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TICKET SCALPING AND DUE PROCESS OF LAW

In *Tyson v. Banton*, 47 Sup. Ct. 426 (1927) the United States Supreme Court, speaking through Mr. Justice Sutherland, held unconstitutional a New York statute requiring that the price be printed on the face of theater tickets and forbidding the resale of tickets at more than fifty cents in excess of such price. Four members of the court dissented: Justices Holmes, Stone, Sanford and Brandeis. The opinion of the court takes the

view that theaters are not affected with a public interest, and that therefore the law-making body may not fix the maximum amount of the charge for tickets. This view is supported by the authority of Lord Chief Justice Hale and by the statement that the price of theater tickets may no more be regulated than the price of provisions or clothing.

Mr. Justice Sutherland states the issue in such a manner as to lend support to the result reached in his opinion. But can it properly be said that the issue is one of price-fixing, when there was no effort to control the price as such, but only the additional charge on resale? The control, it is true, is of one element of price in sale through ticket brokers. And this presents the real issue of the case. The theater itself having fixed what it must have regarded as a reasonable price for tickets, does the public interest justify a prohibition of profit in excess of fifty cents per ticket by brokers who, in fact, by contract with the theaters, control a monopoly of the best seats in substantially all the first class theaters? The reasonableness of the limitation to a fifty cent profit was apparently not questioned, had the court found that power existed to impose a limitation.

The record in this case seems to show that ticket brokers in the borough of Manhattan annually sell about two million tickets, and have a practical monopoly of the best seats in the first class theaters. These facts lead to the conclusion that there is a public interest justifying the regulation of this practice. The dissent of Mr. Justice Stone is more convincing than the opinion of the court, and the dissents of Justices Holmes and Sanford add weight to this conclusion.

While denying legislative power to fix prices for theatrical performances, Mr. Justice Sutherland recognizes some public interest in the control of the sale of theater tickets. He speaks approvingly of the case of *People v. Thompson*, 283 Ill. 87, 119 N. E. 41 (1918) which upheld an ordinance of the city of Chicago requiring that the price of every theater ticket be printed on its face and forbidding any proprietor or employee of a theater to receive or enter into any arrangement or agreement to receive more. Mr. Justice Sutherland speaks of this ordinance as effective. Possibly he has never sought to purchase theater tickets in Chicago. Neither the Chicago ordinance nor the New York statute attempted to fix the price to be charged by the proprietor. The Chicago ordinance is largely unenforceable because of the difficulty of proof. The New York statute adopts an objective and enforceable standard for the effective accomplishment of the result aimed at but not achieved by the Chicago ordinance. The purpose of preventing a confederation of theater owners and ticket scalpers is the same in both cases, as is also the purpose of requiring somewhat equal treatment of those

buying tickets from the theater and of those buying from scalpers who are selling by virtue of contractual relations with the theater. Mr. Justice Sutherland speaks of the ticket broker as "a mere appendage of the theater." The essential difference is that in the New York case the confederation was apparently admitted in the record, and the theater proprietors receive an advantage in the certainty of sale of tickets rather than in increased price of admission. The decision does not point out why it is proper to forbid direct profit by the theater as in the Chicago ordinance but improper to control an indirect but substantially equivalent profit.

The Mr. Justice Sutherland who wrote the ticket scalping opinion is not the Mr. Justice Sutherland who in the present term of the Supreme Court wrote the opinion in *Euclid v. Ambler Realty Company*, 47 Sup. Ct. 114. Speaking for the court in that case, he said that the power to regulate the erection of buildings by zoning ordinances "is to be determined, not by an abstract consideration of the building or the thing considered apart, but by considering it in connection with the circumstances and the locality." In the *Euclid* case he said for the court that the scope of application of constitutional principles "must expand or contract to meet the new and different conditions which are constantly coming within the field of their operation. In a changing world it is impossible that it should be otherwise."

But when applied to the recognized evil of ticket-scalping, the same constitutional principles become rigid in application and must be "applied as they are written." It would almost seem as if ticket-scalpers were mentioned and safeguarded by express provision of the Constitution of the United States. The theater does not come within Lord Chief Justice Hale's definition, some centuries ago, of a business "affected with a public interest," and therefore ticket-scalping evils of today may not be controlled.

The court deciding this case was also different from that in the *Euclid* case. The majority in the ticket-scalping case is composed of the three dissenters in the zoning case, together with Mr. Justice Sutherland and the Chief Justice.

The opinion of the court seems entirely forgetful that, with the approval of the courts, large sums of money raised by public taxation now go into devices for public recreation. See *Booth v. City of Minneapolis*, 163 Minn. 223, 203 N. W. 625 (1925) where public expenditure was for land to be used for a public golf course. The purpose of such expenditure is not dissimilar from that sought by zoning ordinances. And the result aimed at is not dissimilar from that involved in the regulation of ticket-scalping.

Municipal theaters are common in continental cities, and at least one state court has assumed it to be proper for a city to

subscribe to stock of a private theater company. *First Municipality v. Orleans Theater Co.*, 2 Rob. (La.) 209 (1842). In principle it is difficult to distinguish between theaters and golf courses or between theaters and municipal bands. *Loan Association v. Topeka*, 20 Wall. 655 (U. S. 1875) held that a tax levied for other than a public purpose is invalid. If scalping of theater tickets cannot be regulated, how is it possible to justify the expenditure of public money for types of recreation similar to the theater? When an evil cannot be controlled under private management, is there a sufficient public interest to support the expenditure of public funds?

It is unfortunate that the attitude taken in this case will invite more vigorous judicial contest of policies that properly fall within the field of legislative determination. "Due process" as applied by the courts is, of necessity, without definite standard, and must be applied to the facts of specific cases. A refusal to define a broad limitation of this character maintains a desirable flexibility in our constitutional system. But this very flexibility carries with it a constant danger that the court will substitute its judgment for that of the legislature as to the proper policy of legislation. This the court declined to do in the *Euclid* case, but has done as to ticket-scalping in *Tyson v. Banton.*

W. F. D.

ENFORCING PROHIBITION UNDER THE FEDERAL RULE ON UNREASONABLE SEARCHES

The rule in federal courts and some state courts rendering inadmissible evidence obtained by an unreasonable search has since 1920 been applied almost exclusively to cases of prohibition violations. The attempt of judges to restate the rule in the light of these new conditions has produced hundreds of printed decisions.[1] But such decisions reflect merely a theoretical application. The real test of the rule's utility must be sought in its practical operation.[2]

[1] For a collection of recent decisions see (1927) 36 YALE LAW JOURNAL, 536; (1927) 27 COL. L. REV. 300.

[2] The writer is indebted to Professor John Barker Waite of the University of Michigan Law School for data in this comment concerning Michigan. The remainder of the material is based upon personal investigation. Federal and state prosecuting attorneys, commissioners and prohibition agents were interviewed in New York City, Boston, Providence, R. I.; New Haven, Hartford and New London, Conn.; Newark and Trenton, N. J.; and the District of Columbia. Information as also secured from the Department of Justice and the Prohibition unit of the Treasury department in Washington, D. C. In none of the offices visited were suitable statistical records available. This phase of the situation is discussed more fully *infra.*

This question has two aspects. It is important first to understand the operation of the rule as a matter of procedure. Then it is necessary to determine the extent to which the rule fulfills its purpose as a safeguard of constitutional rights. Any justification of the rule must include both considerations.

From a procedural point of view, the operation of the rule is to a large extent governed by more general policies of prohibition enforcement. This is particularly true in the federal courts of New York, New Jersey, Connecticut and Massachusetts. In those districts the federal attorneys have for several years sought to relieve congestion in the courts by prosecuting only those prohibition cases in which convictions are certain. A case founded upon a defective seizure will be immediately discarded rather than held for trial under the risk of a suppression of evidence.[3] As a result of this policy the number of motions for the suppression of evidence because it was illegally obtained has been materially reduced.

Other factors have also contributed to the decrease in the number of motions to suppress evidence. Out of the mass of printed precedent a new federal rule defined to meet the needs of prohibition seems gradually to be crystallizing so that its application to typical sets of facts may be predicted with increasing accuracy. The old search warrants in use at the beginning of the prohibition era have been superseded by new forms technically less vulnerable. Also the government attorneys, because of the frequency with which the question has arisen, have become more skilled in the law of searches and seizures.[4]

It is, however, impossible to ascertain more definitely the

[3] In Connecticut, prohibition agents are instructed by the district attorney to report no case based upon a defective search. In New York, the United States attorney handling cases at the commissioner's hearing apparently may at his discretion dismiss any case where conviction is doubtful. The United States attorney in New Jersey rejects, because of faulty foundations, eighty per cent of all cases reported by the Prohibition Unit. As a result of this policy the number of disposals by pleas of guilty has greatly increased. It is stated that ninety-five per cent of all liquor cases in the federal courts of Massachusetts are ended on pleas of guilty without trial.

[4] The decrease in the number of motions to suppress evidence began in the New York districts late in 1925. Up to that time the question had been raised in practically every case. Today it is seldom raised after the commissioner's hearing, where it now arises in only one out of five cases. The decrease began in New Jersey about the same time. It was hastened by the abolition of the use of the search warrant in the typical raid. In Connecticut, the decrease also followed closely upon that of New York, while in Massachusetts and Rhode Island a change was noted as early as 1923. The situation in the District of Columbia has been unique. There prohibition caused little increase in the use of the motion because the courts were experienced in applying the federal rule to police cases.

extent of this decrease in litigation on the admissibility of unreasonably seized evidence unless through a minute examination of the dockets of each court. Nowhere has an attempt been made to gather statistics either upon the number and disposition of motions to suppress or upon any other problem of searches and seizures. Improvement in the operation of the federal rule has been haphazard. The impressions of attorneys, investigators or judges, who for years have been in daily touch with the situation, are largely conjectural. This is but one more instance of the deplorable dearth of records in the field of criminal law.

But the mere decrease in the use of the motion does not mean that the federal rule has been completely adjusted to prohibition enforcement. Its operation is simply shifted from the courtroom to the field. Obstacles that before were met in trial, now arise earlier, when cases are being constructed. The refusal of the federal attorney to wrestle with the difficulties of unreasonably seized evidence has forced the prohibition agent to assume the burden. His ability to interpret the scope of the federal rule when making his raids governs the degree of efficiency with which prohibition is to be enforced.[5]

One of the chief difficulties presented by this situation in which the searching agent and not the prosecuting attorney is charged with interpreting the reasonableness of a seizure, is the lack of co-ordination between the activities of the Prohibition Unit of the United States Treasury Department and those of the Department of Justice. The administration of the National Prohibition Act is in the hands of the Prohibition Unit. Raids, seizures and arrests, as well as regulations, are made by the officials of that unit without direct advice from the Department of Justice. The latter department controls a given case only after it has been reported for prosecution. From that point onward, the matter is entirely in the hands of United States attorneys, but an effort is seldom made to co-operate with the Prohibition Unit in the legal aspects of the case preliminary to trial. This lack of co-operation is also felt when the Department of Justice is working on appeals. Briefs are prepared and decisions ultimately made without an adequate understanding of the problems of administration on the part of either prosecuting attorneys or judges.[6]

The recent decision of *United States v. Kirschenblatt,* 16 Fed.

[5] The inefficiency of agents in this respect is felt particularly in New York and Rhode Island. It is said largely to result from frequent changes in the personnel of prohibition squads. The employment of trained attorneys has in many places improved the work of prohibition units.

[6] Lack of co-ordination also exists in the internal organization of the Department of Justice. For instance, apparently no attempt has been

(2d) 202 (C. C. A. 2d, 1926) illustrates the necessity for co-ordination between the enforcement officers and the judiciary. The court in that case declared unreasonable a seizure of papers of great evidentiary value although made in the course of a lawful arrest. The decision is based purely upon a construction of precedent. No notice was apparently taken of the fact that the papers and records of those engaged in large conspiracies to violate the Prohibition Act are practically indispensable in tracing the illicit enterprises to their sources. Prohibition agents and attorneys in close touch with the task of running down these conspiracies view the *Kirschenblatt* decision with disappointment, for, they declare, it has closed the most effective avenue of attack upon huge, elusive combinations now operating in the heart of New York City.

An understanding of the practical problems met in the administration of the law would also be valuable in interpreting the relation of the federal rule to several sections of the National Prohibition Act. Section 25 of the Act states that no search warrant shall issue to search any private dwelling occupied as such unless it is being used for the unlawful sale of intoxicating liquor.[7] Evidence secured in violation of that section has recently been declared inadmissible on the ground that the federal rule excludes evidence *illegally* obtained.[8] But that rule is based upon the provisions of the Fourth Amendment which concern an *unreasonable* seizure, and illegality and unreasonableness are not necessarily synonymous. Certainly the mere violation of any existing regulation ought not in every case to render the search unreasonable.[9] This distinction becomes im-

made at the central offices in Washington to investigate problems on searches and seizures confronting the individual district attorneys throughout the country. Such problems are deemed ones of administration to be left entirely in the hands of the attorneys in each district. Only through the occasional personal experiences of some of the attorneys taken from the field to the central offices, does the Attorney General's staff in Washington have any direct contact with the practical difficulties. It is true that echoes of these difficulties are heard in Washington through communications from district attorneys seeking authority to appeal from rulings on motions to suppress. But the policy of the central offices is to withhold such authorization without further investigation of the problems involved.

[7] 41 Stat. 315 (1919), U. S. Comp. Stat. (Supp. 1923) § 10138½m.

[8] Schroeder v. United States, 14 Fed. (2d) 500 (C. C. A. 9th, 1926).

[9] See the dissenting opinion of Anderson, J., in Lee v. United States, 14 Fed. (2d) 400 (C. C. A. 1st, 1926). Certiorari for the Lee case has been granted by the Supreme Court. The basis of the government's appeal will be, *inter alia*, this distinction between an illegal and an unreasonable search. A decision by the Supreme Court establishing that distinction would be a clarifying re-definition of the federal rule. In this connection *cf.* Mr. Justice Stone's opinion in the recent decision of McGuire v. United States, 47 Sup. Ct. 259, 260 (U. S. 1927): "A criminal prosecution is more than a game in which the government may be checkmated and the game lost mere-

portant when, as is often the case, the present application of the federal rule to section 25 of the Act permits the maintenance of large distilleries under the guise of private dwellings. This interpretation of section 25 is declared by officials of the Prohibition unit in Washington to prevent any effective enforcement of the prohibition laws.

But, while the application of the federal rule to prohibition cases has become largely a function of the searching agent, the question is still frequently raised after prosecution has begun. The attack on the seizure is usually first made at the hearing before a United States Commissioner, who now has acquired many of the duties of a judge in the first instance. In New York, for example, the commissioner will listen to testimony concerning the seizure and often dismiss the case outright. The commissioner's findings of facts constituting probable cause are conclusive.[10] But frequent appeals are taken from his findings of law.[11]

Conflict exists, however, on the privilege of a defendant when arraigned before a commissioner to controvert the affidavit and testimony taken for the issuance of the search warrant. The question is one of interpreting the extent to which the practice under the Espionage Act has been incorporated into the National Prohibition Act.[12] In Rhode Island, one commissioner refuses to permit the warrant to be controverted. But the Massachusetts Commissioners are in accord with those of the New York districts in recognizing the privilege.[13]

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ly because its officers have not played according to the rule. *The use by prosecuting officers of evidence illegally acquired by others does not necessarily violate the Constitution, nor effect its admissibility.*" [Italics ours]. It was held in the McGuire case that the fact that an officer had illegally destroyed the liquor did not render his testimony concerning it inadmissible at trial.

[10] Gracie v. United States, 15 Fed. (2d) 644 (C. C. A. 1st, 1926).

[11] United States v. Ephraim, 8 Fed. (2d) 512 (D. C. R. I. 1925).

[12] See CORNELIUS, SEARCHES AND SEIZURES (1926) §§ 89, 256. In United States v. Ephraim, *supra* note 11, it was held that section 15 of the Espionage Act authorizing the commissioner to permit the warrant to be controverted was by reference incorporated into the National Prohibition Act, *supra* note 7. A district court is without power to review the action of a commissioner refusing to quash a search warrant issued by him. The commissioner's action is reviewable only upon writ of error by the Circuit Court of Appeals. United States v. Maresca, 266 Fed. 713 (S. D. N. Y. 1920); In Re 1169 Myrtle Avenue, 288 Fed. 384 (E. D. N. Y. 1923). The much debated question, whether an ordinary prohibition agent is a proper "civil" officer to whom a search warrant may be issued under the National Prohibition Act has evidently been settled in the affirmative. Steele v. United States, No. 2, 267 U. S. 505, 45 Sup. Ct. 417 (1925).

[13] In Massachusetts every search warrant issued by a commissioner is first approved by a United States attorney. This policy reduces the possibility of attack on the warrant.

The part played by the United States Commissioner in issuing search warrants varies according to the searching methods in each district. In Connecticut, where the state courts prosecute most of the prohibition cases, the commissioner issues relatively few warrants.[14] In New Jersey, the use of the search warrant by federal agents has been discarded, except for the raiding of places to which the officers have no open access, on the ground that it is not adapted to the typical prohibition raid. Searches without warrants, of course, must still be reasonable under penalty of rejection by the court, but suppression of evidence because of technical defects in the construction of the warrant is in New Jersey avoided. The marked decrease in the number of successful motions in New Jersey since the adoption of this practice is an indication of the extent to which the operation of the federal rule may be limited without substantial violation of rights.

The practice in New York with respect to search warrants is exactly opposite to that in New Jersey. The warrant is used in almost every search. The reason is a practical one. For while in most cases the preliminary facts upon which a search warrant must be based in themselves constitute probable cause for an immediate search without a warrant, officers often find it convenient to delay raids lest their presence in a particular locality be disclosed too soon. The practice, therefore, is to spend several days collecting facts against a number of places in the same neighborhood, and then to use those facts to secure warrants for simultaneous raids at a later date. This use of the search warrant, which permits raiders to follow in the tracks of "under cover men," is in strict conformity with the requirements of the federal rule, and hence, according to the formula, safeguards the defendant's constitutional rights. Yet, to the man on the street, it constitutes a much greater violation than a search declared unreasonable according to some technical view of probable cause.

According to the decision of *United States v. Weeks*,[15] the validity of the search must be questioned in the normal case by motion before trial. But in New York the practice of raising the question at any time during trial has developed.[16] The ques-

[14] The United States Commissioner at Hartford has issued no more than twelve search warrants in three years. In New Haven, the commissioner issues an average of four a month. The variation reflects the relative activities of the state officials in the two counties. Agents returned half the warrants issued by the New Haven commissioner during the last seven months of 1926 without having found the articles sought. The explanation given for the failures is that the agents' preliminary steps forewarn the suspected persons.

[15] 232 U. S. 383, 34 Sup. Ct. 341 (1914).

[16] Gouled v. United States, 255 U. S. 298, 41 Sup. Ct. 261 (1921) and Amos v. United States, 255 U. S. 313, 41 Sup. Ct. 266 (1921) are the au-

tion is considered in the New Jersey district to be governed by the trial court's discretion, and as a result motions made at trial are generally heard. But in Massachusetts, Connecticut and Rhode Island, the procedure is still in conformity with the rule in the *Weeks* case. When the point does arise in a trial in the New York districts it is rapidly settled. No separate hearing is conducted. Facts are established by affidavits and arguments are as far as possible cut short. Often the court, having already gathered the gist of the case, will peremptorily grant or deny the motion as soon as it is made. In other districts, however, such as Connecticut and Massachcusetts, the hearings on the motions to suppress evidence are trials in themselves.

Observations on the operation of the federal rule thus far made have assumed a straightforward effort on the part of officials to comply with the rule. Obviously, however, the strict requirements of the rule would make the prosecution of some law breakers exceedingly difficult if not impossible. When the government officials are confronted with that situation it is necessary in one way or another to circumvent the rule. This is most easily accomplished by using state or municipal officers to make the search.

It is impossible to discover exactly the extent to which state officers are used in federal cases. In New York most of the small cases in the federal courts are reported by municipal police. They, of course, may testify and introduce evidence in a federal court, irrespective of the reasonableness of their searches. In Massachusetts and Rhode Island a large number of federal indictments for the illegal transportation of liquor are based on seizures made by state officers. On the other hand, in New Jersey and Connecticut, state officers seldom figure in federal courts. In a recent decision, *Byars v. United States,* 47 Sup. Ct. 248 (U. S. 1927), the Supreme Court declared that the mere participation of a federal agent under color of his office in a raid otherwise conducted by state police was sufficient to render the search subject to the federal rule. This holding is a distinct rebuke to a large number of lower court judges who in the past have accepted the testimony of state officers under almost any circumstances short of actual collusion with federal agents.[17] It is doubtful,

thority cited for this practice. The Gouled case permitted the question to be raised at trial where it appeared that the defendant did not know the articles had been seized until they were offered against him. In the Amos case a petition for the return of evidence was made after the jury had been sworn, but before evidence had been offered. This was held sufficiently timely, the court basing its decision on the Gouled case. But neither case is on its facts precedent for the prevailing practice in the federal courts of New York and New Jersey.

[17] See (1927) 36 YALE LAW JOURNAL, 536, 539.

however, whether the *Byars* case will prevent the practice. The federal officials will simply resort to greater secrecy than now is exercised.

Other methods of avoiding the operation of the federal rule are widely used. Thus, in a recent case, *United States v. Mandel,* 17 Fed. (2d) 270 (D. C. Mass. 1927) it was held that employees of the lessee of raided premises who were in possession of the premises at the time of the search, were not in a position to question the reasonableness of the seizure. Upon the authority of this case, the United States attorneys in Massachusetts have instructed raiding agents to secure a denial of ownership from those in possession when the search is made. In Connecticut, federal attorneys, citing *Rouda v. United States,* 10 Fed. (2d) 916 (C. C. A. 2d, 1926), have instructed the prohibition squad that when agents get into a suspected place without a warrant, one agent may be left on guard, while the others return to the commissioner for a warrant which will validate the seizure.[18]

The conclusion to be drawn from a survey of the procedural operation of the rule is not entirely satisfactory. It is true that the number of motions to suppress evidence has decreased, but on the other hand, the rule still troubles the searching agents. The lack of co-ordination between governmental departments prevents a more practical adjustment of the rule to prohibition enforcement, and government officials still find ways to circumvent the rule whenever that is necessary.

But it still remains to consider the extent to which the rule fulfills its purpose as a safeguard of constitutional rights. It has frequently been suggested that the proper way to discourage an unreasonable search is not to suppress the evidence, but to prosecute the officer.[19] Unquestionably, an officer who makes an unreasonable search commits a trespass; and under an act of Congress a prohibition agent who searches a private dwelling without a warrant is guilty of a misdemeanor.[20] But civil suits against trespassing officers rarely occur,[21] and it is doubtful that

[18] If the attorneys in Connecticut are correct in their interpretation of the Rouda case, the federal rule is practically nullified. It is to be noted, however, that the original entry in the Rouda case was held to be lawful. The discussion of the effect of a subsequently issued warrant on a prior unlawful entry is dicta. See 10 Fed. (2d) at 918.

[19] 4 WIGMORE, EVIDENCE (2d ed. 1923) § 2184, at 639.

[20] 42 Stat. 223 (1921).

[21] Four cases have been found in the reports since 1918. In Hart v. Evans, 10 Fed. (2) 892 (D. C. App. 1926) judgment for a defendant prohibition agent was affirmed on the ground that the warrant was legal on its face and the plaintiff had consented to the search. Nothing was found during the search. Banfill v. Byrd, 122 Miss. 288, 84 So. 227 (1920) was a suit against officers for the unlawful search of a hotel. The case was reversed in favor of the plaintiff. In Smith v. Tate, 143 Tenn. 268, 227 S. W. 1026 (1921) the officers were sued for searching a house where a sus-

even one case of a prosecution under the Act of 1921 can be found in the federal reporters.[22] Certainly, motions to suppress evidence occur much more frequently than either civil or criminal actions against officers. Several factors contribute to this variation between punitive and non-punitive methods of giving effect to the Fourth Amendment. The average citizen is reluctant to proceed in court against a public officer; and federal attorneys, in whose hands criminal prosecutions rest, frankly admit an unwillingness to incur the antagonism of prohibition squads, upon whom they must depend for successful administration of their offices. To this extent it is probably true that the threat of direct suits against the searching officer is not alone an adequate protection against unwarranted searches.

But it does not necessarily follow that the federal rule is a satisfactory substitute. The procedure to suppress evidence has developed many technicalities. A motion is often successfully made even where there has been no real invasion of the defendant's rights. On the other hand, it has been pointed out that the federal rule in New York does not prevent practices which to the layman at least, represent the grossest kind of intrusion.

Furthermore, the effect of the federal rule upon unreasonable searches is not the same in all jurisdictions. In Connecticut, Massachusetts and Rhode Island, for example, the rule is not observed in the state courts where prohibition violations are usually prosecuted. While in New York, New Jersey and the District of Columbia, prohibition is enforced entirely in federal courts, and in states like Michigan it is enforced through local courts that have adopted the federal rule.[23]

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pected criminal was thought to be hiding. Judgment for the defendants was affirmed. Weaver v. Ficke, 174 Ky. 432, 192 S. W. 515 (1918) was a suit for malicious trespass by individuals armed with a defective warrant in search of half the carcass of a hog. Judgment for the plaintiff was affirmed.

[22] The act is mentioned in this respect by way of dictum in Ex Parte Houston, 282 Fed. 723, 725 (S. D. Fla. 1922). But the outcome of section 6 seems to have been simply to establish one more test for the theoretical definition of a reasonable search. *Cf.* Carroll v. United States, 267 U. S. 132, 45 Sup. Ct. 280 (1924); Lindsly v. United States, 12 Fed. (2d) 771 (C. C. A. 5th, 1926). *Cf.*, also, United States v. Costanzo, 13 Fed. (2d) 259 (W. D. N. Y. 1926).

[23] Federal courts are not deemed suitable for the intensive police work required in the enforcement of prohibition. For that reason the machinery of state courts is utilized wherever possible. The federal officials desire to prosecute only large cases involving conspiracies, or cases not covered by the state law. For example, the state laws in Massachusetts and Rhode Island do not stipulate the forfeiture of vehicles engaged in the illegal transportation of liquor. Hence it is necessary to try such cases in the federal courts. But cases of the small offenders are taken to the federal courts only where the local tribunals have been unreasonably lax. In New York, however, a repeal of the state enforcement act has shifted the

If the federal rule is an indispensable adjunct of the Fourth Amendment, or kindred provisions in state constitutions, it would seem that the citizens in non-federal rule jurisdictions are being subjected to many more outrages against liberty than those who come under the protection of the rule. This, however, is not the case. Aside from the fact that a federal warrant issues less easily than a state warrant, the character of federal raids in New York, for example, does not seem substantially to differ from the practices of state officers in Connecticut. As a general rule, both endeavor to conform to the requirements of reasonableness.[24] Indeed, state prosecutors in Connecticut insist upon reasonable conduct, if only because it has been found that the jury will be sympathetic toward the victim of an unreasonable search.

The federal rule may in some instances forestall a substantial violation of the individual's rights. But its effect in that respect is much less frequent than are the opportunities which it provides for the protection of guilty defendants on purely technical grounds. To maintain that the federal rule is necessary is to assert that the citizens in the majority of the United States never have been constitutionally secure.

MINORITY INTERESTS IN REORGANIZATION PROCEEDINGS

In the recent case of *Allan v. Moline Plow Co.*, 14 Fed. (2d) 912 (C. C. A. 8th, 1926) an Illinois corporation, pursuant to a reorganization plan, sold out to a Virginia corporation of the same name. The plaintiff was a bondholder of the Illinois corporation to whose bond was attached an agreement to bring no action on the bond unless twenty-five per cent of the bondholders joined. Over ninety-five per cent of both secured and unsecured creditors assented to the reorganization plan. In a suit against the Virginia corporation to set aside the conveyance as fraudulent, and for an order that the assets of the Illinois corporation so received be held for the benefit of the creditors of said corporation judgment was rendered for the defendant. It is well settled that such collateral agreements will be construed with a note and mortgage so as to control the latter.[1] But, for reasons which will appear later in this comment, it is submitted that the same result should be reached even in the absence of such a collateral agreement.

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entire burden to federal courts, and in New Jersey, where the state courts are unwilling to undertake a systematic enforcement of the state law, almost all cases are tried as violations of the National Act. For a discussion of jurisdictional problems in the enforcement of the 18th Amendment in the absence of state legislation see (1926) 36 YALE LAW JOURNAL, 260.

[24] In Michigan, where officers are unable to make a valid search they often resort to a number of illegal raids merely to harass the suspected violator and thus force him out of business.

[1] McClure v. Township of Oxford, 94 U. S. 429, 433 (1876).

The estimate that about fifty per cent of American corporations and railroads owning one-half of the mileage in the United States have been reorganized within a period of twenty years [2] gives some idea of the importance of reorganization. The procedure of reorganization is becoming recognized as "the machinery by which arrangements between the creditors and other parties in interest are carried into effect . . ." [3] It has been described as the "rearrangement of the financial structure of an incorporated enterprise, rendered necessary by insolvency or by the inability of the corporation to secure the necessary funds for its operations because of obstacles resulting from its financial structure." [4] Almost invariably it is "based upon the foreclosure of mortgages or the enforcement of the rights of creditors in some form." [5] It is essentially a redrawing of the financial plan with a view to contraction,[6] although corporations sometimes emerge from the process with an increased capitalization.[7] This latter effect has at times been produced by the rather lavish distributions of common shares during reorganizations of railroads in order to placate disgruntled shareholders and creditors of the corporation.[8] Industrial reorganizations often result in an increased capitalization of the corporation but for different reasons. The financial difficulty of an industrial is more likely to be due to the oppression of a large floating debt (though problems of marketability, fluctuation in public demand, and adverse competition should not be overlooked). Relief is found in funding the debt, although the result is to increase the capitalization and also the fixed charges.[9]

The problem of reorganization is one of social expedience and economic policy as much as a purely legal matter.[10] The immediate problems are to attract new money into the enterprise and to take care of the dissenters.[11] Since the corporation is

[2] See chapter by CRAVATH on "Reorganization of Corporations" SOME PHASES OF CORPORATE FINANCING (1917) 154.

[3] Canada Southern Ry. v. Gebhard, 109 U. S. 527, 539, 3 Sup. Ct. 363, 371 (1883).

[4] CRAVATH, *op. cit. supra* note 2, at 154.

[5] *Ibid.* 155.

[6] 5 DEWING, FINANCIAL POLICY OF CORPORATIONS (1921) 3.

[7] The term "capitalization" is herein used to indicate the aggregate face value, so far as this is possible, of the outstanding bonds and shares of a corporation.

[8] DEWING, *op. cit. supra* note 6, at 160.

[9] DEWING, *op. cit. supra* note 6, at 167.

[10] "Lawyers are apt to exaggerate their own importance and the significance of their legal machinery in determining the form and details of reorganization procedure, forgetful that a reorganization is primarily an adjustment of human motives and economic conditions, circumscribed, rather than determined by the law." DEWING, *op. cit. supra* note 6, at 31.

[11] Rosenberg, *Reorganization—The Next Step* (1922) 22 COL. L. REV. 14.

in financial difficulties, new money can be attracted only by offering a return which is high enough to compensate for the unusual risk (which is obviously impractical) or by affording such new money a lien prior to the old secured indebtedness. Among the dissenters are to be found honest men with bona fide claims as well as those "guerillas who hang about the outskirts of reorganizations and endeavor to levy tribute as a condition of abating the nuisance of their presence." [12] Among industrials, there are often the additional problems of getting relief from the burden of unpaid dividends on cumulative preferred shares or the burden of a floating debt. The former is solved by a mere capital adjustment, relatively easy in the case of a healthy corporation. The latter may be funded.[13]

The defects in the present practice are the lack of control by the courts, the danger of tyranny by the majority, and the bogey of obstructive tactics by the minority. The problem is really one of extinguishing claims of dissenting creditors against the property of the insolvent with something other than cash. What is needed is an arrangement that will bring all parties in interest together, an opportunity for grievances to be aired, claims to be adjudicated, and, finally, a plan which shall bind all. Such an arrangement would save time and expense and relieve from those additional burdens which now often fall upon the reorganized property as a result of protracted legal proceedings.

There has been a gradual increase in the use of judicial coercion in reaching such settlements but this has been more marked in the case of railroads and public utilities than among industrials. This is partly explained by the public interest in the continuation of the utility [14] with reference to which the bond-

[12] A. H. Joline, quoted in CRAVATH, *op cit. supra* note 2, at 197.

[13] The capital adjustment, which is more of a bookkeeping change than a vital alteration of the financial structure of the company, "may take the form of: (1) the issue of a new higher dividend-paying preferred stock in exchange for the old cumulative preferred stock with its arrears of unpaid dividends; (2) a funding of the preferred stock dividend accumulations into new securities; (3) the funding of the old contingent charge preferred stock, with its accumulated dividends, into new bonds bearing interest charges lower than the dividend rate on the old preferred stock." DEWING, *op. cit. supra* note 6, at 176.

The floating debt is the unsecured outstanding obligations of the company arising out of the ordinary course of business. It may be funded by a bond issue. *Ibid.* 174.

[14] "The necessary conclusion is that the state has a right to enforce the continuous exercise of the corporate powers and franchises for public use, to the exhaustion of the value of such property and franchises; and this is true, no matter what private right may embrace the title of the property." Gates v. Boston & New York Air Line R. R., 53 Conn. 333, 344, 5 Atl. 695, 700 (1885); writ of error dismissed 122 U. S. 646 (1887).

holders are regarded as having contracted.[15] Another reason is the difference in the respective forms of capitalization of public utilities and industrials. The amount of bonds is relatively small among industrials,[16] whereas among public utilities generally the proportion of bonds is estimated at sixty per cent.[17] When losses occur, the railroad bondholder is more likely to discover that the property securing his bond has depreciated, and so, finding his position as a bondholder is not as impregnable as the strong legal verbiage upon his bond would seem to indicate, he is less likely to resist coercion than is the industrial bondholder who still has, as a buffer between himself and personal loss, the greater equity remaining to the shareholders. The problem of coercing secured creditors does not arise where there are tangible assets sufficient to liquidate such claims. But there may be so great a difference between the value of the assets of the company as such and the value of the going concern as to warrant the belief that there will be enough assets to pay secured creditors and still leave an equity remaining in the shareholders. Granting a respite to the company under these circumstances will not only profit the secured creditors but encourage the shareholders to advance new money. Courts, consequently, are more reluctant to coerce the minority in the case of industrials and apply with less liberality the rule of *Fosdick v. Schall.*[18] Until recently, the courts felt that they had little authority to act in reorganization proceedings. In *Merchants' Loan & Trust Co. v. Chicago Rys.*,[19] the court refused to authorize a reorganized company to issue bonds and make them a first lien over the objection of prior mortgagees whose liens would thereby be displaced. The machinery provided by the Bankruptcy Act would appear to be of no substantial value in dealing with these problems of reorganization.[20]

In general, even now, the majority of the bondholders can not compel the minority to accept payment of their claims in new securities rather than in money. In *Canada So. Ry. v.*

[15] (1924) 28 A. L. R. 1196.

[16] DEWING, *op. cit. supra* note 6, at 163.

[17] RIPLEY, MAIN STREET AND WALL STREET (1927) 310.

[18] 99 U. S. 235 (1878) permitting a court to insist that a receiver shall meet "current expenses" incurred during and immediately before the receivership before meeting fixed charges on capital. The justification for this rule is said to be "the imperative public necessity of operation, a necessity which the public character of the railroad business places ahead of the merely private property rights of stockholders and bondholders." DEWING, *op. cit. supra* note 6, at 100. For a discussion of the cases interpreting this rule, see *ibid.* 101–2 and notes.

[19] 158 Fed. 923 (C. C. A. 7th, 1907).

[20] ROSENBERG, *op. cit. supra* note 11, at 14.

Gebhard,[21] the Supreme Court said: "in the absence of statutory authority or some provision in the instrument which establishes the trust, nothing can be done by a majority, however large, which will bind a minority without their consent." Nor does it matter what the motive of the minority may be.[22] The power to foreclose and sell [23] is so inherently imbedded in our concept of a mortgage that the possibility of plucking this "rooted sorrow" seems remote.

The tendency away from this view is most noticeable, as stated before, in the field of railroad reorganization. "Railroad mortgages are not sacred because of the strong legal terms in which they are drawn, but are dependant on success in the business of transportation." [24] The gradual transition toward a stronger judicial policy is marked by several leading cases, each a further development away from the mortgage taboo. *Canada So. Ry. v. Gebhard* [25] held legislation valid whereby minority interests are obliged to accept securities in a reorganized corporation when the plan of reorganization is approved by the court. The case is only a recognition of a Canadian reconstruction statute (involving coercion of minorities) as binding upon the holders of securities of a railroad company chartered in Canada, even though such holders were citizens of the United States.[26] The case suggests, however, that confirmation of a reorganization scheme is similar to a composition in bankruptcy which is binding on a non-assenting minority.[27] There is no more deprivation of property without due process here than in the case of an ordinary bankruptcy statute. Though the statute involved here was Canadian, this case tends at least to uphold the constitutionality of *legislation* to this effect.

It is the opinion of one well known writer that the federal courts of equity have power without the aid of legislation to compel all creditors to accept something other than cash in satisfaction of their claims.[28] This is based upon the language used by the court in *Northern Pacific R. R. v. Boyd*.[29] In that

[21] *Supra* note 3, at 535, 3 Sup. Ct. 363 at 368. See also Walker, *Reorganization By Decree* (1921) 6 CORN. L. Q. 154.

[22] See Hallister v. Stewart, 111 N. Y. 644, 660, 19 N. E. 782, 789 (1889).

[23] Walker, *op. cit. supra* note 21, at 165.

[24] Green, *The Commercial Basis for Railway Receivership* (1894) 33 AM. L. REG. 417, quoted in DEWING, *op. cit. supra* note 6, at 31, n. 3. "The letter of the railroad mortgage bond has come to be nothing more than mere legal verbiage. . . ." *Ibid.* 87.

[25] *Supra* note 3.

[26] Walker, *op. cit. supra* note 21, at 157.

[27] *Supra* note 3, at 536, 3 Sup. Ct. at 369; Rosenberg, *op. cit. supra* note 11, at 18.

[28] *Ibid.* 20.

[29] 228 U. S. 482, 33 Sup. Ct. 554 (1912).

case, Boyd was a judgment creditor of the Northern Pacific Railroad. The property of the railroad was sold to a newly created railway company in pursuance of a reorganization plan. Boyd, not having been a party to the foreclosure, claimed that the property of the old company in the hands of the new company was subject to the payment of his debt. The claim, brought fifteen years after the reorganization, was sustained. The actual holding is that "a plan of reorganization which admits stockholders of the debtor company to an interest in the reorganized company, even upon the payment of cash, is constructively fraudulent as against creditors if it does not make to them a fair offer of an interest in the reorganized company, and that in such case creditors may follow the property of their debtor into the hands of the reorganized company. The actual decision was purely negative, that this reorganization was inequitable and would be disregarded as against the plaintiff." [30] The result is that general creditors are not barred by such a reorganization but may still attack its terms. This case was at first regarded as a nightmare because it subjected a reorganization sale "to serious danger of subsequent destructive attack." [31] However, one of the authorities who was alarmed at first has since changed his mind.[32] A dictum in the case [33] suggests that it is not necessary to pay unsecured creditors in cash, that if they decline a fair offer they are in the same position as any other judgment creditors and, upon their refusal to agree to a fair plan, they may no longer come into equity to attack its terms. If the dictum means more than merely loosely spoken words (which one authority asserts is the limit of their significance) [34] it necessarily follows that unsecured creditors have the option of accepting either payment in such securities as are allotted to them under the reorganization plan or "the empty relief of a worthless judgment against the old company." [35]

In the *Boyd* case, only unsecured creditors were before the

[30] Swaine, *Reorganization—The Next Step: A Reply to Mr. James N. Rosenberg* (1922) 22 COL. L. REV. 121, 122.

[31] Rosenberg, *A New Scheme of Reorganization* (1917) 17 COL. L. REV. 523, 526. "The result of this decision has been to introduce the greatest uncertainty and confusion in the reorganizations which have since been attempted and those which are now pending. It has materially reduced the opportunities for stockholders to participate in reorganizations controlled by mortgage bondholders, for, manifestly, the simplest way for a committee of mortgage bondholders to avoid the embarrassments of the *Boyd* case is completely to exclude the stockholders and thereby, gain freedom to exclude the unsecured debt." See also CRAVATH, *op. cit. supra* note 2, at 195.

[32] Rosenberg, *op. cit. supra note* 11, at 14.

[33] *Supra* note 29, at 508, 33 Sup. Ct. 554 at 561.

[34] Swaine, *op. cit. supra* note 30, at 122.

[35] Rosenberg, *op. cit. supra* note 11, at 17.

court, not mortgage holders. Yet it has been suggested [36] that had the interest of secured creditors been involved, if notice were given, and the assent of the majority [37] of such creditors obtained, new money could be given a lien prior to or on a parity with the bondholders despite the objection of the dissenting minority. The same author [38] suggests that an extension of this treatment of minorities to industrials is likely to occur if some large industrial affected with an undoubted public interest goes into a receivership. No case has as yet gone so far as to uphold such treatment of secured creditors of public utilities. The same may be said of both the secured and unsecured creditors of industrials.

The dictum in the *Boyd* case would seem to have been followed in the *Rock Island* [39] case. Here the court actually assumed the power and, in effect, accomplished a reorganization by decree without the burden or expense of a foreclosure sale. With respect to outstanding claims, it fixed their value in new shares which general creditors were required to accept because no other provision was made for them. Here, however, no secured debt was involved and the authority of the case is somewhat questionable, it never having been appealed.

In *Phipps v. Chicago, R. I. & P. Ry.*,[40] the court compelled all creditors, including the minority, to take shares for their claims, denied them the right of suing the defendant new company and even did away with the form of a sale to this company. Phipps, a judgment creditor, was actually enjoined from bringing suit. So far as unsecured creditors are concerned, the dictum in the *Boyd* case seems to be more than merely loosely spoken words.

In *Graselli Chemical Co. v. Aetna Explosives Co.*,[41] a corporation in the hands of receivers prospered through the business acumen of its receivers and the profits derived from war contracts. The preferred shareholders, who had nine votes each while their dividend payments were in default, arranged a meeting at which they planned to approve a reorganization favorable

[36] *Ibid.*

[37] This suggests a further problem. There may be senior and junior lien bonds. Among railroads, there may be, in addition, general underlying bonds. What, among these, will constitute a majority is quite problematical. A graduation of voting power may be worked out according to the seniority of the lien.

[38] Rosenberg, *op. cit. supra* note 11, at 25.

[39] American Steel Foundries v. Chicago, R. I. & P. Ry. (1917), not reported. Discussed in Walker, *op. cit. supra* note 21, at 162.

[40] 284 Fed. 945 (C. C. A. 8th, 1922). Phipps, a judgment creditor of the Chicago, Rock Island & Pacific Ry. challenged a decree of the district court preventing him from recovering on his judgment in any other way than than that provided by a reorganization plan approved by the court.

[41] 252 Fed. 456 (C. C. A. 2d, 1918).

to themselves. The common shareholders sought an injunction to prevent the holding of the meeting. The district judge examined in detail the reorganization plan, concluded it was unfair to the common shareholders, and granted the injunction. His decision was affirmed by the Circuit Court of Appeals. This has been hailed as "a notable milestone in the jurisprudence of reorganization." [42]

The cases, then, show a tendency of the courts to solve the problems of reorganization through judicial coercion. In England, a statute [43] provides that where a compromise is proposed between a company and its creditors or between the company and its members, it may, if sanctioned by the court, become binding upon all of them including secured as well as unsecured creditors. Such a statute would be as valid in this country as the Bankruptcy Act. It has been contended [44] that such a statute would have the advantage of permitting business men to make their own contracts instead of having them imposed by governmental agencies and "paternalistic" judges.

On the other hand, it has been suggested that the federal courts of equity are better fitted for this.[45] A set of precedents has gradually grown up [46] which are more elastic than the strict statutory requirements of bankruptcy proceedings. The court can adapt its modes to changing economic problems which seems preferable to the "straight-jacket" [47] nature of an act of Congress. The real problems in a reorganization are worked out by bankers, engineers and various kinds of technical experts. The ultimate question is: is it fair? It is therefore believed that statutory regulation might prove undesirable and that federal judges are in a better position to solve these problems than a commission composed of political appointees whose

[42] Rosenberg, THE AETNA EXPLOSIVES CASE (1920) 20 COL. L. REV. 733, at 740.

[43] JOINT STOCK COMPANIES ARRANGEMENT ACT, (1870) 33 & 34 Vict. c 104.

[44] Swaine, *op. cit. supra* note 30, at 132.

[45] "This is a question of equities; a question as to whether senior and majority interests have been fair or oppressive to minorities and to the investors in junior securities. Have the mortgage bondholders exacted too hard a bargain? Have the trade creditors been fairly dealt with? Have the rights of the stockholders been protected? When plans finally come before the court there is either agreement on these points, or a residuum of difference on what generally reduces itself to the single question of fairness, of justice. Are we to leave that question to Federal Commissions, whose membership is apt to be composed of political appointees holding positions of short tenure? Is there any body of men to whom we can more safely turn than to Federal judges who through life appointment are detached from the personal equation?" ROSENBERG, CORPORATE REORGANIZATION AND THE FEDERAL COURT (1924) p. x (preface).

[46] CRAVATH, *op. cit. supra* note 2, at 159.

[47] ROSENBERG, *op. cit. supra* note 45.

term of office is limited. Under such an arrangement, the interests of the bondholders would be safeguarded. They are usually well represented at reorganization meetings. The head of the bondholders' committee is usually a man who owns a large number of the bonds himself. It is not like a shareholders meeting where large number of proxies may have been scooped up by a zealous clique. It may be that the result of such a policy will tend to drive investors from bonds into shares. If so, the advantage will be on the investor's side. The man investing his savings seeks two things, *viz.*, security of his principal, and a return on his investment. There is a popular impression that the greater safety of bonds over shares is an adequate recompense for the lower returns they offer. But this popular fallacy has recently been challenged by careful studies over long periods of time.[48] These studies show that an average investor would be better off financially by buying common shares than by buying bonds no matter during what phase of the financial cycle the purchases take place.[49]

In the last analysis, the current interest of both bondholder and shareholder is in the going concern. If most of them want to continue, how many shall be necessary? There is an identity of interest of all the security holders in the principal thing — the going concern. If the judgment of a substantial number, fairly exercised, is that the company continue, why should not their combined judgment override the technical paper rights of the minority?

PAYEES AS HOLDERS IN DUE COURSE

Recent decisions in England and in this country to the effect that a payee may not be a holder in due course make it increasingly apparent that uniformity of judicial opinion may not be expected.[1] This will no doubt give further impetus to the vari-

[48] VAN STRUM, INVESTING IN PURCHASING POWER (1925).

[49] *Ibid.* 222-234.

[1] Jones, Ltd. v. Waring & Gillow, Ltd. [1926] A. C. 670. In this case B, indebted to the defendants in the sum of £5000, and having no means of paying, fraudulently persuaded the plaintiff corporation to sign an agreement making it agent for the sale of motor cars and requiring a £3000 deposit. On objection by the plaintiff to paying this sum to B, the latter told the plaintiff that the defendants were his principals and suggested that the money be paid to the defendants. Checks for £2000 and £3000 were drawn by plaintiff, delivered to B, who in turn delivered to the defendants in payment of his debt. Subsequently the plaintiff gave a check for £5000 directly to the defendants in exchange for the others. The defendants, without notice of the fraud, cashed the check, and returned to B goods which they held as security. On discovery of the fraud the plaintiff sued to recover the £5000. A judgment for the plaintiff in the King's Bench Division was reversed by the Court of Appeal. On appeal by the plaintiff to the House of Lords, *held*, all the Law Lords concurring on this

ous suggestions which have been made for the amendment of the Negotiable Instruments Law relative to this point.[2] In at least one country, by express legislation, it is recognized that the payee may be a holder in due course.[3]

The question is carefully analyzed in a recent article in which a review of the English and American decisions, both before and after the statutes, is made.[4] From his analysis of the problem the writer concludes that in the light of the historical background it may well be held without amendment that a payee who takes as "purchaser" may be a holder in due course, but one who takes as a "promisee" may not.[5] The outstanding illus-

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point, that as defendants were payees they could not be holders in due course. For note on this case see (1927) 40 HARV. L. REV. 494.

A similar problem was presented in Foster v. Security Bank & Trust Co., 288 S. W. 438 (Tex. Comm. App. 1926), *reversing* a judgment for the defendant rendered by the Texas Court of Civil Appeals in 249 S. W. 227 (1923). This was an action brought by the co-makers of a promissory note against the payee, for the cancellation of the same. The payee had received the note from the principal maker for value and without notice of fraud or of the agreement between the co-makers that before delivery additions would be made to their signatures so as to make the note the obligation of the bank of which they were directors. *Held*, that the payee was not a holder in due course, and the co-makers were entitled to a cancellation of the note.

[2] Mr. Zechariah Chafee, Jr., suggests that uniformity and clarity might be obtained by changing the opening clause of section 52 to read as follows: "A holder in due course is a *payee or other holder* who has taken, etc." And also amending sub-section 4 of section 52 to read: "That at the time *he became a holder* he had no notice of any infirmity in the instrument or *that* the title of the person negotiating it *was defective or that the delivery to himself was wrongful.*" BRANNAN, NEGOTIABLE INSTRUMENTS LAW, ANN. (Chafee's 4th ed. 1926) 361.

The wording of this suggestion has been criticized, (1926) 36 YALE LAW JOURNAL, 158, at 159.

[3] India. The Negotiable Instruments Law of 1881 provides that "'holder in due course' means any person who for consideration became the possessor of a promissory note, bill of exchange or cheque if payable to bearer, or the payee or indorsee thereof, if payable to, or the order of, a payee, before the amount mentioned in it became payable, and without having sufficient cause to believe that any defect existed in the title of the person from whom he derived his title."

[4] Aigler, *Payees as Holders in Due Course* (1926) 36 YALE LAW JOURNAL, 608.

For other discussions see (1898) 11 HARV. L. REV. 473; (1902) 15 *ibid.* 579; (1903) 16 *ibid.* 596; (1923) 36 *ibid.* 751; (1922) 1 WIS. L. REV. 421; HENSING, *The Uniform Negotiable Instruments Law* (1911) 59 U. PA. L. REV. 471; (1926) 74 *ibid.* 331; Feezer, *May the Payee of a Negotiable Instrument be a Holder in Due Course* (1925) 9 MINN. L. REV. 101; (1924) 9 IOWA L. Bull. 299; (1923) 18 ILL. L. REV. 47; (1922) 10 CALIF. L. REV. 413; (1922) 20 MICH. L. REV. 908; (1923) 21 *ibid.* 591; (1924) 22 *ibid.* 581; (1925) 25 COL. L. REV. 227; (1915) 24 YALE LAW JOURNAL, 429; BRANNAN, *op. cit. supra* note 2, at 119, 361.

[5] Aigler, *op. cit. supra* note 4, at 631, says " . . . whether a payee is a

have been filled in contrary to instructions.[10] In such cases, though the courts are about evenly divided, the payee has many times been held to be a holder in due course.

II. In the case of a suit by the payee against an accommodation indorser, where delivery was made directly by the maker to the payee, the question is raised in a somewhat different manner.[11] Courts saying that a payee cannot be a holder in due course would seem to be required to hold that any defense such as a fraud between the maker and indorser would be available as a defense to the indorser.[12] This would certainly appear to be true if section 58, which provides specifically that "in the hands of any holder other than a holder in due course, a negotiable instrument is subject to the same defenses as if it were non-negotiable," is applied. It is in situations of this sort, however, that the desirability of recognizing the possibility of a payee being a holder in due course is most apparent. And for this purpose it would seem to be immaterial whether the payee may be said to have taken as "purchaser" or as "promisee." [13]

256 S. W. 434 (1923). *Contra:* Rice v. Jones, 102 Okla. 30, 225 Pac. 958 (1924). *Cf.* Builders' Lime & Cement Co. v. Weimer, 170 Iowa, 444, 151 N. W. 100 (1915).

[10] Holding that the payee was a holder in due course: Simpson v. First Nat'l Bank, 94 Or. 147, 185 Pac. 913 (1919); see Boston Steel & Iron Co. v. Steuer, 183 Mass. 140, 66 N. E. 646 (1903). *Contra:* Herdman v. Wheeler, *supra* note 6; Vander Ploeg v. Van Zuuk, 135 Iowa, 350, 112 N. W. 807 (1907); Consolidated Wagon & Machine Co. v. Houseman, 38 Idaho, 343, 221 Pac. 143 (1923).

[11] Holding that the payee may be a holder in due course: McDonough v. Cook, 19 Ont. L. Rep. 267 (1909); Knetchel Furniture Co. v. Ideal Furniture Co., 19 Manitoba Rep. 652 (1910); Ex parte Goldberg & Lewis, 191 Ala. 356, 67 So. 839 (1914); Liberty Trust Co. v. Tilton, 217 Mass. 462, 105 N. E. 605 (1914); Lowell v. Bickford, 201 Mass. 543, 88 N. E. 1 (1909); Johnston v. Knipe, 260 Pa. 504, 105 Atl. 705 (1918).

Contra: Southern Nat'l Life Realty Co. v. People's Bank, 178 Ky. 80, 198 S. W. 543 (1917); Strother v. Wilkinson, 90 Okla. 247, 216 Pac. 436 (1923); Farmer's State Bank v. Mowry, 107 Okla. 275, 232 Pac. 26 (1925); Walker v. Traylor Engineering & Mfg. Co., 12 Fed. (2) 382 (C. C. A. 8th, 1926); Howth v. Case Threshing Machine Co., 280 S. W. 238 (Tex. Civ. App. 1926).

Of course, if section 29 is to be interpreted as allowing a recovery against an accommodation indorser by a holder for value, whether or not a holder in due course, the question is not raised. This is not a desirable interpretation, however, and the farthest that any court has gone is to allow a holder for value to recover where the instrument was taken after maturity but in good faith. Marling v. Jones, 138 Wis. 82, 119 N. W. 931 (1909). See also (1926) 24 MICH. L. REV. 847.

[12] See the cases cited *supra* in the second paragraph of note 11.

[13] It might be contended that in suits against indorsers and sureties courts allowing the payee to recover could reach that conclusion by applying contract law. Thus where the payee has given a new consideration for the instrument, a failure of consideration between maker and indorser, or some other fraud by the principal maker against the indorser, where done with-

tration of the "purchaser" case is where the paper, for example, a bank draft, has been purchased by a third party and then delivered to the payee. A payee taking from the drawer or maker or agent of either is regarded as a "promisee." If the act is to be amended to resolve the present conflict in decision, it is important to consider whether it would be desirable to continue this distinction. Granting that the distinction has some historical basis,[6] it does not appear to have been entirely satisfactory, for "in a considerable number of cases" the payee has been treated as a holder in due course, "though the payee dealt directly with the promisors." [7]

Instances where the courts have had occasion to determine whether payees who might be said to have taken as "promisees" rather than as "purchasers" should be treated as holders in due course are numerous. Those in which the question becomes important may, however, be divided into four type situations.

I. As between maker and payee alone, (that is, where no other parties are concerned) it is fairly obvious that the question is usually of little importance because defenses, as for example that of failure of consideration, may be interposed. Even here, however, the possibility of a payee being a holder in due course may be important.[8] The principal cases raising the question have been those where there has been some alteration in the instrument before delivery,[9] or where blanks in the instrument

holder in due course is a question not susceptible of a categorical answer. In each instance the conclusion should depend upon the type of situation presented. No doubt, prima facie, a payee is not a holder in due course because presumptively he took the instrument as promisee rather than as purchaser. But it always should be open to proof that he really acquired the paper in the latter capacity, in which event, his status may be that of a due course holder."

The writer states that an opposite conclusion as to the prima facie status of the payee is reached by many of the courts and text writers, who argue that since by section 191, a "holder means the payee or indorsee of a bill or note, who is in possession of it, or the bearer thereof," and by section 59, "every holder is deemed *prima facie* to be a holder in due course . . ."; that the payee, therefore, is prima facie a holder in due course. See Colonial Fur Ranching Co. v. First Nat'l Bank, 227 Mass. 12, 116 N. E. 731 (1917); McLaughlin v. Paine Furniture Co., 245 Mass. 377, 139 N. E. 542 (1923).

[6] Munroe v. Bordier, 8 C. B. 862 (1849); Poirier v. Morris, 2 El. & Bl. 89 (1853); Watson v. Russell, 3 B. & S. 33 (1862); Lewis v. Clay, 67 L. J. Q. B. 224 (1898); Herdman v. Wheeler, 1 K. B. 361 (1902).

[7] Aigler, *op. cit. supra* note 4, at 629.

[8] If the payee may not be a holder in due course, section 28 reading that "absence or failure of consideration is matter of defence as against any person not a holder in due course . . ." might be applied with some propriety as stating a rule regarding burden of proof. See (1925) 35 YALE LAW JOURNAL, 369.

[9] Holding that the payee was a holder in due course: Thorpe v. White, 188 Mass. 333, 74 N. E. 592 (1905); Snyder v. McEwen, 148 Tenn. 423,

III. There are many cases involving co-makers, one of whom has delivered the instrument to the payee contrary to the instructions of some one or more of the others, but nevertheless where the payee has taken in good faith and for value.[14] *Foster v. Security Bank & Trust Co.*[15] affords a good example of this type as here one signer delivered the instrument in violation of the understanding of the others. The instrument was complete and regular and was taken in good faith and for value before maturity. Of course the payee may be said in a sense to be a "promisee" not only of the party delivering the instrument but of the other makers as well. Conceivably the courts might adopt the theory that the delivering signer appeared to be owner so that, as to the defrauded signers, the payee would be a "purchaser," or that the delivering signer acted within his apparent authority although contrary to instructions. But whatever rationalization be indulged in, the important consideration, it is submitted, is the commercial desirability that defenses between co-makers should be cut off not only as against indorsees but also as against payees taking in good faith and for value.[16]

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out the knowledge of the payee, should be no defense whether he were considered a holder in due course or not. For this type of situation, see Knetchel Furniture Co. v. Ideal Furniture Co., *supra* note 11; Ex Parte Goldberg & Lewis, *supra* note 11; Liberty Trust Co. v. Tilton, *supra* note 11. But where no new consideration is advanced for the note, and it is given, for example, for a pre-existing debt, it is essential that the payee be considered a holder in due course to protect him against defenses between maker and surety or indorser. Lowell v. Bickford, *supra* note 11; Johnston v. Knipe, *supra* note 11.

[14] Holding that the payee may be a holder in due course: Ford v. Shapiro, 207 Mass. 108, 92 N. E. 1029 (1910); Merchant's Nat'l Bank v. Smith, 59 Mont. 280, 196 Pac. 523 (1921); American Nat'l Bank v. Kerley, 109 Or. 155, 220 Pac. 116 (1923). *Contra:* Long v. Shafer, 185 Mo. App. 641, 171 S. W. 690 (1914).

[15] *Supra* note 1.

[16] Several of the courts have found difficulty in protecting the rights of accommodation makers and indorsers when the payee either extends the time of payment without the consent of the accommodation maker or discharges collateral security without the knowledge or consent of the accommodation maker or indorser. Confronted with the provisions of sections 119 and 120 of the N. I. L., the former of which does not provide for discharge of those primarily liable by extension of time or by release of collateral security, and the latter of which does not provide for discharge of those secondarily liable where there is a release of collateral security, a few courts have avoided the difficulty by holding that a payee was not a holder in due course, hence, by section 58, the instrument was subject to all defenses the same as if it were non-negotiable, so that resort to sections 119 or 120 was unnecessary, as the ordinary rules of contract or suretyship law could be applied. Southern Nat'l Life Realty Co. v. People's Bank, *supra* note 11; Strother v. Wilkinson, *supra* note 11; Howth v. Case Threshing Machine Co., *supra* note 11; Long v. Shafer, *supra* note 14. It would be preferable to treat the payee as capable of being a holder in due course, and amending sections 119 and 120 so as to expressly cover these cases.

IV. The courts have had no difficulty, apparently, in giving the payee the status of holder in due course for purposes of suit against the acceptor.[17] Yet if a payee cannot be a holder in due course it would follow logically, under the Negotiable Instruments Law, that defenses between drawer and drawee could be interposed just as if the instrument were non-negotiable. There is nothing in the statutory contract of the acceptor which would avoid this result.[18] The acceptor, just as does the maker,[19] engages that he will pay according to tenor. True, the acceptor admits in addition the drawer's power of drawing, but it is well settled that notwithstanding this, a payee taking in fraud or after maturity, so as not to be a holder in due course for these reasons, cannot recover in the face of defenses on the part of the acceptor.[20] Apparently the rule, before the Negotiable Instruments Law, was so well settled on this point that, whatever the inconsistency with other holdings, it will never be disturbed.

With these situations to be considered, the question resolves itself into one of policy, with three main courses open. One is to deny the possibility of a payee being given the status of holder in due course; the second is to distinguish between whether the payee is a "promisee" or "purchaser"; and the third to accord to the payee in all cases as much protection as any other taker of a negotiable instrument in good faith and for value. Courts interpreting the statute so as to adopt the first course appear to have a notion that "negotiation" must relate only to subsequent transfers of an instrument.[21] To say that this is neces-

[17] Jarvis v. Wilson, 46 Conn. 90 (1878); Bergstrom v. Ritz-Carlton Co., 171 App. Div. 776, 157 N. Y. Supp. 959 (1916); Carnegie Trust Co. v. First Nat'l Bank, 213 N. Y. 301, 107 N. E. 693 (1915).

[18] By section 62 of the N. I. L., "The acceptor by accepting the instrument engages that he will pay it according to the tenor of his acceptance; and admits:

1. The existence of the drawer, the genuineness of his signature, and his capacity and authority to draw the instrument, and

2. The existence of the payee and his then capacity to indorse."

[19] Section 60 of the N. I. L. provides that "The maker of a negotiable instrument by making it engages that he will pay it according to its tenor, and admits the existence of the payee and his then capacity to indorse."

[20] See Hill v. First Nat'l Bank, 129 Ark. 265, 195 S. W. 678 (1917).

[21] The argument is presented in this fashion in Foster v. Security Bank & Trust Co., *supra* note 1: "The reason for the doctrine of protection of a holder in due course of a negotiable instrument is the favor which the law puts upon such commercial transactions to facilitate confidence in commercial paper and to expedite transfers thereof free from hidden infirmities. It is an aid to a transfer of a completed instrument, and has nothing to do with the issuance and completeness of such instrument. Until there has been a complete issuance there is nothing, as between the immediate parties, to transfer, therefore there can be no transfer nor passing of any sort of title."

sarily true because the instrument has not been "issued" and so has not become part of the exchangeable currency of the country available for purchase is merely to assume the result. "Holder in due course" as used in the Act may be regarded as being merely a symbol which may by legislative act, if not by decision, be given what content is shown to be desirable. The character of the opinions following the first course, taken with the fact that so many cases hold that at least in some situations a payee may be treated as a holder in due course, indicates that there is little opinion in favor of, or reason for, denying the possibility of a payee being given such a status.

The second course would adopt the suggestion that a payee should be treated as a holder in due course when the instrument was taken from a so-called "remitter," but not when taken from an agent of the drawer or maker.[22] The distinction made in this suggestion applies, if at all, only in cases where the deliv-

This reasoning clearly does not apply in the case of payee versus acceptor, nor does it seem desirable in the case of payee versus co-maker or irregular indorser. As to such parties, if it is necessary to indulge in a fiction, it seems only fair to hold that the case is the same as though the instrument were signed by the indorser or co-maker to the order of the delivering party and by him indorsed to the creditor (payee). Howard Nat'l Bank v. Wilson, 96 Vt. 438, 120 Atl. 889 (1923). The case then falls squarely within the orthodox statement of policy. But even without this, one major item of policy is served by the increase of "confidence in commercial paper" which would come by recognizing that a payee may be a holder in due course.

[22] Moore, *The Right of the Remitter of a Bill or Note* (1920) 20 COL. L. REV. 749, at 758. The distinction is supported on the ground that the protection of the innocent purchaser depends on the ownership or apparent ownership of the third party. The case is limited to what is described as true "remittable" paper, such as bills of exchange and bank drafts, and would exclude checks, since a third person offering the latter to the payee "commonly is and always offers the appearance of being the agent for the drawer." But in a number of cases the payee of a check was considered a holder in due course. Watson v. Russell, *supra* note 6; Boston Steel & Iron Co. v. Steuer, *supra* note 10; Nat'l Investment Co. v. Corey, 222 Mass. 453, 111 N. E. 357 (1916); Colonial Fur Ranching Co. v. First Nat'l Bank, *supra* note 5; Bergstrom v. Ritz Carlton Co., *supra* note 17; Drumm Const. Co. v. Forbes, 305 Ill. 303, 137 N. E. 225 (1922); McLaughlin v. Paine Furniture Co., *supra* note 5. Professor Moore explains these cases on the ground that the courts overlooked the fact that checks are not habitually remitted, and says that if they were, the decisions would be correct. Yet of the cases decided after the adoption of the N. I. L. cited by Professor Moore in support of his view, two of them, Hathaway v. County of Delaware, 185 N. Y. 368, 78 N. E. 153 (1906) and Apostoloff v. Levy, 186 App. Div. 767, 174 N. Y. Supp. 828 (1919), make no mention of the N. I. L. and are decided on their peculiar facts which were such that the payees could not have taken in good faith without further inquiry; and the third, Bowles Co. v. Fraser, 59 Wash. 336, 109 Pac. 812 (1910) was decided at a time when Washington was holding that in any case a payee could not be a holder in due course.

ery was made by an *unauthorized* agent, and in such case it should not be necessary to say that the payee *cannot* be a holder in due course but only that in the particular case he *was* not such a holder.[23] The situation, however, involves conflicting principles: that the maker should not be bound if his agent exceeded his actual and apparent authority and, on the other hand, that a bona fide taker of a negotiable instrument is to be given special protection. The identical problem, moreover, may be presented whenever a specially indorsed instrument is delivered to the indorsee by the agent of the indorser in violation of instructions,[24] so it obviously does not require holding, where delivery is made to the payee by an agent of the maker, that the payee can not be regarded as a holder in due course.

It is believed that the wisest course would be to place the payee on the same footing as any other taker of a negotiable instrument. As pointed out in situation I, this would not allow recovery as against maker or drawer where there had been a failure of consideration or a taking in bad faith. But it would allow recovery against a co-maker, accommodation indorser and acceptor where such defenses by maker or drawer do not exist

[23] In a case where the instrument was stolen from the drawer and presented to the payee by the thief who represented himself as the agent of the drawer, it was held that the payee could not recover. Empire Trust Co. v. Manhattan Co., 97 Misc. 694, 162 N. Y. Supp. 629 (1916).

The question of whether a payee may be a holder in due course under the N. I. L. has not yet been decided by the New York Court of Appeals.

[24] There seems to be no authority as to when and under what circumstances an indorsee may be a holder in due course, where the payee has specially indorsed the instrument and given it to an agent who delivers it to the indorsee for the use and benefit of his principal, but in excess of his authority. However, when a payee indorses the instrument in blank and delivers it to his agent who delivers it to the indorsee in violation of his instructions, either for his own benefit or for the benefit of his principal, it has been held that the indorsee is a holder in due course without inquiring as to the scope of the agent's authority. Wedge Mines Co. v. Denver Nat'l Bank, 19 Col. App. 182, 73 Pac. 873 (1903). See JOYCE, DEFENSES TO COMMERCIAL PAPER (1907) § 121 and cases cited. This result is reached because the agent is considered as the apparent owner of the instrument indorsed in blank. On the other hand, when an agent, trustee, or officer of a corporation, in violation of his authority, indorses the instrument and applies the same to his own indebtedness, the indorsee is held to be under a duty to ascertain the extent of his authority. Ward v. City Trust Co., 192 N. Y. 61, 84 N. E. 585 (1908); Fisk Rubber Co. v. Pinkey, 100 Wash. 220, 170 Pac. 581 (1918); Bank of Benson v. Gordon, 103 Neb. 508, 172 N. W. 367 (1919); Jenkins v. Planter's Bank, 34 Okla. 607, 126 Pac. 757 (1912). From these two extreme rules might be drawn a modification applicable to the situation first above mentioned. Section 16 requires that "as between immediate parties . . . the delivery, in order to be effectual, must be made either by or under the authority of the party . . . indorsing." The finding of apparent authority may well be influenced in a particular case by the taking in "good faith."

and defenses between such parties and the drawer or maker are sought to be interposed. It is just this protection which the payee believes that he has acquired when he takes a negotiable instrument.

The "remitter" situation presents an additional factor, that is, protection from defenses between drawer or maker and "remitter." The situation was well exemplified by the case of *Jones, Ltd. v. Waring & Gillow, Ltd.*[25] The decision might be sustained legalistically by saying that checks are not "remittable" paper, interjecting an arbitrary distinction on which, however, it would be hard to reach unanimity of opinion.[26] It was put, however, on the bare ground that under the Bills of Exchange Act the payee of an order instrument cannot be a holder in due course. If the general possibility of a payee being a holder in due course is recognized, it may perhaps be unnecessary to give attention to this special situation.

Moreover, the adoption of the third course would bring the payee question into harmony with two other situations arising under the Negotiable Instruments Law, which must be considered. Ordinarily the maker or drawer makes the instrument payable directly to the order of the payee. But the maker or drawer might evidence his obligation by making it payable to himself and indorsing it to his creditor, the erstwhile payee. In this case, it never has been contended, apparently, that the creditor could not be a holder in due course.[27] The result is reached without resort to a "remitter" doctrine. And obviously the creditor is really no more a "purchaser" than if he had been named as payee. Again, the instrument may be drawn payable to bearer. In this case, too, the creditor would seem to satisfy the requirements of section 30 requiring only "delivery" to constitute "negotiation" of a bearer instrument and so might be con-

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[25] *Supra* note 1.

[26] See the article by Feezer, *op. cit. supra* note 4, at 104, n. 13. The writer argues that the interest of the payee should not depend merely upon the type of instrument he uses, and points out that not only in the case of checks, but promissory notes, too, payees have been treated as holders in due course. Ex parte Goldberg & Lewis, *supra* note 11; Liberty Trust Co. v. Tilton, *supra* note 11.

[27] Exchange Bank v. Beckwith, 37 Ga. App. 729, 124 S. E. 542 (1924); Public Bank of New York City v. Knox-Burchard Mercantile Co., 135 Minn. 171, 160 N. W. 667 (1916); Merritt v. Duncan, 54 Tenn. 156 (1872). *Cf.* Vogel v. Pyne, 197 App. Div. 633, 189 N. Y. Supp. 285 (1921). But *cf.* Little v. Rogers, 1 Metc. 108 (Mass. 1840).

The question of whether a payee may be a holder in due course apparently has not yet arisen in the highest courts of Georgia and Minnesota, although in the latter state, it was assumed in State Bank v. Missia, 144 Minn. 410, 175 N. W. 614 (1920), that a payee might be a holder in due course. Tennessee has squarely decided in the affirmative. See *supra* note 9.

sidered a holder in due course.[28] While matters of form are of importance in many cases, it does not seem that this distinction is understood in the business world, if indeed it is established as a matter of law, nor does there seem to be any point in recognizing it by legislation. On the contrary, it would be better to provide that the first taker of a negotiable instrument, whether he be payee, bearer or indorsee, is as much entitled to be given the status of holder in due course as is any other taker.

In those jurisdictions which have not recognized the possibility of a payee being a holder in due course, either section 52 or section 30 should be modified. It is submitted that, by amending only the latter portion of section 30, the section defining negotiation, to read, "if payable to order it is negotiated *to the payee by delivery or to a subsequent party* by the indorsement of the holder completed by delivery," [29] all points could be satisfactorily covered.

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[28] But see dictum in Foster v. Security Bank and Trust Co., *supra* note 1 reading as follows:

"In the act of negotiation there must be a transferer and a transferee. There must of necessity be an 'instrument' the subject matter of the transfer. This instrument must be owned by the transferor, whose title at least must not have been known to the transferee as having any infirmity. In other words, the subject of the transfer must be an instrument with all the elements of completeness in form and other requirements affecting the validity of its issuance. It must have been at the time of the transfer a negotiable instrument. It is suggested that the language 'if payable to bearer it is negotiated by delivery,' supports the view that a delivery to the payee is a negotiation of the instrument. But not so at all. The act is speaking of completed instruments—delivered instruments."

[29] (1926) 36 YALE LAW JOURNAL 158, at 160.