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DEDUCTIONS OF INTEREST IN COMPUTING NET INCOME FOR THE FEDERAL INCOME TAX

Among the deductions from gross income which an individual or a corporation is allowed to make in computing net income for purposes of the federal income tax is "all interest[1] paid or ac-

[1] Interest paid on delinquent taxes is deductible. Evans & Howard Fire Brick Co. v. Commissioner, 8 B. T. A. 867 (1927); see Northwestern Motor Car Co. v. Commissioner, 15 B. T. A. 1276, 1281 (1929). But *cf.* Kossar & Co. v. Commissioner, 16 B. T. A. 952 (1929).

crued[2] within the taxable year on indebtedness,[3] except on in-

[2] The taxpayer is privileged to render his returns on either the cash receipts and disbursements or the accrual basis, provided that his true income is clearly reflected. If books are kept and returns rendered on the cash receipts and disbursements basis, only interest paid within the taxable year may be deducted. Appeal of Seaboard Oil Co., 1 B. T. A. 1259 (1925); Appeal of Utah Orpheum Co., 3 B. T. A. 1041 (1926); Appeal of Georgia State Savings Ass'n, 4 B. T. A. 748 (1926); J. Kearsley Mitchell v. Commissioner, 19 B. T. A.—(Feb. 27, 1930). If the accrual basis is used, only interest accrued within the tax year may be deducted. Appeal of Tel-Electric Co., 1 B. T. A. 434 (1925); Appeal of John W. Butler, Inc., 1 B. T. A. 1105 (1925); Appeal of North Wayne Tool Co., 2 B. T. A. 366 (1925); Appeal of McIntosh-Seymour Corp., 2 B. T. A. 953 (1925); Appeal of Cumberland Glass Mfg. Co., 2 B. T. A. 1122 (1925); Appeal of H. Harwood & Sons Inc., 2 B. T. A. 1293 (1925); Appeal of Higginbotham-Bailey-Logan Co. v. Commissioner, 8 B. T. A. 566 (1927); Appeal of Saner-Ragley Lumber Co., 3 B. T. A. 927 (1926); George D. Davidson Co. v. Commissioner, 14 B. T. A. 91 (1928); *cf.* Appeal of Raymond-Hadley Corp., 4 B. T. A. 889 (1926). If the taxpayer changes from the cash disbursements to the accrual basis, interest accrued before such change and paid after the change can not be deducted. Appeal of National Bank of N. J., 1 B. T. A. 1238 (1925). Where payments of principal are due in one year and payments of interest, due in a subsequent year, are contingent upon some event occurring in the latter year, such interest is deductible in the latter year, even though returns are made on the accrual basis. Concord Electric Co. v. Commissioner, 7 B. T. A. 1027 (1927). If the basis on which the accounts are kept does not clearly reflect the true income, the taxpayer may be ordered to recast its accounts on another basis. Appeal of Comstock-Castle Stove Co., 4 B. T. A. 114 (1926).

[3] A tort claim against the taxpayer does not constitute "indebtedness" until reduced to judgment. Appeal of Joseph W. Bettendorf, 3 B. T. A. 378 (1926).

Interest paid by the taxpayer on indebtedness of another is not deductible, since the taxpayer has a claim against the principal debtor for reimbursement. P. P. Griffin v. Commissioner, 7 B. T. A. 1094 (1927) (endorser of note paid interest due thereon); Appeal of Farmers & Traders Bank, 4 B. T. A. 753 (1926) (owner of 37/90 of equity in land, legal title to which was in another, provided legal owner with funds to pay interest on mortgage); Continental Trust Co. v. Commissioner, 7 B. T. A. 539 (1927). But *cf.* with last case cited, Overland Knight Co. v. Commissioner, 15 B. T. A. 870 (1929). The principal debtor can not deduct as interest the amount repaid to the one paying the interest in the year in which reimbursement is made. William D. Hutchins v. Commissioner, 14 B. T. A. 421 (1928). Taxes assessed to meet interest on bonded indebtedness of a local improvement district are not deductible as interest by the person against whom they are assessed. F. A. Smith & Wife v. Commissioner, 11 B. T. A. 301 (1928); C. N. Comstock v. Commissioner, 15 B. T. A. 769 (1929).

Where an agreement to pay interest is unsupported by consideration, interest paid is not deductible. Miller Safe Co. v. Commissioner, 12 B. T. R. 1388 (1928); Simon Benson v. Commissioner, 9 B. T. A. 279 (1927) (interest-bearing note executed as a gift); A. Backus Jr. & Sons v. Commissioner, 6 B. T. A. 590 (1927); Appeal of Ohio Valley Tie Co., 3 B. T. A. 339 (1926); Drayton Mills v. Commissioner, 19 B. T. A.—(1930) (interest on deferred dividends on preferred stock prior to date of declaration).

debtedness[4] incurred or continued to purchase or carry obligations or securities . . . the interest upon which is wholly exempt from taxation under this title."[5] The Congress has quite wisely made no attempt to define the meaning of this section, leaving that task entirely to federal administrative and judicial bodies. In dealing with many of the situations which have arisen these bodies have been required to choose, as the basis for decision, between the form which the transaction has taken and the substance of the facts, which may not be truly reflected in the form. In most instances the tribunal passing upon the case has, after professing not to be governed by form, actually allowed itself to be controlled almost entirely by the shape in which the parties have molded their agreement to pay interest, regardless of the unreasonableness of the result obtained. Some recent cases, especially in the Circuit Courts of Appeals, have been decided in complete disregard of the form adopted, but in the main reliance still seems to be entirely upon this factor. Two distinct factual set-ups will be discussed as illustrative.

The first involves the situation where a taxpayer purchases an article, contracting to pay therefor in installments or in a lump

[4] This exception has been held not to apply to indebtedness incurred by a corporation to purchase stock in a domestic corporation, although dividends on the stock are not taxable to the holder. Appeal of Greenville Textile Supply Co., 1 B. T. A. 152 (1924). It does apply to interest paid on bonds of joint-stock land banks organized under the Federal Farm Loan Act of 1916, the proceeds of which bonds are used to make interest bearing loans to farmers, the interest on such loans being tax-exempt. First National Bank of Chicago v. United States, [1930] 3 C. C. H. 8407 (Ct. Cl.). As applied to the interest paid by a dealer in municipal bonds on indebtedness incurred in order to purchase such bonds, it has been held unconstitutional. Nauts v. Slayton, 36 F. (2d) 145 (C. C. A. 6th, 1929); (1930) 43 HARV. L. REV. 969. *Contra:* Appeal of Paul P. Prudden, 2 B. T. A. 14 (1925).

[5] 45 STAT. 799 (1928), 26 U. S. C. § 2023 (b) (1928). This is the present wording of the statute and the cases herein considered have all arisen under essentially similar provisions. Cases under the Corporation Tax Law of 1909, dealing with the limitation of the interest deduction to the amount of the paid-up capital stock, are not discussed since such limitation no longer exists.

With reference to the instant statute, the following provisions are contained, *inter alia*, in T. D. Reg. 74, art. 141: Interest paid by the taxpayer on a mortgage upon real estate of which he is the legal or equitable owner, even though he is not directly liable upon the bond or note secured by such mortgage, may be deducted as interest on his indebtedness. [But *cf.* Appeal of Farmers & Traders Bank, *supra* note 3]. Interest paid by a corporation on scrip dividends is deductible. Interest calculated for costkeeping or other purposes on account of capital or surplus invested in the business which does not represent a charge arising under an interest bearing obligation is not deductible. [*Cf.* Ella Daly King v. Commissioner, 10 B. T. A. 698 (1928), where interest paid by a partnership to the partners on their capital contributions was held not deductible in computing the net income of the partnership].

sum at a future date, the total price to be paid being in excess of the cash purchase price. May he deduct from his gross income this excess over the cash price on the ground that it represents interest? The Board of Tax Appeals has declared that he may if he can sustain the burden of proving that the parties to the contract intended that a definite portion of the payments should constitute interest.[6] Apparently, however, this declaration is of little aid to the taxpayer unless specific mention of interest has been made in the contract, for it has been held that such burden of proof is not sustained by showing that the deferred price exceeded the cash price and that the vendee had the option of paying before the due date any balance remaining less a discount thereon at a specified rate for the unexpired term;[7] and more recently the Board has stated flatly that ". . . where sales are made on the deferred payment plan, interest not being provided for in the contract of sale, no part of the deferred payments will be considered as interest."[8] In the common case where the credit price is computed by adding to the cash price an amount equivalent to a higher rate of interest than would be allowed under the usury laws the purchaser will be unable to incorporate a reference to interest in the contract, since the vendor will be unwilling to have it appear that the excess is regarded as interest for fear of running afoul of the defense of usury.[9] Thus the purchaser on credit will, through the medium of the income tax, be subjected to an additional expense by the very usury laws which were designed to protect him.

In these cases the theory of the Board has been that the excess over the cash price represents compensation for the risk of nonpayment plus payment for the use of money, and that only the latter amount constitutes interest.[10] Proof by the taxpayer of the exact sum paid as interest in this sense is demanded and such proof is regarded as impossible unless provision has been made in the contract of sale. Such a theory is certainly inconsistent with allowing the maker of a note bearing six per cent. interest to deduct the entire six per cent.,[11] for such interest also repre-

[6] See Appeal of Marsh & Marsh, Inc., 5 B. T. A. 902, 904 (1926).

[7] Appeal of Marsh & Marsh, Inc., *supra* note 6; Appeal of Carl Lang, 3 B. T. A. 417 (1926); *cf.* Robert Long v. Commissioner, 5 B. T. A. 438 (1926); Appeal of Anderson & Co., 6 B. T. A. 713 (1927).

[8] Daniel Bros. Co. v. Commissioner, 7 B. T. A. 1086 (1927), *aff'd*, Daniel Bros. Co. v. Commissioner, 28 F. (2d) 761 (C. C. A. 5th, 1928).

[9] Where an article is sold on credit for an amount which exceeds the cash price by more than the amount of interest on the cash price allowable under the usury law, nevertheless the defense of usury will usually be held unavailable to the purchaser if no specific mention of interest at a usurious rate is made in the contract. Comment (1930) 39 YALE L. J. 408.

[10] See Appeal of Marsh & Marsh, Inc., *supra* note 6, at 905.

[11] Such interest is clearly deductible. Appeal of N. Shure Co., 4 B. T. A. 1181 (1926).

sents payment for the use of money plus compensation for the risk of non-payment of the principal. The theory which the Board has adopted, however, has been upheld by one court:

> "There would be an obvious lack of plausibility in a contention that in the case of any contract of sale under which the agreed price is payable not when the sale takes effect but thereafter, the buyer's compliance with his obligation to pay the agreed price involves the payment of interest. [This] would amount to saying that every credit purchase . . . . gives rise to a right to a deduction for interest paid or accrued, on the theory that the credit price includes what the cash price would have been plus interest on the amount of the cash price." [12]

It is submitted that the amount by which the credit price exceeds the cash price is as much interest in the case where the credit price is stated in one amount in the contract of sale as it is in the case where it is stated in two amounts, one of which is designated as interest. In the former case, perhaps, any attempt to prove the cash price should be scrutinized carefully to prevent avoidance of the tax, but where the cash price has been clearly proved, the doctrine that in the interpretation of tax statutes any doubt must be construed "most strongly against the government and in favor of the citizen," [13] should lead to a construction of the Revenue Act to allow the deduction of the excess of the credit over the cash price.[14] Indeed, the Board of Tax Appeals has recently allowed the deduction of a portion of annual sums paid for the purchase of land, where the only distinction from former cases lay in the fact that the payments were to be made for an indefinite period (the life of the vendor), rather than for a definite length of time. While it was this difference which influenced nine members of the Board (seven dissented) to reach an opposite result from that of former cases,[15] such a distinction seems tenuous at best.

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[12] Daniel Bros. v. Commissioner, *supra* note 8, 28 F. (2d) at 762.

[13] See Gould v. Gould, 245 U. S. 151, 153, 38 Sup. Ct. 53 (1917).

[14] Given the cash price, the amount of the installments, and the length of time in which payment is to be made, the rate of interest to be deducted each year may be computed by the use of the formula $P = \frac{a}{1+r} + \frac{a}{(1+r)^2} + \ldots . \frac{a}{(1+r)^n}$ where P = cash price, a = amount of each installment, n = the number of years, and r = rate of interest. For example, assume the cash price to be $100 and the credit terms to be $200 payable in two equal annual installments. Then $100 = \frac{100}{1+r} + \frac{100}{(1+r)^2}$ and r = .62. The deduction for interest would be $62 the first year and $38 the second (*i.e.* 62% of the portion of the principal remaining unpaid).

[15] John C. Moore Corp. v. Commissioner, 15 B. T. A. 1140 (1929). "If we regard the annuity payments here in question as deferred payments of the purchase price, there is no fixed cost until the annuitant dies, and insoluble

A second situation, in which, at least from an administrative point of view, it may be more justifiable to rely on the form of the transaction, arises when an incorporated taxpayer attempts to deduct so-called dividend payments on securities created by it. Where the incidents of such securities are of a peculiar nature it becomes extremely difficult to determine whether payments thereon are in the nature of dividends on shares of stock or interest on indebtedness. The fact that one corporate creditor may be preferred over another is scarcely sufficient to justify a refusal to allow the debtor a deduction for interest paid the junior creditor, yet the difference between debenture bonds, interest on which is deductible,[16] and some types of preferred shares, amounts to little more than this.

For instance, a corporation creates a security which it designates "preferred stock," having the following incidents: cumulative dividends at a fixed rate are to be paid out of "surplus" or "net profits"; the shares are preferred, but limited, as to dividends and distribution of assets both over existing classes of shares and any classes which may subsequently be created; the holders are not entitled to vote; severe restrictions are placed on the corporation with respect to incurring unsecured indebtedness and it is forbidden to mortgage its property while the "preferred stock" is outstanding; and the claims of the holders are made subordinate to those of creditors.[17] In addition, it may be provided that the "shares" must be redeemed at par on a certain date, and that on failure to pay the dividends or to redeem the holder may, at his option, require liquidation and receive payment out of the assets.[18] The security may even be designated

difficulties appear in the application of the tax law to any transaction which necessitates the fixing of such cost prior to such death." *Ibid.* 1143. The Board assumed an interest rate of 6 per cent. and allowed a deduction of the excess of each annual payment over the present value of such payment at the time the contract was made.

[16] Appeal of New Orleans, Texas & Mex. Ry., 6 B. T. A. 436 (1927).

[17] William Cluff Co. v. Commissioner, 7 B. T. A. 662 (1927). The corporation, while the "preferred stock" was outstanding, was forbidden to create any unsecured indebtedness of more than one year, was required to maintain an excess of current assets over current liabilities equal in amount to 150% of the "preferred stock", and was required to establish, and pay specified annual sums into, a sinking fund for the redemption of the "preferred stock."

[18] Appeal of Leasehold Realty Co., 3 B. T. A. 1129 (1926). *Cf.* Paramount Knitting Mills v. Commissioner, 17 B. T. A. 91 (1929). There a creditor of the taxpayer corporation held a note bearing interest at 6 per cent. Upon his demand for a 2 per cent. increase in the interest rate the corporation issued to him 8 per cent. preferred stock, having a par value equal to the face value of the note. The creditor was allowed to retain the note and had the right, upon returning the shares, to demand cash payment of the note at any time. It was agreed that all dividends up to 6 per cent. on the shares should be treated as interest on the note. The

"debenture stock." [19] Should a so-called "debenture bond" be given these incidents the Board of Tax Appeals would undoubtedly allow the corporation to deduct interest thereon,[20] but where such words as "stock," "dividends," "shares of preferred stock," etc. have been used the deduction has been disallowed on the ground that payments made constituted "dividends," not "interest on indebtedness." "To be sure [said the Board] the holders of this class of stock are preferred in such a manner that they are almost certain to have their stock redeemed," [21] yet this was considered insufficient to raise the securities to the plane of representing money borrowed, as distinguished from an "investment which is risked in the enterprise." [22]

In these cases the Board is faced with the necessity of differentiating between interest on indebtedness and dividends on shares. Both shareholder and creditor in fact are investing in the enterprise and each expects repayment of his money plus an additional sum as compensation for furnishing the money. The distinction between them is one of degree only; there is probably no one incident or group of incidents which is exclusively typical of either. Some types of securities may have such a preponderance of incidents usually possessed by one class that decision thereon will not be difficult,[23] but when the Board is

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Board held payments up to 6 per cent. deductible as interest. *Cf.* Overland Knight Co. v. Commissioner, *supra* note 3. If the note is exchanged for the shares, however, and the shares are surrendered upon repayment of the amount of the loan, dividends paid on the shares while outstanding are not deductible by the corporation. Appeal of Dickey Grocery Co., 1 B. T. A. 108 (1924).

[19] Appeal of Kentucky River Coal Corp., 3 B. T. A. 644 (1926).

[20] *Cf.* Appeal of New Orleans, Texas & Mex. Ry., *supra* note 16.

[21] William Cluff Co. v. Commissioner, *supra* note 17, at 668.

[22] The Board has attempted to differentiate between dividends and interest in the following language: "Ordinarily interest is compensation for the use of money borrowed, while dividends represent that part of the earnings paid to the stockholder on his investment which is risked in the enterprise." Doan Savings & Loan Co. v. Commissioner, 12 B. T. A. 772, 780 (1928). Obviously, both creditors and shareholders risk their funds in the enterprise; the difference lies only in the degree of risk.

[23] The Board has refused to allow co-operative associations to deduct payments made only out of earnings which were designated by the by-laws as "interest on paid-up capital stock not exceeding 5% per annum." Equity Union Creamery & Merc. Ex. v. Commissioner, 9 B. T. A. 413 (1927); Appeal of the Farmers' Cooperative Ass'n, 5 B. T. A. 61 (1926); Appeal of Trego County Cooperative Ass'n, 6 B. T. A. 1275 (1927); Farmers' Cooperative Milk Co. v. Commissioner, 9 B. T. A. 696 (1927); Selby Equity Union Exchange v. Commissioner, 12 B. T. A. 1383 (1928); *cf.* Appeal of Sacred Heart Cooperative Merc. Co., 2 B. T. A. 24 (1925).

Dividends on stock of a building and loan association, which has failed to qualify for an exemption from taxation accorded to building and loan associations because of lack of mutuality in its organization, may not be deducted as interest paid, even though the shareholders are entitled to with-presented only with the creation of a peculiar security and the peculiar incidents thereof, in what way can it determine whether such security represents "indebtedness" or a "share of stock"? Administrative considerations make it desirable to adopt a rule which will enable the tax collecting bodies to dispose of cases with facility; the great number of cases handled by the Board of Tax Appeals alone is a forcible argument in favor of such a rule.[24] In such a situation it seems reasonable to say that the income tax law sets forth its provisions in order that the taxpayer may make his choice of the form in which he will phrase transactions into which he enters and that he should be bound by his election. Reliance on the form of the security would greatly facilitate the decision of each case. Such a rule, designed for the aid of the tax collecting bodies, should, if possible, not be applied when its application will enable a taxpayer to make deductions by the use of a form which on its face is obviously fictitious, yet the Board has shown some indication of a willingness to apply the rule even to such an extent.[25]

Where, however, the taxpayer shows that the creation of the security originated in a loan transaction, the incidents attached to the security and the manner in which it is worded cease to be

draw at any time, receiving the amount of all credits upon withdrawal, less any share of the company's loss in excess of the reserve fund. Doan Savings & Loan Co. v. Commissioner, *supra* note 22; Guaranty State Savings & Loan Co. v. Commissioner, 14 B. T. A. 72 (1928). But where such an association attempted to qualify for the exemption accorded to building and loan associations by requiring all borrowers to apply for "loan stock" and make small deposits thereon, the Board, looking beyond the form, concluded on the facts that there was no bona fide intention to make such borrowers shareholders and that the application for stock was merely a colorable attempt to avoid all income taxation. Having so concluded, it was held that "dividend" payments on "loan stock" were in reality interest payments on the deposits made and deduction for such interest was allowed. Guaranty State Savings & Loan Co. v. Commissioner, *supra*.

[24] Since the Board heard its first case on August 19, 1924, and to April 1, 1930, it has by decision or final order disposed of approximately 30,000 cases, exactly 6,000 of them by written decision and upon the merits. Book Review, Manual to United States Board of Tax Appeals Reports (June 1930) 39 YALE L. J.——.

[25] In Johnson Locke Merc. Co. v. Commissioner, 15 B. T. A. 1314 (1929) the taxpayer had entered into a composition agreement with creditors whereby it was to pay 45 per cent. of the principal obligation within a specified time. Such payment, it was agreed, would discharge all liability of the taxpayer to the creditors involved. The contract provided that all sums paid should be regarded as interest and not as payments on principal. The Board declared that all sums paid under such an agreement could be deducted, so long as the deductions did not exceed the total liability of the taxpayer under the agreement. It is difficult to comprehend how all of the payments which went to discharge the principal obligation could be considered as interest, even though the parties had so designated such payments. *Cf.* Ella Daly King v. Commissioner, *supra* note 5.

the only factors on which decision need be based. If the incidents and form leave the question as to the nature of the security in doubt, proof that a credit transaction was for some purpose obscured in the creation of a hybrid type of security should be sufficient to resolve the doubt in favor of the taxpayer. Thus one wishing to borrow money may, at the instance of the lender, be forced to incorporate his business and issue to the lender securities having such incidents as those set out above in order to cover up usurious interest which may be exacted. Even in such a case the Board of Tax Appeals has refused to look beyond the form of the transaction and, despite the fact that "dividends" were payable out of various funds in addition to earnings, has held that no deduction would be allowed.[26] On appeal to the Circuit Court of Appeals, however, the decision of the Board was reversed,[27] the court saying:

> "We therefore conclude that a taxpayer who borrows money at a usurious rate of interest and who, to conceal the usury, is compelled to execute a document which does not correctly describe the relationship of the parties, may, as against the government, disclose the true relationship of debtor and creditor. Sums by it paid as interest, regardless of the name by which it is called, may be deducted by the taxpayer from its income."

A similar result was reached in the recent case of *Wiggin Terminals v. United States*.[28] In 1915 the petitioner, a warehouse company, determined to establish a fumigating plant in its warehouse. Application for the necessary funds was made to two banking houses, Estabrook & Co. and Parkinson & Burr. An informal oral understanding was reached to the effect that the bankers were to advance $50,000, to be repaid with interest at 6 per cent., with an additional payment of a lump sum of $50,000,

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[26] Appeal of Arthur R. Jones Syndicate, 5 B. T. A. 853 (1926). A syndicate formed to buy, sell, and rent land wished to borrow from *X*, who demanded 14 per cent. interest. To avoid the usury laws the syndicate issued to *X* its "First preferred shares," redeemable at a certain date. These were the only shares of this class created. They had no voting power, except upon default in redemption, when they would acquire complete voting power, including power to sell the land. "Dividends" at the rate of 14 per cent. were payable out of rents in excess of expenditures, out of money borrowed, or out of money furnished by the other shareholders. The first preferred were subordinate to creditors.

[27] Arthur R. Jones Syndicate v. Commissioner, 23 F. (2d) 833 (C. C. A. 7th, 1927). In McCoy-Garten Realty Co. v. Commissioner, 14 B. T. A. 853 (1928), a somewhat similar situation was presented and the deduction disallowed. The Jones Syndicate case was distinguished on the ground that there was no showing that the borrower was compelled to execute a document incorrectly describing the relationship of the parties in order to avoid the usury law.

[28] 36 F. (2d) 893 (C. C. A. 1st, 1929), *rev'g* 29 F. (2d) 576 (D. Mass. 1928).

all to be paid out of the earnings of the fumigating plant. In pursuance of the informal understanding the bankers made expenditures and entered into contracts for the construction of the plant. In 1916 the petitioner caused to be incorporated the Terminal Fumigating Co. The bankers then contracted with the fumigating company to complete the plant, transfer it at cost to the fumigating company, and procure a lease to said company of the premises of the warehouse company on which the plant was located. The fumigating company promised to reimburse the bankers for all expenses incurred in the construction of the plant and, in addition, to transfer to them its entire authorized capital stock. The bankers then entered into a contract with the warehouse company which provided that the bankers should acquire the capital stock of the fumigating company and transfer it free of charge to the warehouse company when the bankers had received all advances plus interest, and $25,000 apiece in dividends on such shares. In 1916 the fumigating company paid the $50,000 advances with interest, and in 1917 Estabrook & Co. received $25,000 in dividends. Parkinson & Burr waived their dividends in 1916 and 1917, as they were privileged under the contract to do, and in 1918 entered into a new contract with the warehouse company pursuant to the terms of which they transferred to the said company the shares held by them in the fumigating company, the warehouse company agreeing to pay Parkinson & Burr $25,000 out of one half the dividends on the shares of the fumigating company. This latter payment was made in 1918 and the warehouse company, filing a consolidated return with the fumigating company, sought to deduct it as interest. The deduction was disallowed, the tax paid under protest, and suit brought to recover the additional tax. The district court sustained a demurrer to the petition on the ground that the form in which the formal transaction had been molded changed the nature of the payments from interest on a loan to capital expenditure for the purchase of the shares in the fumigating company. The Circuit Court of Appeals, however, came to the conclusion that the transaction was in its inception a loan transaction and, looking beyond the form that was adopted in order to protect the bankers against a defense of usury as to the $50,000 bonus, reversed the lower court.

In such a case, where the facts clearly show a loan transaction involving usurious interest, it seems unjustifiably harsh to force the borrower to submit to an additional tax merely because he was compelled to deprive himself of the defense of usury in order to obtain the loan. Clear and convincing proof should be demanded of a taxpayer who asserts that the form of a transaction into which he has entered does not clearly reflect the substance of the transaction, but when such proof is forthcoming it seems unreasonable to hold that the form is determinative of the taxpayer's rights.

PROOF OF DAMAGE UNDER THE ANTI-TRUST ACTS

The Sherman Anti-Trust Act[1] was passed "to prevent the stifling of competition."[2] As a remedy for individuals injured as a result of the formation of illegal combinations or monopolies, Section 7 provides for the award of damages three times those suffered by reason of the illegal restraint.[3] The same clause was made a part of the Clayton Act.[4] In the recent case of *Paterson Parchment Paper Co. v. Story Parchment Co.*,[5] the Circuit Court of Appeals for the first circuit was faced with the difficulty of applying this treble damage clause. The plaintiff sued for damages alleged to be the result of a monopoly maintained by the defendants in violation of Section 2 of the Sherman Act.[6] The defendants, with others, controlled the parchment paper market by means of a price fixing association. The plaintiff, acting upon the belief that its more efficient machinery would enable it to produce the product more cheaply, tried to enter the market by underselling the existing "competitors." The latter concertedly lowered their prices, and the plaintiff's business failed. The plaintiff claimed two items of damages: (a) "loss of profits", based upon the difference between the prices actually received from the sale of its goods and the prices existing upon its entrance into the field, and (b) the depreciation in the value of its

[1] 26 STAT. 209 (1890), 15 U. S. C. § 1 *et seq.* (1926).

[2] See Whitwell v. Continental Tobacco Co., 125 Fed. 454, 462 (C. C. A. 8th, 1903). In U. S. v. Patterson, 201 Fed. 697, 716 (S. D. Ohio 1912), the court in discussing the purposes of the Sherman Act insisted: "Eminent authority, beginning with Lord Chief Justice Hale, have declared that the Christian religion is a part of the law of England . . . It is said by Justice Brewer . . . that the United States is a Christian nation. No finding on this question is here made, for it is not necessary; but it may safely be said that civilization, as we understand it, so far as the recognition of the individual in the community and his rights are concerned, is the outgrowth of the appreciation that, among many other things, dealings between man and man must be on terms of justice, and justice requires that no man shall build up his business by acts whose purpose is to put the purchasing public at his mercy or to exploit others to his advantage, and destroy thereby the opportunities of others to exercise their talents and desires in the same field of mercantile activity."

[3] "Any person who shall be injured in his business or property by any other person or corporation by reason of anything forbidden or declared to be unlawful by this act, may sue therefor, . . . and shall recover threefold the damages by him sustained. ." 26 STAT. 210 § 7 (1890), 15 U. S. C. § 15 (1926).

[4] 38 STAT. 731 § 4 (1914), 15 U. S. C. § 15 (1926).

[5] 37 F. (2d) 537 (C. C. A. 1st, 1930). The Supreme Court has granted *certiorari*. U. S. Daily, April 15, 1930, at 489.

plant due to its being forced out of business. The jury in the District Court found that there had been a monopoly in restraint of trade as a result of which the plaintiff had been injured in its business, and awarded damages. The Circuit Court of Appeals, reversing this decision, held that a verdict should have been directed for the defendants because (1) the "loss of profits" was speculative and conjectural, and (2) the factory depreciation was not shown to have been caused by the defendants' monopoly. A dissenting opinion maintained that the definiteness of the proof of loss of profits and the existence of causal relation between the depreciation and the restraint were both questions of fact for the jury which were improperly decided by the court.

To recover under Section 7 of the Sherman Act a plaintiff must prove that there has been a restraint of trade on the part of the defendants, that he has suffered an injury in his business and property, and that the injury sustained was caused by the illegal acts of the defendants.[7] There are thus three different evidential requirements to be met, failure to meet any of which will effectually block a recovery.[8] In the instant case there was no question of the proof of a restraint of interstate commerce—that was con-

[6] "Every person who shall monopolize or attempt to monopolize or combine or conspire with any other person or persons to monopolize any part of the trade or commerce among the several states or foreign nations, shall be deemed guilty of a misdemeanor. . . ." 26 STAT. 209 § 2 (1890), 15 U. S. C. § 2 (1926).

[7] See the express provisions of the section, *supra* note 3.

[8] Many cases brought under § 7 of the Sherman Act fail to run the procedural gauntlet, and thus never reach the point of having to meet these three evidential requirements. A few of the cases decided on demurrer are: Binderup v. Pathe Exchange Inc., 263 U. S. 291, 44 Sup. Ct. 96 (1923); Gibbs v. McNeeley, 102 Fed. 594 (C. C. W. D. Wash. 1900); Wheeler-Stenzel Co. v. National Window Glass Jobbers' Ass'n, 152 Fed. 864 (C. C. A. 3d, 1907); Thomsen v. Union Castle Mail S. S. Co., 166 Fed. 251 (C. C. A. 2d, 1908); Pennsylvania Sugar Refining Co. v. American Sugar Refining Co., 166 Fed. 254 (C. C. A. 2d, 1908); People's Tobacco Co. v. American Tobacco Co., 170 Fed. 396 (C. C. A. 5th, 1909); Ware-Kramer v. American Tobacco Co., 180 Fed. 160 (E. D. N. C. 1910); Hale v. O'Connor Coal & Supply Co., 181 Fed. 267 (C. C. D. Conn. 1908); Hale v. Hatch & North Coal Co., 204 Fed. 433 (C. C. A. 2d, 1913); Marienelli v. United Booking Offices of America, 227 Fed. 165 (S. D. N. Y. 1914); Hood Rubber Co. v. United States Rubber Co., 229 Fed. 583 (D. Mass. 1916); United Copper Securities Co. v. Amalgamated Copper Co., 232 Fed. 574 (C. C. A. 2d, 1916); American Steel Co. v. American Steel & Wire Co., 244 Fed. 300 (D. Mass. 1916); Noyes v. Parsons, 245 Fed. 689 (C. C. A. 9th, 1917).

[9] In the following cases the plaintiff failed to meet the first of these three requirements: Virtue v. Creamery Package Co., 227 U. S. 8, 33 Sup. Ct. 202 (1913); Blumenstock Bros. Adv. Agency v. Curtis Pub. Co., 252 U. S. 436, 40 Sup. Ct. 385 (1920); Frey & Son, Inc. v. Cudahy Packing Co., 256 U. S. 208, 41 Sup. Ct. 451 (1921); U. M. W. A. v. Coronado Coal Co., 259 U. S. 344, 42 Sup. Ct. 570 (1922); Dueber Watch-Case Co. v. Howard Watch Co., 66 Fed. 637 (C. C. A. 2d, 1895); Whitwell v. Continental Tobacco Co.,

sidered to have been established.[9] But in regarding the plaintiff's loss of profits as speculative and conjectural the court raised the issue presented by the second requirement. Likewise, though admitting the depreciation of the plant, the court refused recovery on the ground that a "measurable" connection had not been established between the damage and the collusion, thus raising the issue presented by the third requirement.

A long line of cases has laid down the rule that damages cannot be recovered if based solely on "speculation and conjecture" but must be logically inferrable from facts and expressible in figures.[10] To this rule the court adhered in the instant case. But although the application of this rule to the facts of a given case is usually left to the jury,[11] the Circuit Court of Appeals here ordered a directed verdict for the defendants. Were the facts in this case so clear as to warrant this summary action on the part of the court?

Normally such action has been taken in cases where, had the alleged damage actually been suffered, far better proof of it would have been available than was produced at the trial. Thus in *Central Coal & Coke Co. v. Hartman*,[12] a retail coal dealer claimed damages for the refusal of certain wholesale coal dealers to sell him coal. This inability to secure coal allegedly resulted in a decrease in the plaintiff's retail sales, but on the trial no books or accounts were produced to prove such a decrease. The court held that, in the absence of proof of the actual expenses and profits of an established business anterior to and during the period of restraint, any claim of damages based on diminished profits would be speculative, remote and conjectural. Throughout the opinion it was intimated that, had the plaintiff been injured as claimed, acceptable evidence not produced at the trial would have been available to substantiate the claim of injury.[13]

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supra note 2; Locker v. American Tobacco Co., 218 Fed. 447 (C. C. A. 2d, 1914); Konecky v. Jewish Press, 288 Fed. 179 (C. C. A. 8th, 1923). For an exhaustive article on the meaning of "restraint" under § 8 of the Sherman Act, see Comment (1929) 38 YALE L. J. 503.

[10] Lowry v. Tile, Mantel & Grate Ass'n of California, 106 Fed. 38, 46 (N. D. Cal. 1900); McCornick v. United States Mining Co., 185 Fed. 748, 751 (C. C. A. 8th, 1911); American Sea Green Slate Co. v. O'Halloran, 229 Fed. 77, 79 (C. C. A. 2d, 1915).

[11] Lowry v. Tile, Mantel & Grate Ass'n of California, *supra* note 10. This case was later affirmed in 115 Fed. 27 (C. C. A. 9th, 1902) and in 193 U. S. 38, 24 Sup. Ct. 307 (1904).

[12] 111 Fed. 96 (C. C. A. 8th, 1901).

[13] *Ibid.* 102. In McCornick v. United States Mining Co., *supra* note 10, the plaintiff claimed damages for the inactivity of a mine closed by an injunction issued upon the request of the defendants. The damages estimated were based on an output far in excess of the actual output either before or after the inactive period. Terming the claim "speculative" because not substantiated by the company's books showing the real output, the court refused a recovery. Again the claim seemed fictitious when con-

The case of *American Sea Green Slate Co. v. O'Halloran*[14] presented a similar situation. The plaintiff was forced to buy slate at advanced prices due to an illegal sales agreement of the de- and for the difference between his purchase price and the market price of slate; but on the trial the loss of specific customers was not shown and the "market price" turned out to have been computed without reference to the qualities and quantities which the plaintiff had bought. In the absence of more specific evidence the court held the loss had not been established and denied recovery.[15]

An even clearer case against recovery was presented in *Jack v. Armour & Co.*[16] The plaintiff there set out in considerable detail an illegal combination maintained in the meat-dressing and packing business. He then alleged that he was engaged in the business of buying and selling hogs and cattle. The petition concluded with the bare statement that he had been injured in his business in the sum of $25,000 by reason of the monopoly. Since the plaintiff failed to prove specific injury, the court held that no cause of action inured to his benefit as a result of the monopoly merely because he was in the same business with the defendants.[17] And in *Keogh v. C. & N. W. Ry.*,[18] upon which the court in the *Paterson* case laid much emphasis, the plaintiff's evidence of damage was even less satisfactory. There the plaintiff sought damages based on freight rates charged him by the defendants. The rates were shown to have been held reasonable by the Interstate Commerce Commission. In denying the plaintiff's claim that he was entitled to have his freight shipped at rates set by competition among the carriers, the court held that "damages" resulting from a nonexistent, illegal theory of rate-making were purely speculative. Clearly, having paid rates recognized by the Commission, the plaintiff had suffered no damage.[19]

These are the leading cases in which the courts have held the

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sidered in the light of the best evidence: the books and accounts of the going concern.

[14] *Supra* note 10.

[15] But see *infra* notes 20 and 22.

[16] 291 Fed. 741 (C. C. A. 8th, 1923).

[17] The refusal of the court to recognize such a claim as this is readily understood. The plaintiff, presumably a dealer who sold to such organizations as that of the defendants, is seeking to capitalize on the existence of the conspiracy. But § 7 is not so broad in its terms as to give any rights to those who have not been specifically injured.

[18] 260 U. S. 156, 43 Sup. Ct. 47 (1922).

[19] The claim of the plaintiff was obviously ridiculous. The rates had been held reasonable in proceedings before the Interstate Commerce Commission to which the present plaintiff had himself been a party. Were a shipper forced to pay rates declared excessive by the Interstate Commerce Commission, however, it is clear that recovery would be granted. See Meeker v. Lehigh Valley Ry., 162 Fed. 354, 358 (C. C. S. D. N. Y. 1908).

evidence of injury too speculative to admit of a recovery. There are, however, many decisions in which recoveries have been granted. The simplest case is where a plaintiff alleges and proves the loss of specific customers due to the illegal activities of the defendants.[20] If he shows loss due to his inability to round out his stock because of the refusal of the defendants to sell him goods he may recover for that loss.[21] If he shows that he was forced to pay higher prices for goods of the defendants than others paid, that is a recoverable loss.[22] If a plaintiff has a going concern and can show the difference between profits made during a period of discrimination against him and an earlier period when he was dealing in a competitive market, he can recover the difference as anticipated profits.[23] Finally, if a plaintiff has been forced to pay enhanced prices due to a price-fixing combination, the courts have awarded as damages the difference between the price paid and "the reasonable price of the commodity under natural competitive conditions." [24]

A study of the cases discussed indicates that "speculation and conjecture" cannot be categorically defined so that the decisions will fall automatically into the recovery or the non-recovery group. The courts must take care lest a conspiracy in restraint of trade be always followed by a series of fictitious damage suits; yet an award of damages should be made if an injury has in fact occurred. The rule laid down and followed should therefore be elastic enough to permit of application to the many variations in fact situations.[25] The facts of the instant case differ in two important respects from those in the cases in which the rule had previously been applied. In the first place, the plaintiff in those cases had always been a going concern pre-dating the illegal conspiracy, while the plaintiff in the *Paterson* case entered the parchment paper industry after the monopoly was fully organized. In the second place, the discriminations sued on in the earlier cases were vertical (mainly refusals to sell goods),

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[20] Thomsen v. Cayser, 243 U. S. 66, 37 Sup. Ct. 353 (1917).

[21] Victor Talking Mach. Co. v. Kemeny, 271 Fed. 810 (C. C. A. 3d, 1921).

[22] Lowry v. Tile, Mantel & Grate Ass'n of California, *supra* note 10; Straus v. Victor Talking Mach. Co., 297 Fed. 791 (C. C. A. 3d, 1924).

[23] Eastman Kodak Co. v. Southern Photo Material Co., 295 Fed. 98 (C. C. A. 5th, 1923). But the courts refuse the recovery of anticipated profits based upon past earnings in a non-competitive field. Victor Talking Machine Co. v. Kemeny, *supra* note 21; Eastman Kodak Co. v. Blackmore, 277 Fed. 694 (C. C. A. 2d, 1921).

[24] Atlanta v. Chattanooga Foundry & Pipe Works, 127 Fed. 23 (C. C. A. 6th, 1903).

[25] It is at once apparent that "speculation and conjecture" has much in common with such concepts as "public interest", "due care", or "proximate cause". Boundless in themselves, their limits must be pricked out by a series of judicial utterances. And irregularities in the resulting pattern are inevitable.

whereas in the *Paterson* case the plaintiff claimed injuries resulting from attempted horizontal competition with the defendants. These dissimilarities increased materially the difficulty of proving damages. Since the concern was new, neither the loss of customers, nor a decrease in business, nor the record of earlier profits were available as standards by which to measure damages. Prices in the open market were likewise unavailable as a measure of damages, for there had been no open market for years. Furthermore, as this was not a simple vertical set-up, damages could not be proved merely by showing a refusal of the defendants to deal with the plaintiff. Thus all of the standards used to measure damages in the earlier cases were unavailable in the case under discussion.

To demand of the plaintiff that he use these standards or none precluded a recovery.[26] The effect of such a holding is to make the damage clause of the Anti-Trust Acts available as a remedy only to well established concerns, and not to newcomers in a particular field. Yet the act was designed to protect the one as well as the other.[27] To accomplish this protection it seems reasonable that the court should have recognized the new elements peculiar to the plaintiff's situation and allowed the question of the existence and amount of damage to go to the jury.[28]

In addition to the "loss of profits" item the plaintiff sued for damages caused by the depreciation in the value of his factory. The Circuit Court of Appeals, vacating the decision of the lower court in which the jury had awarded damages based partly on

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[26] Cases such as the Paterson case must of course be distinguished from a case such as Pennsylvania Sugar Refining Co. v. American Sugar Refining Co., *supra* note 8, where the defendants have acquired share control of a competing organization and have by this means proceeded to undermine the welfare of the rival company. No such direct interference characterizes the case of competing industries carrying on a price war.

[27] "It is as unlawful to prevent a person from engaging in business as it is to drive a person out of business". Thomsen v. Union Castle Mail S. S. Co., *supra* note 8, at 253.

[28] See Loder v. Jayne, 142 Fed. 1010, 1020 (C. C. E. D. Pa. 1906), where the court announced the test to be whether or not the plaintiff submitted "the best evidence he could under the circumstances." See also Straus v. Victor Talking Machine Co., *supra* note 15, at 802: "The constant tendency of the courts is to find some way in which damages can be awarded when a wrong has been done. Difficulty of ascertainment is no longer confused with the right of recovery."

The court in the instant case, took the view that it was altogether speculative that the prices existing when the plaintiff entered the market would have continued had the defendants not illegally changed them. This is true, but might not that price level still have been used by the jury as a base from which to reckon the damages, taking into account the factor of a possible change due to the entrance of a new competitor. As the dissenting opinion maintains, this would be no more speculative than assessing the damages for a lost limb, or in many a trademark and patent case.

this depreciation, insisted that the plaintiff's failure was obviously "inevitable either from lack of capital or inefficient management or both," and that the plaintiff had failed to prove "that the subsequent depreciation was due in any measurable degree to any violation of Section 2 of the Sherman Anti-Trust Act."

In cases of vertical restraint where the defendants injure the plaintiff by refusing to deal with him, the causal relation between the illegal restraint and the damage is obvious. But in the case of units competing on the same level, such causal relation is far more difficult to prove. Since each single unit of industry is merged in the entire industrial system with its numerous interrelationships and interdependencies, it is impossible to trace clearly the influence of a particular factor upon the welfare of any particular unit. Therefore, to seek a self-sufficient sequence from the operation of any particular factor on a unit, as did the court in the *Paterson* case, is to ignore other factors which have an inescapable bearing on that sequence. And if it is desired to reduce to terms of cause and effect the influence of a particular factor on the welfare of a particular industrial unit, much must necessarily be left to inference. It is here that the jury is important to make a finding of "fact." In the instant case, the defendants conspired to drive the plaintiff out of business. Business failure followed in the course of a few months. That the conspiracy was a moving factor in bringing about this failure seems at least a fair assumption. The court, in refusing to let the question of causation go to the jury, did not indicate what evidence would have been acceptable, or available, to establish the conspiracy as a "measurable" cause of the failure.[29] If the situation is such that evidence of a direct interference could be produced, then the maximum of available evidence should be required. But if, as in the present case, the situation is such that inferential evidence alone can exist, the plaintiff should not be penalized because of the complexity of the industrial system in which he is seeking to set up shop.[30]

In its holdings on both points the court in the *Paterson* case seems to have gone well beyond the decisions on which it relies.[31]

[29] The court held lack of capital to have been a cause of the plaintiff's failure. Even assuming this, without the conspiracy on the part of the defendants the failure would not have occurred so soon. Had the plaintiffs been allowed to make a better showing at the start of their enterprise, additional outside capital might have been attracted. Furthermore, even assuming the plaintiff's failure to have been eventually inevitable, should this arbitrary illegal interference of the defendants on that account be condoned?

[30] See Loder v. Jayne, *supra* note 28.

[31] Compare the facts in the instant case with those in the Jack case, *supra* note 16, and in the Keogh case, *supra* note 18, on which the court principally relies.

If the case becomes recognized as a valid extension of the evidential requirements laid down in earlier cases, it will clearly lead to a further emasculation of the already weakened Anti-Trust Acts.[32] Though scarcely in accord with the express philosophy underlying the acts that "competition is the life of trade," [33] such a policy may well be consistent with the trend of economic development. The transition from petty trade to great industry is bringing in its wake an increasing skepticism of the beneficence of competition and an increasing tolerance of regulated monopoly.[34]

JUDICIAL INTERPRETATION OF SECTION 7 OF THE CLAYTON ACT

The Clayton Act,[1] passed by Congress in 1914, was officially labelled an attempt to supplement the Sherman Anti-trust Law of 1890.[2] This end was to be accomplished by specifically prohibiting certain trade practices not defined in the Sherman Law, and by arresting "the creation of trusts, conspiracies and monopolies in their incipiency and before consummation." [3] Yet the history of the Act in the courts seems to support certain criticism levelled at it, shortly after its passage, for its apparent failure to add anything new to the Sherman Law or even to facilitate the accomplishment of similar ends.[4] More specifically, partly as a result of its inherently limited scope and partly as a

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[32] See the statement of the court in Konecky v. Jewish Press, *supra* note 9, at 182.

[33] Pennsylvania Sugar Refining Co. v. American Sugar Refining Co., *supra* note 8, at 260.

[34] The problem of liability is complicated by the difficulty of fixing a causal relation. The problem of reducing damage to pecuniary terms is likewise exceedingly complex. It is a question too broad to be discussed in this comment whether the existing machinery of judge and jury lends itself to a satisfactory determination of these two problems.

In seeking to fix "reasonable prices" the courts are faced with the same difficulty. In this connection, in United States v. Trenton Potteries Co., 273 U. S. 392, 398, 47 Sup. Ct. 377, 379 (1927), Mr. Justice Stone declared: " . . . We would hesitate to adopt a construction making the difference between legal and illegal conduct in the field of business relation depend upon so uncertain a test as whether prices are reasonable—a determination which can be satisfactorily made only after a complete survey of our economic organization and a choice between rival philosophies."

[1] 38 STAT. 730 (1914), 15 U. S. C. §§ 12-27 (1926), entitled "An Act to supplement existing laws against unlawful restraints and monopolies, and for other purposes."

[2] 26 STAT. 209 (1890), 15 U. S. C. §§ 1-7 (1926).

[3] Report of the Senate Judiciary Committee on the Clayton Act. See Swift & Co. v. Federal Trade Commission, 8 F. (2d) 595, 597 (C. C. A. 7th, 1925).

[4] Levy, *The Clayton Law* (1916) 3 VA. L. REV. 411, 417; Stevens, *The Clayton Act* (1915) 5 AM. ECON. REV. 38.

result of cautious judicial application, Section 7[5] of the Act, forbidding intercorporate shareholding where the effect thereof may be "to substantially lessen competition" or "to tend to create a monopoly", has contributed little to pre-existing legislation.[6]

At the outset, the Sherman Law, declaring illegal "every contract, combination in the form of trust or otherwise, or conspiracy, in restraint of trade or commerce,"[7] by the very breadth of its language, had already included the particular method of consolidation covered by Section 7 of the Clayton Act. Under the earlier Law several combinations formed by intercorporate shareholding had been dissolved by the Supreme Court before the later Act was passed.[8] Additional legislation, therefore, except in so far as it provided for catching such combinations in their incipiency, would have seemed unnecessary.

The seeming inadequacy of the section to cope with corporate methods of merger was made apparent at an early date. The Federal Trade Commission, given concurrent jurisdiction under the Act with the Federal Courts,[9] shortly held that the acquisition of physical assets could not be prohibited, even though the result thereof was to lessen competition.[10] Consequently, where stock was acquired immediately prior to an outright purchase of property, an order from the Commission requiring divestment of such stock would obviously prove an empty ceremony. In a case involving this situation, the Court held that the Commission had no power to order a divestment of property as well as stock.[11] Yet

[5] "No corporation engaged in commerce shall acquire, directly or indirectly, the whole or any part of the stock or other share capital of another corporation engaged also in commerce, where the effect of such acquisition may be to substantially lessen competition between the corporation whose stock is so acquired and the corporation making the acquisition, or to restrain such commerce in any section or community, or tend to create a monopoly of any line of commerce." The section does not apply "to corporations purchasing such stock solely for investment" nor prohibit them from owning the stock of subsidiary corporations.

[6] See Stevens, *op. cit. supra* note 4, at 43.

[7] *Supra* note 2, at 209, 15 U. S. C. § 1.

[8] Northern Securities Co. v. United States, 193 U. S. 197, 24 Sup. Ct. 436 (1904); Standard Oil Co. v. United States, 221 U. S. 1, 31 Sup. Ct. 502 (1911); United States v. American Tobacco Co., 221 U. S. 106, 31 Sup. Ct. 632 (1911).

[9] The Clayton Act, *supra* note 1, at 734, 736, 15 U. S. C. §§ 21, 25.

[10] Conference Ruling, 1 Fed. Trade Com. Dec. 541 (1916). In the following cases, the section was directly violated and a divestment of the stock acquired ordered: United States v. New England Fish Exchange, 258 Fed. 732 (D. Mass. 1919); Federal Trade Commission v. Armour & Co., 4 Fed. Trade Com. Dec. 457 (1922); Aluminum Co. of America v. Federal Trade Commission, 284 Fed. 401 (C. C. A. 3d, 1922), *certiorari* denied, 261 U. S. 616, 43 Sup. Ct. 362 (1923); Federal Trade Commission v. Western Meat Co., 272 U. S. 554, 47 Sup. Ct. 175 (1926).

in an opinion rendered simultaneously, where the defendant had acquired physical assets after the institution of proceedings to order divestment of stock, the Supreme Court, noting the clear attempt to evade the Act, sustained the Commission's inclusion of physical property in the divestment order.[12] The absurdity of determining the scope of remedial power according to whether the property was acquired before or after the institution of the remedial action is pointed out in Mr. Justice Brandeis' dissent to the holding in the former case. The fallacy of assuming Section 7 to be inherently limited to stock acquisition is indicated by the Court's decision in the latter case.

The mere inclusion of the word "substantially" limits still further the applicability of the Section. If there is no substantial competition between two companies, acquisition by one of the capital stock of the other can scarcely tend "to substantially lessen" competition in the broad sense in which the word is used in the Act.[13] Where, however, there exists some such competition, the question arises as to how much must exist before the section will apply. Since Court and Commission exercise concurrent jurisdiction, it would seem particularly advisable, from the standpoint of effective enforcement, that both apply the same test.

The confusion arising from a failure to observe so elementary a requirement is apparent in the recent case of *Federal Trade Commission v. International Shoe Co.*[14] There the Commission concluded from the facts that substantial competition had existed between the defendant and another large shoe company, and hence that the acquisition of all the capital stock of the latter tended "to substantially lessen competition." [15] From the very same facts the Supreme Court drew the conclusion that there had been no substantial competition between the two, and consequently that the purchase could not violate the Act. It is significant that the Commission applied a quantitative test, giving an exact and scientific interpretation to the word "substantial,"

[11] Thatcher Mfg. Co. v. Federal Trade Commission, Swift & Co. v. Federal Trade Commission, 272 U. S. 554, 47 Sup. Ct. 175 (1926), *rev'g* 5 F. (2d) 615 (C. C. A. 3d, 1925) and 8 F. (2d) 595 (C. C. A. 7th, 1925); see Note (1926) 26 COL. L. REV. 594; Note (1927) 75 U. OF PA. L. REV. 463.

[12] Federal Trade Commission v. Western Meat Co., *supra* note 10.

[13] Niles-Bement-Pond Co. v. Iron Moulders' Union, 246 Fed. 851 (S. D. Ohio 1917); In the Matter of Austin, Nichols & Co., 9 Fed. Trade Com. Dec. 170 (1925); Merger of Certain Steel Companies, 33 Op. Att'y Gen. 225 (1922).

[14] 50 Sup. Ct. 89 (1930). Justices Stone, Holmes and Brandeis dissented. For facts of the case see *infra* note 18. See Note (1930) 24 ILL. L. REV. 908.

[15] In the Matter of International Shoe Co., 9 Fed. Trade Com. Dec. 441 (1925) (two commissioners dissenting), *aff'd*, 29 F. (2d) 518 (C. C. A. 1st, 1928). See Comment (1929) 27 MICH. L. REV. 931.

whereas the Supreme Court held that "the standard of legality was the absence or presence of prejudice to the public interest by *unduly* restricting competition or *unduly* restraining the course of trade." [16]

The test applied by the Commission is based primarily upon a consideration of the relative size of various factors.[17] The facts are first analysed to determine (1) the products manufactured in common by the two companies; (2) the proportion of these competing products (a) to the total annual output in the United States, (b) to the total annual output of the two companies; (3) the type of trade, whether wholesale or retail; (4) the localities in which the competing goods are sold.[18] After this analysis has been made the problem becomes one of degree, but it is a degree easily reducible to terms of percentage, the solution of the problem hinging on whether or not a certain ratio falls within a precise mathematical definition of the word "substantially." In sharp contrast to this scientific approach to the problem is the method adopted by the Supreme Court. In place of what seems to be a sufficiently accurate, if arbitrary, test within the terms of the Section, it has substituted the criterion of "public interest."

Authority for using such a test has been found in certain decisions of the court under the Sherman Law where the "rule of reason" has of late been rather consistently applied.[19] Here

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[16] 50 Sup. Ct. at 91. (Italics ours).

[17] This is the method used by the Attorney General in his report to the Senate on the proposed merger of the Bethlehem Steel and other companies, *supra* note 13.

[18] The International Shoe Co. and the McElwain Co. both sold similar lines of shoes. In 1921 the latter concern fell into financial difficulties and proposed a merger with the International Co. The proposition was considered and subsequently adopted, the International Co. buying up all the McElwain Co.'s capital stock, but leaving the management and organization of the latter concern intact. In 1923 the Federal Trade Commission issued its complaint charging a violation of § 7.

The Commission made the following findings: (1) both companies manufactured and sold men's dress shoes "similar in style and comparable in price"; (2) the International Co. was the largest manufacturer of leather shoes in the United States and the McElwain Co. the largest Manufacturer of mens' dress shoes; (3) both companies sold to retailers; but (4) 95% of the International Co.'s sales were in the rural districts of the West and South and 95% of the McElwain Co.'s in the large cities of the East. On the other hand there was evidence of close competition in Missouri, Kentucky, Tennessee and Texas.

[19] The "rule of reason" was first enunciated by Chief Justice White in Standard Oil Co. v. United States, *supra* note 8, and followed in United States v. American Tobacco Co., *supra* note 8; Nash v. United States, 229 U. S. 373, 33 Sup. Ct. 780 (1913); Eastern Lumber Ass'n v. United States, 234 U. S. 600, 34 Sup. Ct. 951 (1914); Chicago Board of Trade v. United States, 246 U. S. 231, 38 Sup. Ct. 242 (1918); United States v. Keystone Watch Co., 218 Fed. 502 (E. D. Pa. 1915); United States v. Prince Line, 220 Fed. 230 (S. D. N. Y. 1915); American Press Ass'n v. United States,

"the essence of the law is injury to the public. It is not every restraint of competition and not every restraint of trade that works an injury to the public; it is only an undue and unreasonable restraint of trade that has such an effect and is deemed unlawful." [20] Under the Sherman Law, which embodies the general terms of the common law, such a test may have been necessary and even otherwise justifiable. Yet after its first enunciation there was some sentiment to the effect that the court was saying, "There are good trusts and bad trusts, and we have the power to say what are the good trusts and what are the bad trusts, according to our economic and political views." [21] Even within the court itself there has been a division of opinion over the rule and it is by no means universally applied.[22]

245 Fed. 91 (C. C. A. 7th, 1917); McLatchy v. King, 250 Fed. 920 (D. Mass. 1917); Fosburgh v. California & Hawaiian Sugar Ref. Co., 291 Fed. 29 (C. C. A. 9th, 1923); United States v. Fur Dressers' and Fur Dyers' Ass'n, 5 F. (2d) 869 (S. D. N. Y. 1925); *cf.* Lee Line Steamers v. Memphis Packet Co., 277 Fed. 5 (C. C. A. 6th, 1922) (holding that when a monopoly is complete no question can arise as to its reasonableness).

[20] United States v. Trenton Potteries, 273 U. S. 392, 395, 47 Sup. Ct. 377, 379 (1925). This was the charge the defendant company requested the court to give to the jury. Refusal to submit the question of reasonableness was brought as error to the Supreme Court where the conviction was upheld on the ground the "rule of reason" was not to be applied to cases involving price-fixing agreements.

As stated by Chief Justice White: ". . . . it was intended that the standard of reason which had applied at the common law and in this country in dealing with subjects of the character embraced by the statute, was intended to be the measure used for the purpose of determining whether in a given case a particular act had or had not brought about the wrong against which the statute provided." Standard Oil Co. v. United States, *supra* note 8, at 60, 31 Sup. Ct. at 516.

[21] TAFT, THE ANTI-TRUST ACT AND THE SUPREME COURT (1914) 114.

By inserting into the Act the word "undue", so as to negative the prohibition of every restraint of trade, the court has made "Congress say what it did not say, what, as I think, it plainly did not intend to say and what, since the passage of the act, it has explicitly refused to say . . . In short, the court now, by judicial legislation in effect amends an act of Congress relating to a subject over which that department of the government has exclusive cognizance." Dissenting opinion of Justice Harlan, United States v. American Tobacco Co., *supra* note 8, at 192, 31 Sup. Ct. at 652. That the rule "can never serve other than rhetorical ends" see KEEZER & MAY, THE PUBLIC CONTROL OF BUSINESS (1930) 83. See also Pope, *Legal Aspects of Monopoly* (1907) 20 HARV. L. REV. 167, 178; Watkins, *Change in Trust Policy* (1922) 35 HARV. L. REV. 815.

[22] It is generally recognized that price fixing agreements are in themselves unreasonable, particularly in the case of common carriers, so that the rule as to them is inapplicable. United States v. Trans-Missouri Freight Ass'n, 166 U. S. 290, 17 Sup. Ct. 540 (1897); United States v. Joint Traffic Ass'n, 171 U. S. 505, 19 Sup. Ct. 25 (1898); Addyston Pipe Co. v. United States, 175 U. S. 211, 20 Sup. Ct. 96 (1899); Bement v. National Harrow Co., 186 U. S. 70, 22 Sup. Ct. 747 (1902); Chesapeake Fuel Co v. United States, 115 Fed. 610 (C. C. A. 6th, 1902); Thomsen v.

It is clear that the adoption of the rule of reason under the older act had its effect on the legislation of 1914.[23] Certain practices were specifically prohibited, and an attempt was made to define accurately what was illegal and what was not.[24] Although a lower federal court on one occasion read the rule of reason into the Clayton Law,[25] the Supreme Court at the time insisted that "the words being clear, they are decisive", and that resort should not be had to extraneous standards.[26] Later, in *Swift &*

Cayser, 243 U. S. 66, 37 Sup. Ct. 353 (1917); Keogh v. C. & N. W. R. R., 260 U. S. 156, 43 Sup. Ct. 47 (1922); United States v. Trenton Potteries Co., *supra* note 20. For comment on the confusion in the decisions under the Sherman law see Bledsoe, D. J.: "I confess that you can read certain decisions emanating from the most exalted tribunal in the world, respecting the Sherman Anti-Trust Act, and then you can read other decisions emanating from the same tribunal, and if you are only human you may be held to assert that they do not always seem to be consistent one with another." Continental Candy Corp. v. California & Hawaiian Sugar Ref. Co., 270 Fed. 302, 304 (N. D. Cal. 1920).

[23] The National Platform of the Democratic Party adopted at the Baltimore Convention in 1912 said: "We regret that the Sherman Anti-Trust Law has received a judicial construction depriving it of much of its efficiency, and we favor the enactment of legislation which will restore to the statute the strength of which it has been deprived by such interpretations."

[24] President Wilson in his message to Congress on Jan. 20, 1914 said: "The business of the country awaits also, has long awaited and has suffered because it could not obtain, further and more explicit legislative definition of the policy and meaning of the existing anti-trust law . . . surely we are sufficiently familiar with the actual processes and methods of monopoly and of many hurtful restraints of trade to make definition possible, at any rate up to the limits of what experience has disclosed. These practices, being now abundantly disclosed, can be explicitly and item by item forbidden by statute in such terms as will practically eliminate uncertainty, the law itself and the penalty being made equally plain." See also HENDERSON, THE FEDERAL TRADE COMMISSION (1924) 15-26; KEEZER & MAY, *op. cit. supra* note 21, at 20-26.

[25] Standard Oil Co. v. Federal Trade Commission, 282 Fed. 81 (C. C. A. 3d, 1922). The court said in applying the rule to § 3, which prohibits tying agreements, ". . . . in determining whether given acts amount to unfair methods of competition within the meaning of the Federal Trade Commission Act, or substantially lessen competition and tend to create a monopoly within the meaning of the Clayton Act, the only standard of legality with which we are acquainted is the standard established by the Sherman Act . . . and by the courts in construing the Sherman Act with reference to acts 'which operate to the prejudice of the public interest by unduly restricting competition or unduly obstructing the due course of trade.'" 282 Fed. at 87.

[26] "There is nothing to construe. To search elsewhere for a meaning either beyond or short of that which they disclose is to invite the danger, in the one case, of converting what was meant to be open and precise, into a concealed trap for the unsuspecting, or, in the other, of relieving from the grasp of the statute some whom the Legislature definitely meant to include." Sutherland, J., in George Van Camp & Sons v. American Can Co., 278 U. S. 245, 253, 49 Sup. Ct. 112, 113 (1929) (involving § 2 of the

Co. v. United States,[27] the Court specifically rejected the rule as applied to Section 7. The same attitude was also adopted in cases arising under similarly worded sections of the Act, the Court saying in *United Shoe Machinery Corp. v. United States:* [28] "The Sherman Act and the Clayton Act provide different tests of liability . . . the Clayton Act was intended to supplement the Sherman Act, and within its limited sphere established its own rule." [29]

In the light of such considerations, the reasoning of the Court in the *International Shoe Co.* case seems peculiarly out of place. Had Congress intended to inject the standard of "reason" and "public interest" into the Clayton Act, the rule, so recently enunciated, could easily have been incorporated in express words. No procedural justification exists for applying a test, rendered necessary by the general terms of the Sherman Law, to supplemental legislation providing its own rather definite standards. And such a practice seems particularly ill-advised when it creates a conflict of standards between the Supreme Court and the Federal Trade Commission in the enforcement of one section of the Act, whereby the effective scope of that Section is automatically reduced to the small group of cases in which the two tests coincide in outlawing the industrial combination under investigation.

There are even further hazards to effective enforcement in the very vagueness of such a criterion as the "rule of reason." [30] While the interpretation of the anti-trust laws, by their nature so general that what they aim to prevent can not be precisely defined, can never be rendered so stereotyped as entirely to exclude the political and economic preferences of judges, yet a frank judicial adoption of a "rule of reason" paves the way for much greater predominance of such preferences in the decisions. One assumption made in the *International Shoe Co.* case illustrates the sort of danger inherent in such a flexible test. When the International company purchased the stock of its competitor, the latter was in severe financial straits and there was a possibility that it might fail although the Commission, after a careful analysis, found that it was not insolvent.[31] With only these facts be-

Clayton Act). See also Standard Fashion Co. v. Magrane-Houston Co., 258 U. S. 346, 356, 42 Sup. Ct. 360, 362 (1922); United Shoe Machinery Corp. v. United States, 258 U. S. 451, 459, 42 Sup. Ct. 363, 366 (1922) (§ 3 of the Clayton Act).

[27] 8 F. (2d) 595 (C. C. A. 7th, 1925).

[28] *Supra* note 26.

[29] 258 U. S. at 459, 42 Sup. Ct. at 366.

[30] See Sutherland J., *supra* note 26.

[31] "The property of W. H. McElwain Company at value shown in the balance sheet of April 30, 1921 (the contract of purchase was made on May 11), exceeded its debts approximately $10,000,000." On May 31 (after the purchase) the value of the property in excess of the company's debts was over $8,000,000 and on November 30 over $3,000,000. *Supra* note 15, at 454.

fore it, the Court definitely assumed that the company would have failed had no purchaser rescued it, by stating that the purchase could not possibly tend to lessen competition, since the only alternative was failure and a resultant cessation of competition. Under such circumstances, agreed six members of the Court, "we hold that the purchase of its capital stock . . . is not in contemplation of law prejudicial to the public."[32] Even could it have been proved that the company would have failed, the Clayton Act does not expressly authorize consideration of such factors in its enforcement.[33]

Judicial recognition of such considerations only serves to narrow still further the scope of Section 7. At the outset confined in its application to one form of corporate consolidation, then reduced to a trap to catch the unwary by the decisions permitting simultaneous property acquisition, now restricted to a small fraction of cases by conflicting interpretations of the word "substantially", the Section has been practically squeezed out of effective existence by the possibility of escape afforded any defendant who can show the court that the consolidation is probably harmless. Furthermore, the benefits intended to be derived from enforcement by a body of fact-finding experts composing the Trade Commission vanish now that it appears that the ultimate conclusion as to what is reasonable rests with the Supreme Court, and that the conclusions of the Commission will bear little weight until approved by the highest tribunal.

Either the legislative intent embodied in the Section is so inadequately expressed as to render enforcement impossible[34] without resort to such considerations as the "public interest," or else there exists a fundamental disagreement as to the most effective means by which to achieve certain sweeping but ill-defined economic advantages. Yet the Supreme Court has itself emphasized the fact that the legislative words are plain and unambiguous, and that in themselves they furnish adequate procedural standards.[35] Moreover, in the first important case which arose under Section 7,[36] the Court indicated that it was not out

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[32] *Supra* note 14, at 93.

[33] "If an exception to the operation of the statute ought and is to be raised in cases where the concern whose stock is acquired is small and weak, or *for any reason unlikely long to endure*, it must come through statutory enactment and not by judicial construction." Alschuler, J., in Swift & Co. v. Federal Trade Commission, *supra* note 27, at 599 (italics ours).

[34] This is the contention of Felix H. Levy in *A Decade of the Federal Trade Commission* (1924) 11 VA. L. REV. 21, 111, 196, 278, 372.

[35] *Supra* note 26.

[36] Aluminum Co. v. Federal Trade Commission, 284 Fed. 401 (C. C. A. 3d, 1922), *certiorari* denied, 261 U. S. 616, 43 Sup. Ct. 362 (1923). In this case, two competing companies *A* and *B* jointly created a third company (in which *A* held two thirds of the capital stock) and *B* secured one third by selling to *C* that part of its business which had competed with *A*. The

of sympathy with the general legislative purpose when it went so far as to sustain a conviction, based on an extension of the Section beyond its precise language. That the Court should now feel itself compelled to interpret the Section in the hazy light of "public interest" would seem to indicate a questioning of the desirability of the immediate legislative purpose for which such definite provision is made—namely, the indiscriminate curbing of monopolies and the protection of competition as an end in itself.

An actively critical attitude on the part of the Court may be condemned as judicial usurpation of legislative function, or because it here results in the inevitable emasculation of a beneficial if imperfect law. It may be supported as a progressive and courageous stand for principles more in keeping with an industrial age than those which lie behind the written Act. Somewhere between these two extremes is the probable explanation of the court's action. For judicial application of a statute is tempered by a composite of influences. Not only the popular and official attitude of several years ago, which found expression in the antitrust statutes, is to be reckoned with here, but also the permeating spirit of the old common law which permitted reasonable "restraints of trade", and the post-war popular indifference to mergers and big business combinations. If the ardor for trust-busting has been mollified by a realization that there are evils in rate wars and cut-throat competition,[37] and benefits in large-scale production which decreases over-head expenditures, recognition of the change of emphasis will not be openly expressed in the opinions of the Court, but will be concealed behind legal rationalizations made necessary by strict statutory wording. The decision in the *International Shoe Co.* case need not therefore be considered a conscious effort to debilitate a bad law, nor to read into existing legislation a definite economic policy. It is rather an indication of judicial tolerance of popular ideas, reflecting a general acceptance of modern industrial methods.

EFFECT OF INCONTESTABILITY CLAUSE UPON PROVISION FOR LIMITED LIABILITY IN CASE OF SUICIDE

The case of *Fore v. New York Life Ins. Co.*,[1] recently decided by the Supreme Court of Arkansas, raises the interesting question of whether the incontestable clause of a life insurance

commission found that the result of this deal was a lessening of competition between *A* and *B* and ordered *A* to divest itself of all the stock held in *C*. 3 Fed. Trade Com. Dec. 302 (1921).

[37] Compare the attitude of the courts in England towards cut-throat competition. Attorney-General of Australia v. Adelaide S. S. Co., 15 C. L. R. 65 (1912), *aff'd*, [1913] A. C. 781.

[1] 22 S. W. (2d) 401 (Ark. 1929).

policy continues to operate after the suicide of the insured to defeat a provision for limited liability for suicide occurring within a specified period. It appeared that the decedent had applied for and received an insurance policy upon his life naming his wife as beneficiary thereunder. The policy provided: "In case of self-destruction during the first two insurance years, whether the insured be sane or insane, the insurance under this policy shall be a sum equal to the premiums thereon which have been paid to and received by the company, and no more." It was also provided that the policy should be incontestable after two years from its date of issue with certain named exceptions. Approximately twenty-two months after the issuance of the policy the insured committed suicide. Some time after the expiration of the two year period the beneficiary brought an action against the company to recover the face amount of the policy. The company answered alleging death by suicide, to which answer the plaintiff demurred, setting up the incontestable clause. The beneficiary had judgment in the lower court for the total amount of the premiums paid, which amount the company had tendered, but upon appeal recovery was granted for the face value of the policy, the court holding that the incontestable clause operated as a short statute of limitations controlling the suicide clause.

The dissenting opinion pointed out that "it is not a contest of the policy to insist that only that liability be enforced which under the contract the company assumed."[2] This view is well supported by cases in other jurisdictions[3] which distinguish a contest of the original validity of the policy from an insistence upon the limited liability which the contract of insurance expressly assumed.

The validity of a policy may be contested by reason of fraud, misrepresentation, breach of warranty, the failure to perform a condition precedent or the occurrence of a condition subsequent.[4] But these defenses should not be confused with risks expressly excepted or excluded from the policy.[5] Fraud, mis-

[2] *Ibid.* 404.

[3] See cases cited *infra* notes 12 and 18. Although these cases deal with different wordings of the suicide clause all protect the company. Note (1926) 11 MINN. L. REV. 254.

[4] It is unnecessary to enlarge upon the various kinds of provisions, the materiality of the breach or non-performance, or the statutes controlling the subject. These are fully discussed in 4 COUCH, CYCLOPEDIA OF INSURANCE LAW (1929) c. 13.

[5] "An insurance company or benefit society has the right to select the particular risks it is willing to assume and there is no public policy against a contract exempting insurance company in advance from liability for the

representation and breach of warranty or condition may create in the insurer a power to extinguish existing legal relations under the contract, and the power so created may be subsequently destroyed by reason of an express waiver, laches, estoppel, or the operation of the incontestable clause. But the exception of a described risk by the terms of the policy, creates not a power but an entire immunity in the insurer from any liability for the risk so excluded, unless provision is made for reduced liability.[6] An exception, therefore, is not waived by the operation of law, as, for example, by reason of laches, since no liability, defeasible or otherwise, was ever assumed.[7] It is conceded that the line is frequently difficult to draw.

A recent case in New York[8] indicates with notable precision the distinction made above. There an insurance company submitted for approval to the state superintendent of insurance a rider which provided that: "Death as a result of service travel or flight in any species of aircraft, except as a fare-paying passenger, is not a risk assumed under this policy; but, if the insured shall die as a result, directly or indirectly, of such service, travel or flight, the company will pay to the beneficiary the reserve on this policy." Approval of this rider was refused on the ground that it was inconsistent with the incontestable clause prescribed by New York Insurance Law.[9] In *certiorari* proceedings the company prevailed in the Appellate Division,[10] which result was affirmed in the Court of Appeals. The opinion, delivered by Chief Judge Cardozo, clearly distinguishes between "a denial of coverage and a defense of invalidity." The clause here proposed related not to the validity of the policy but to the coverage or risk assumed thereunder, and therefore was in no wise inconsistent with the incontestable clause.

In the construction of the suicide clause similar language has been used. Thus in *Mack v. Connecticut General Life Ins. Co.*,[11] the court said:

"The contract provision expressly excluding the assumption of the risk of suicide for two years is entirely distinct from the

death due to certain specified causes." 6 COOLEY, BRIEFS ON INSURANCE (2d ed. 1928) 5182.

[6] Usually provision is made for the return of premiums paid. This should be regarded as in a sense a separate contract of coverage for the risk excluded from the main coverage of the policy.

[7] Professor Vance propounds this line of reasoning in the second edition of his work on Insurance which is to be published shortly. VANCE, INSURANCE (2d ed. 1930) 822.

[8] Metropolitan Life Insurance Co. v. Conway, 252 N. Y. 449, 169 N. E. 642 (1930); (1930) 30 COL. L. REV. 572.

[9] N. Y. CONS. LAWS c. 28 § 101.

[10] 226 App. Div. 408, 235 N. Y. Supp. 501 (3d Dep't 1929).

[11] 12 F. (2d) 416, 418 (C. C. A. 8th, 1926).

incontestable clause, is consistent with it, and the one in no way contradicts the other. There is a distinction between facts which would warrant a rescission of the contract and a risk not covered by the contract. The incontestable clause relates to the former. The suicide clause relates to the latter."

Whenever the suicide clause provides that suicide "is not a risk assumed" under the policy, it would seem that the above result should not be difficult to reach.[12] Yet there are decisions in which the incontestable clause has been held to override such an express exception. These cases are possibly distinguishable, however, since the exclusion of the risk of suicide from the policy was without time limitation and the suicide occurred after the expiration of the period of limitations contained in the incontestable clause.[13] In theory, however, where a risk has been excluded from the coverage of the policy, the insurance company should in no event be held liable upon the occurrence of that risk.[14] But the very existence of these cases demonstrates the caution with which theoretical distinctions must be made, especially in cases of life insurance contracts which are so strictly construed against the insurer.[15] In partial explanation of these decisions the suggestion may be hazarded that few courts are inclined to regard with favor the exclusion of the

[12] The following cases sustain this interpretation. Mack v. Connecticut General Life Ins. Co., *supra* note 11; Howard v. Missouri State Life Ins. Co., 289 S. W. 114 (Tex. Civ. App. 1927); Hearin v. Standard Life Ins. Co., 8 F. (2d) 202 (D. Ark. 1925); Wright v. Philadelphia Life Insurance Co., 25 F. (2d) 514 (D. S. C. 1927).

[13] Mareck v. Mutual Reserve Fund Life Ass'n, 62 Minn. 39, 64 N. W. 68 (1895); Seymour v. Mutual Protective League, 155 Ill. App. 21 (1910); Mutual Reserve Fund Ass'n v. Payne, 32 S. W. 1063 (Tex. Civ. App. 1895); Court of Honor v. Updegraff, 68 Kan. 474, 75 Pac. 477 (1904); Northwestern Mutual Life Ins. Co. v. Johnson, 254 U. S. 96, 41 Sup. Ct. 47 (1920) (policy "void" in the event of suicide). *Contra:* Childress v. Fraternal Union of America, 113 Tenn. 252, 82 S. W. 832 (1904). This case is distinguishable, however, since the risk of suicide was not totally excluded but the amount payable to the beneficiary was reduced to one-third of the amount otherwise due.

[14] Thus in Childress v. Fraternal Union of America, *supra* note 13, at 255, 82 S. W. at 833, it is said: "The incontestable clause has no reference to the suicide clause, and the latter is in no wise affected by the former. If the insured commit suicide after the expiration of the two years from the date of the policy, the effect is the same as if it occur within two years." In Metropolitan Life Ins. Co. v. Conway, *supra* note 8, at 463, 169 N. E. at 643, it was stated: "Where there has been no assumption of the risk there can be no liability . . . (citing cases) . . . The kind of insurance one has at the beginning, that, but no more, one retains until the end."

[15] The distinction here drawn between representations, warranties, conditions etc. and exceptions in insurance policies is not, however, intended to be theoretical but factual.

suicide risk for the entire life of the policy. Thus the incontestable clause would seem to be a means to circumvent the strict provision. But, however that may be, the importance of these cases is now rapidly diminishing since the suicide clause in most policies issued at the present time excludes that risk only for one or two years from the date of the policy (usually for the same period as that specified in the incontestable clause).[16] Under this wording of the clause the problem of a subsequent suicide does not arise, that risk being included in the insurance coverage.[17]

Frequently, instead of expressly excepting the risk, the suicide clause provides, as in the *Fore* case, that in the event of suicide the amount payable under the policy is limited or reduced —usually to the amount of premium paid. Under such a clause the question arises whether suicide is to be treated as an excepted risk or as a condition in the policy. The greater number of decisions hold that this clause restricts the liability of the company and that, in refusing to pay more than the reduced amount, the company does not contest the validity of the policy but merely insists upon payment in accordance with its express contract terms.[18] The effect, therefore, is that the risk of suicide

[16] But "A contest made within two years is not to be confused with a defense of death by suicide committed within two years. In the incontestable clause, the two year period is a period of limitation . . . But in the suicide clause the two year period is a period of exclusion of risk on account of suicide." Mack v. Connecticut General Life Ins. Co., *supra* note 11, at 418. In Stean v. Occidental Life Ins. Co., 24 N. M. 346, 171 Pac. 786 (1918) the period in the suicide clause was two years while the period of contestability was only one. The suicide occurred after the elapse of one year but before two years had passed. The clauses were held distinct and the company protected.

[17] The policy under consideration in the Fore case reduced the liability of the company for suicide occurring during the first two policy years. Yet the opinion cites as authority and quotes extensively from the case of Mareck v. Mutual Reserve Fund Ass'n, *supra* note 13, in which the risk of suicide was totally excluded from the policy. Furthermore, as pointed out above, the suicide in the latter case occurred after the five year period of contestability. In Meyers v. Liberty Life Insurance Co., 124 Kan. 191, 197, 257 Pac. 933, 936, (1927), discussing the Mareck case, the court says: "The case is well decided. It did not decide that a contestable clause in an insurance policy nullifies a clause providing that the risk of suicide is not assumed; it merely decided that, under the circumstances stated, the incontestable clause under consideration applied, and the company was liable for the face amount of the policy. The case is frequently cited as establishing a principle of universal application." Upon substantially the same facts the court in the Meyers case reached the opposite conclusion from that of the Arkansas court.

[18] Meyers v. Liberty Life Ins. Co., *supra* note 17; North American Union v. Tranner, 138 Ill. App. 586 (1908); Scales v. Jefferson Standard Life Ins. Co., 155 Tenn. 413, 295 S. W. 58 (1926); Woodbery v. New York

is excepted from the main coverage of the policy and by express provision is covered in another manner providing for reduced liability.

The result of the decision in the Arkansas case is that the incontestable clause continues to operate for the benefit of the beneficiary after the suicide of the insured. This result has been reached many times where the insured has died within the period of limitation in the incontestable clause and the company has denied liability on the basis of fraud.[19] In such cases, however, different considerations are involved, not the least of which is that the company may begin an investigation of fraud from the very inception of the policy and may contest it at any time within the period established by the incontestable clause even if the insured does not die.[20] But the company cannot contest a policy on the ground of suicide until that very act occurs and it may have little or no time to do so if the suicide takes place near the end of the period. Furthermore, as many decisions point out, to contest the policy for fraud is to deny its original validity, whereas to deny more than limited liability in the event of suicide is merely to insist upon the contract obligation of the company as expressly provided in the policy. Too frequently the fraud cases are cited as authority for similar holdings in suicide cases.[21]

Many of the difficulties enumerated above are eliminated by the form of the incontestable clause now adopted by many companies and required by statute in several states. This form of the clause provides that the policy shall be incontestable after it has been "in force during the lifetime of the insured" for a

Life Ins. Co., 129 Misc. Rep. 365, 221 N. Y. Supp. 357 (Sup. Ct. 1927). As tersely expressed in Stean v. Occidental Life Ins. Co., *supra* note 16, at 349, 171 Pac. at 787, "the suicide clause is not one which enters into the validity of the policy but one which limits the right of recovery after the full existence of the contract is established."

[19] The rule that the company must contest the policy for fraud within the period of limitation despite the death of the insured within the period is practically universal. The leading case is Mutual Life Ins. Co. v. Hurni Packing Co., 263 U. S. 162, 44 Sup. Ct. 90 (1923). Minnesota is the only state which holds to the contrary, *viz.*, that the death of the insured within the period fixes the rights of the parties. Indianapolis Life Ins. Co. v. Aaron, 158 Minn. 359, 197 N. W. 757 (1924). On this subject see Note (1930) 15 CORN. L. Q. 298.

[20] But see Cooper, *Incontestable Life Insurance* (1924) 19 ILL. L. REV. 226, 240, who argues against the rule permitting the incontestable clause to run in favor of the beneficiary even in fraud cases.

[21] Thus Standard Life Ins. Co. v. Robbs, 177 Ark. 275, 6 S. W. (2d) 520 (1928), upon which the instant Arkansas case relies, cites the case of Missouri State Life Ins. Co. v. Cranford, 161 Ark. 602, 257 S. W. 66 (1923). It is interesting to note that an action on the identical policy in the Robbs

named period.[22] Under this wording of the clause the rights of both the insurer and the beneficiary become fixed upon the death of insured by suicide or otherwise within the period established.[23] While the suicide clause itself should dispose of the risk of self-destruction independently of the incontestable clause, the use of this form of the incontestable clause will protect companies against such decisions as that reached by the Arkansas Court.

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case had previously been instituted in the Federal courts and a demurrer to the complaint sustained. Hearin v. Standard Life Ins. Co., *supra* note 12.

[22] See Note (1930) 15 CORN. L. Q. 298, 301. This is the wording in Metropolitan Life Ins. v. Conway, *supra* note 8, set out in full above. N. Y. CONS. LAWS c. 28 § 101; ILL. REV. STAT. (Smith-Hurd, 1929) c. 73 § 261 (3). See Note (1930) 15 CORN. L. Q. 298, 301.

[23] Aetna Life Ins. Co. v. Kennedy, 31 F. (2d) 971 (C. C. A. 8th, 1929); *cf.* McKenna v. Metropolitan Life Ins. Co., 220 App. Div. 53, 220 N. Y. Supp. 568 (2d Dep't 1927) ("in force").