requires to be filled out and signed when the customer applies for a loan.[11] The credit statement ordinarily contains a summary of the financial condition of the applicant, and printed provisions to the effect that the customer is submitting a true statement of his financial condition and that the bank may declare any claim against the customer immediately due and payable if it appears that the customer has misrepresented his financial condition, has failed to notify the bank of any material change, or is insolvent.[12] Provisions such as these have been interpreted to be part of the loan agreement and to permit the bank to set off according to the provisions of the credit statement[13] even in states where insolvency of itself does not give a right of set-off.[14] The protection thus afforded the bank seems reasonable in light of the importance of accurate credit statements to a bank in making loans.[15]

The Supreme Judicial Court of Massachusetts, which has adhered to the minority rule requiring an adjudication of insolvency before a bank can set off deposits against the unmatured obligation of the insolvent,[16] recently reached a result which denies the bank the protection of set-off under circumstances which are normally considered exceptions to the minority rule: undisclosed insolvency at the time the loan was made, and a special agreement permitting a set-off in the event of insolvency, or on the discovery of untruth in the customer's statement. A company engaged in selling automobiles desired to open a commercial account in the defendant bank. Before making the loan, the bank required the company to fill out and sign a credit statement similar to those already described. Thereafter the defendant bank made loans to the company from time to time in compliance with their loan agreement, taking notes as collateral security; and the customer supplied up-to-date credit statements, the last of which was as of July 31, 1931. Shortly thereafter the company became insolvent, but did not disclose this fact to the bank, which on June 8, 1932, renewed a note of $2,800 for one month. Three days later the bank discovered the company's insolvency and

10. Wright v. Seaboard Steel & Manganese Corp., 272 Fed. 807 (C. C. A. 2d, 1921); American Bank & Trust Co. v. Morris, 16 F. (2d) 845 (C. C. A. 4th, 1927); Southwark National Bank v. Beck, 98 Pa. Super. 213 (1930).

11. KNIFFIN, THE PRACTICAL WORK OF A BANK (8th ed. 1934) 320, 323, 325.

12. For examples of these provisions in credit statements, see Harding v. Broadway National Bank of Chelsea, 200 N. E. 386, 387 (Mass. 1936); Corn Exchange National Bank v. Locher, 151 Fed. 764 (C. C. A. 3d, 1907).

13. Updike v. Manufacturers' Trust Co., 243 App. Div. 15, 275 N. Y. Supp. 716 (1st Dep't 1934), *aff'd*, 267 N. Y. 528, 196 N. E. 563 (1935); See Corn Exchange National Bank v. Locher, 151 Fed. 764, 766 (C. C. A. 3d, 1907).

14. American Bank & Trust Co. v. Morris, 16 F. (2d) 845 (C. C. A. 4th, 1927); Southwark National Bank v. Beck, 98 Pa. Super. 213 (1930); Steiner v. Mutual Alliance Trust Co. of New York, 139 App. Div. 645, 124 N. Y. Supp. 184 (1st Dep't 1910) (Decided before passage of N. Y. DEBTOR AND CREDITOR LAW § 151).

15. Kniffin, *op. cit. supra* note 11, 359, 377.

16. Wiley v. Bunker Hill National Bank, 183 Mass. 495, 67 N. E. 655 (1902).

immediately notified the company that it was setting off against the note the balance of $1,673.64 standing in the company's account. Shortly thereafter, the company's petition for dissolution was filed and the receiver brought suit against the bank for breach of contract, asking as damages the balance of the account which the bank had charged off against the note. The bank maintained that the credit statement gave it the right to accelerate the note and to take the set-off. The lower court found that the company had been insolvent for a long time prior to the renewing of the last note and that the bank had relied on the credit statements in making its loans, but held that the insolvency did not give the bank the right of set-off, the provisions of the credit statement not being incorporated into the note so as to give the bank such a right. On appeal, the findings and judgment of the lower court were affirmed.[17]

The issue of whether the fraudulent conduct on the part of the company by itself justified the set-off may not have been pressed by counsel, and certainly was not decided by the court, although the undisputed facts and findings of the court should clearly permit the set-off on this ground.[18] Furthermore, the refusal of the court to construe the provisions of the credit statement and the note as parts of a single contract, so as to allow the set-off, seems entirely inconsistent with the previous cases on this point.[19] The court appears to have failed to treat the loan agreement between a commercial bank and its customer realistically. The loan agreement, made against the background of a current account, may well be considered to consist of an exchange of the following promises, implied in fact from the observed usage of the business community, and here made concrete in the documents which passed between the parties.[20] The customer promises to pay at the end of the agreed period, not the face value of any one of the notes given by him, but the amount of the debit balance then standing in his current account. The bank promises to make loans by accepting, and perhaps by renewing, the customer's notes, and then by honoring the customer's checks against the customer's credit balance, including the amount of the customer's notes less discount, until the expiration of the agreed period.[21] Moreover, this promise by the bank may be subject to implied conditions, one of which is that the bank may terminate the loan agreement at once if, before the end of the loan period, the customer becomes insolvent.

17. Harding v. Broadway National Bank of Chelsea, 200 N. E. 386 (Mass. 1936).

18. See cases *supra,* note 8.

19. See cases *supra,* note 13.

20. Moore and Sussman, *Legal and Institutional Methods Applied to the Debiting of Direct Discounts* (1931) 40 YALE L. J. 381, 389. If the action were on the note it is probably true that under the parole evidence rule extrinsic evidence would not be admissible to vary the time of maturity expressed in the note. Hall v. Bank, 173 Mass. 16, 53 N. E. 154 (1899); NORTON, BILLS AND NOTES (4th ed. 1914) 109; 5 WIGMORE, EVIDENCE (1923) 337. However, in an action, as in the present case, for the bank's breach of the loan agreement in failing to pay over the depositor's credit balance, evidence of the terms of the loan agreement should be admissible. Roe v. Bank of Versailles, 167 Mo. 406, 67 S. W. 303 (1902).

21. Moore and Sussman, *op. cit. supra* note 20, 395.

The majority rule in effect recognizes this condition[22] and the provisions of the credit statement in the present case do no more than make it express. Under the rule of the present case, the only way such conditions may be made effective is apparently by incorporating the acceleration conditions printed on credit statements into the note by specific reference.

## Repudiation of Disability Insurance Clauses *

An insurance company under a typical disability clause in a life insurance policy, which provided for waiver of premiums and an agreed monthly income in the event of total and permanent disability, denied, after paying monthly benefits for about two years, that the insured was any longer so disabled. Upon refusal by the insured to resume the payment of premiums and after the expiration of a term of grace, the insurer declared the policy lapsed upon its records, without, however, notifying the insured. In an action by the insured for the total value of the benefits which would have been payable to him during the period of his life expectancy, the Supreme Court of the United States held that there had been no repudiation of the insurer's obligation, since it had acted in good faith in denying its liability within the terms of the contract, but only a partial present breach. There could consequently be no recovery beyond the benefits accrued at the commencement of the action, which were less than the required jurisdictional amount in the federal courts, so that the defendant's demurrer should be sustained.[1]

Prior to the decision in *Federal Life Insurance Company v. Rascoe*[2] no federal and few state courts had recognized a right in an insured to collect future benefits under such contracts where there had been a disavowal of liability by the insurer.[3] Some courts simply followed the rule that there can be no recovery of benefits which have not accrued under a contract which has been completely performed by the plaintiff.[4] In the *Rascoe* case

22. "A banker has ordinarily no right to apply the deposit account to a note not yet due because it is contrary to his obligation to honor checks, but in case of supervening insolvency by the weight of authority that right arises." Kane v. First National Bank of El Paso, 56 F. (2d) 534, 538 (C. C. A. 5th, 1932).

*New York Life Ins. Co. v. Viglas, 297 U. S. 672 (1936).

1. *Ibid., rev'g* Viglas v. New York Life Ins. Co., 78 F. (2d) 829 (C. C. A. 1st, 1935), and affirming the judgment of the District Court for the District of Massachusetts.

2. 12 F. (2d) 693 (C. C. A. 6th, 1926), *cert. denied*, 273 U. S. 722 (1926).

3. The *Rascoe* case was apparently the first in the federal courts involving repudiation of a disability policy. The cases in the state courts are collected in Note (1932) 81 A. L. R. 379.

4. Puckett v. National Annuity Ass'n, 134 Mo. App. 501, 114 S. W. 1039 (1908); Supreme Tent Knights of Maccabees v. Cox, 25 Tex. Civ. App. 366, 60 S. W. 971 (1901); see Note (1932) 81 A. L. R. 379; *cf.* 3 Williston, Contracts (1920) § 1330. This limitation, inspired by the distinction in Roehm v. Horst, 178 U. S. 1, 17 (1899), between unilateral and bilateral contracts with respect to anticipatory breach, was no doubt due in part to the vigorous objections of many authorities to the entire doctrine of anticipatory breach. Greenway v. Gaither, 10 Fed. Cas. No. 5,788 (C. C. D. Md. 1853); Daniels v. Newton, 114 Mass. 530 (1874); see Williston, *Repudiation of Contracts* (1901) 14 Harv. L. Rev. 317, 428.

the Circuit Court of Appeals, endeavoring to avoid this limitation, concluded through a process of rather strained logic that a similar contract fell within the rule applicable to mutually executory agreements: the proofs of continued disability required by the policy were construed not as conditions precedent, but as obligations "which may be enforced by refusal to pay", though concededly not by action on the part of the company.[5] The decision, however, has been expressly and consistently disapproved by the lower federal as well as by several state courts.[6] Recovery has been opposed on various grounds. Some courts have held without more that "there can be no anticipatory breach of a unilateral contract",[7] assuming, perhaps inaccurately, that an alleged breach of this sort *is* an anticipatory one,[8] or have decided, more elaborately, that the doctrine of anticipatory breach does not apply to contracts for the payment of money in future instalments which have been completely executed by the parties on one side.[9] The objection has been made in some instances that, when the damages demanded are the full value of the insurance contract, to be computed necessarily by the use of actuarial data, the amount is so uncertain as to be arbitrary and unfair.[10] The insurer's paying a lump sum rather than periodic instalments during disability has been said in other cases to defeat the intention of the contracting parties.[11] And finally, the recovery of future benefits has been denied on the ground that the refusal to pay accrued instalments is not a breach of future contingent obligations, but a breach only of a present duty.[12]

In this most recent disapproval of the *Rascoe* case, the Court, while averse to the "mechanical application of a uniform formula",[13] is perhaps crystallizing a new one in its use of good faith as a criterion for distinguishing

5. Federal Life Ins. Co. v. Rascoe, 12 F. (2d) 693, 696 (C. C. A. 6th, 1926); *cf.* RESTATEMENT, CONTRACTS (1932) § 318; see Comment (1926) 36 YALE L. J. 263.

6. Mobley v. N. Y. Life Ins. Co., 74 F. (2d) 588, 590 (C. C. A. 5th, 1935), and cases there cited, *aff'd*, 295 U. S. 632 (1935).

7. Cobb v. Pacific Mut. Life Ins. Co., 4 Cal. (2d) 565, 573, 51 P. (2d) 84, 88 (1935), citing 3 WILLISTON, CONTRACTS (1920) § 1328; Parks v. Md. Casualty Co., 59 F. (2d) 736 (W. D. Mo. 1932) *semble*. *Contra:* Pollack v. Pollack, 46 S. W. (2d) 292 (Tex. Comm. App. 1932); see Comment (1926) 36 YALE L. J. 263.

8. See note 21, *infra*.

9. Kithcart v. Metropolitan Life Ins. Co., 1 F. Supp. 719 (W. D. Mo. 1932); Rishmiller v. Prudential Ins. Co., 192 Minn. 348, 353, 256 N. W. 187, 189 (1934); *cf.* Manufacturers' Furniture Co. v. Cantrell, 172 Ark. 642, 290 S. W. 353 (1927). But see Pollack v. Pollack, 46 S. W. (2d) 292, 295 (Tex. Comm. App. 1932); 3 WILLISTON, CONTRACTS (1920) § 1328.

10. Menssen v. Travelers' Ins. Co., 5 F. Supp. 114 (E. D. N. Y. 1933); Howard v. Benefit Ass'n of Railway Employees, 239 Ky. 465, 39 S. W. (2d) 657 (1931). But *cf.* Pierce v. Tenn. Coal, Iron & R. R. Co., 173 U. S. 1, 16 (1899).

11. Smith v. Mutual Benefit Health & Accident Ass'n, 10 F. Supp. 110 (W. D. Okla. 1933); Mid-Continent Life Ins. Co. v. Christian, 164 Okla. 161, 23 P. (2d) 672 (1932); Donlen v. Fid. & Cas. Co., 117 Misc. 414, 192 N. Y. Supp. 513 (Sup. Ct. 1921) (before *Rascoe* case).

12. Brix v. People's Mut. Life Ins. Co., 2 Cal. (2d) 446, 41 P. (2d) 537 (1935); *cf.* Huffman v. Martin, 226 Ky. 137, 10 S. W. (2d) 636 (1928).

13. N. Y. Life Ins. Co. v. Viglas, 297 U. S. 672, 681 (1936).

repudiation of a contract from disavowal of liability within its terms.[14] The early decisions defining repudiation insisted only that it must be absolute and unequivocal.[15] Later, in cases involving a sincere dispute as to the construction of the terms of a contract, some courts, following Mr. Justice Holmes' consideration of the factor of good faith in an early Massachusetts case,[16] held that the promisee could not treat the contract as at an end.[17] The view, however, that the denial in good faith of liability under an unambiguous disability insurance clause is not a legal repudiation, while it has become increasingly popular, is comparatively recent,[18] and in most instances its justification is not considered by the courts.[19] Its acceptance in this case led to the conclusion that the insurance company was not denying its duty to pay monthly benefits if certain conditions precedent existed, but only that those conditions did exist.[20] Nevertheless, whether or not such a disavowal in good faith makes for a technical repudiation, its effect may be no less a deprivation of the insured's benefit payments than would be the effect of a technical repudiation. The insurer's refusal to continue benefits, in good

14. The Circuit Court of Appeals, construing the complaint as alleging an unqualified denial of all liability by the insurer, did not discuss the good faith factor; the case was, of course, decided on a demurrer to the complaint. Viglas v. N. Y. Life Ins. Co., 78 F. (2d) 829 (C. C. A. 1st, 1935). In Mobley v. New York Life Ins. Co., 295 U. S. 632 (1935), the Court had also denied that there had been a repudiation of a disability insurance clause where the insurer had shown good faith, but that case was distinguishable. See N. Y. Life Ins. Co. v. Viglas, 297 U. S. 672, 678 (1936).

15. Smoot's Case, 15 Wall. 36 (U. S. 1872); Dingley v. Oler, 117 U. S. 490 (1886); 3 WILLISTON, CONTRACTS (1920) § 1324.

16. Daley v. People's Bldg., Loan & Savings Ass'n, 178 Mass. 13, 59 N. E. 452 (1901). The association notified the plaintiff in good faith that his stock was forfeited. The suit, however, was for rescission, and the possibility of a suit to enforce the contract was expressly left open.

17. Kimel v. Mo. State Life Ins. Co., 71 F. (2d) 921 (C. C. A. 10th, 1934), (1935) 35 COL. L. REV. 105; Southern Publishing Ass'n v. Clements Paper Co., 139 Tenn. 429, 201 S. W. 745 (1918); Bare v. Victoria Coal & Coke Co., 73 W. Va. 632, 80 S. E. 941 (1914). *Contra:* Armstrong v. St. Paul & Pac. Coal Co., 48 Minn. 113, 50 N. W. 1029 (1892); De Mille Co. v. Casey, 115 Misc. 646, 189 N. Y. Supp. 275 (Sup. Ct. 1921); Clausen v. Canada Timber & Lands, Ltd., [1923] 4 D. L. R. 751 (P. C.).

18. Wyll v. Pacific Mut. Life Ins. Co., 3 F. Supp. 483 (N. D. Tex. 1933); Jefferson Standard Life Ins. Co. v. Slaughter, 190 Ark. 402, 79 S. W. (2d) 58 (1935); Ind. Life Endowment Co. v. Reed, 54 Ind. App. 450, 103 N. E. 77 (1913); *cf.* Mutual Life Ins. Co. v. Marsh, 186 Ark. 861, 56 S. W. (2d) 433 (1933). *Contra:* Protective Mut. Life Ins. Ass'n v. Duke, 91 S. W. (2d) 753 (Tex. Civ. App. 1936); *cf.* Ill. Bankers' Life Ass'n v. Armstrong, 100 Ind. App. 696, 710, 192 N. E. 901, 907 (1934) (declaration of lapse held evidence by which jury "could well have found" repudiation).

19. *E. g.*, National Life & Accident Ins. Co. v. Whitfield, 186 Ark. 198, 53 S. W. (2d) 10 (1932); Robbins v. Travelers Ins. Co., 151 Misc. 151, 269 N. Y. Supp. 841 (Sup. Ct. 1934). Actually there is no question of an intentional abandonment in most cases.

20. An actual declaration of lapse would, of course, amount to a denial of the insurer's duty to pay benefits even if the conditions precedent did exist, unless the lapse were conditioned on reinstatement upon a showing that the company's judgment had been in error.

faith or bad, would seem clearly to have been a partial present breach of the contract here—not strictly an anticipatory breach, as the Court observed[21] —which effected a "frustration of the ends it was expected to subserve",[22] and consequently went to the essence of the contract.[23] It is poor consolation for a person who is presumably totally and permanently disabled that there remains to him the benefit of the stipulated cash surrender, paid up policy or extension of time privileges. It would seem more equitable, if the effect is the same, to treat the good or bad faith of the insurer not as a conclusive guide, but as one factor in determining the reparation to be awarded in a particular case.

At the same time, although the ends of a contract have been frustrated by the insurer's treating it as lapsed, it does not follow necessarily that the insured, in order to be given full reparation, should recover the total present value of all the benefits that would have been payable to him had the policy remained in force. An immediate award of future benefits seems an unjust penalty for a test of liability which may have been made in good faith,[24] particularly with respect to a type of insurance which has caused its issuers increasingly great losses.[25] A judgment based upon actuarial data is, moreover, at best highly speculative in the case of an individual life expectancy, and even more so in the case of a person whose life expectancy has probably been diminished by his total and permanent disability. When, in addition, the duty of the insurer is conditioned not only upon the life of the insured, but upon his continued disability, as it is in disability policies, the measure of damages is obviously not a matter for mortality tables. The insured might, however, sue for the accrued payments and for a declaratory judgment establishing his right to future benefits,[26] or the same result might be accomplished in the form of an equitable decree.[27] In either case provision

21. N. Y. Life Ins. Co. v. Viglas, 297 U. S. 672, 681 (1936).

22. *Id.* at 680.

23. See Helgar Corp. v. Warner's Features, Inc., 222 N. Y. 449, 453, 119 N. E. 113, 114 (1918).

24. See Kimel v. Mo. State Life Ins. Co., 71 F. (2d) 921, 923 (C. C. A. 10th, 1934).

25. See PATTERSON, CASES AND MATERIALS ON INSURANCE (1932) 325; Ackerman, *Anticipatory Repudiation and Disability Insurance* (1936) 1 NEWARK L. REV. 47.

26. Brix v. People's Mut. Life Ins. Co., 29 P. (2d) 233 (Cal. App. 1934), *rev'd*, 37 P. (2d) 448 (Cal. 1934); *cf.* Bullas v. Empire Life Ins. Co., [1931] 4 D. L. R. 443 (Ont.); Killian v. Metropolitan Life Ins. Co., 251 N. Y. 44, 48, 166 N. E. 798, 800. *Contra:* Green v. Inter-Ocean Cas. Co., 203 N. C. 767, 167 S. E. 38 (1932).

27. *Cf.* Equitable Life Assurance Soc. v. Branham, 250 Ky. 472, 63 S. W. (2d) 498 (1933) ("continuing judgment"); see Note (1935) 99 A. L. R. 1171, 1177; Ackerman, *supra* note 25, at 71. But see Brix v. People's Mut. Life Ins. Co., 2 Cal. (2d) 446, 450, 41 P. (2d) 537, 539 (1935). In cases like the instant one, in which the requirement of jurisdictional amount must be satisfied, it would seem that the maximum benefits recoverable in the event of a judgment or decree for the plaintiff should govern, even if the damages as awarded turn out to be a lesser sum than the jurisdictional amount; for "The amount in controversy is the sum claimed by the plaintiff in his complaint in good faith where he is entitled to recover that sum, if the evidence sustains his allegations." 1 HUGHES, FEDERAL PRACTICE JURISDICTION AND PROCEDURE (1931)

should be made for subsequent relitigation of the question of disability. Shifting the burden of showing a termination of disability to the insurer upon reopening of the judgment or decree would have the effect of discouraging arbitrary and frequent relitigation by the company.[28] These remedies would not preclude an immediate award of past and future benefits where such a course would be warranted, as in a case, for example, where the insurer "wilfully and contumaciously" harasses the insured.[29] This solution would seem to be a more practical and equitable one than either an "acceleration of future benefits",[30] which are necessarily speculative, or an award simply of the benefits which have accrued at the time of suit, with the attendant hazard of recurrent litigation in the event of repeated denials of payments by the insurer.

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§ 429; *cf.* Commercial Cas. Ins. Co. *v.* Humphrey, 13 F. Supp. 174, 178 (S. D. Tex. 1935).

28. It would also restore the value of the claim of the insured for purposes of assignment, which may have been materially decreased by the initial repudiation.

29. See Cobb v. Pacific Mut. Life Ins. Co., 4 Cal. (2d) 565, 574, 51 P. (2d) 84, 88 (1935).

30. N. Y. Life Ins. Co. v. Viglas, 297 U.S. 672, 682 (1936).