Comments

REPUDIATION OF PATENT PROTECTION BY EXTENSION OF SECTION 3 OF THE CLAYTON ACT

THE recent litigation between the DeForest Radio Company and the Radio Corporation of America is illustrative of the basic conflict between the principles embodied in the Clayton Act [1] and those enacted by the patent statute.[2] The present status of that litigation indicates further an apparent tendency on the part of the federal courts to draw the requisite dividing-line between enforced competition and protected monopoly so as to restrict within narrow limits the monopoly granted by the patent law. The Radio Corporation, after acquiring patents on a large number of radio receiving sets through cross-licensing agreements, had in turn licensed others to manufacture the sets, stipulating in Clause 9 of the licensing agreements that the unpatented audion tubes to make the sets "initially operative" be purchased exclusively from the Radio Corporation.[3] Control of virtually 100 per cent of the manufacture of radio receiving sets thus vested in the Radio Corporation a practical monopoly in the sale of the unpatented tubes. The DeForest Company, engaged in the manufacture of such tubes, found itself deprived of any substantial market for them by the restrictions embodied in Clause 9. It therefore sought an injunction under Section 3 of the Clayton Act to forbid the enforcement of these restrictions. A preliminary injunction was granted by the Federal District Court of Delaware,[4] affirmed by the Circuit Court of Appeals,[5] and ap-

[1] 38 STAT. 731 (1914), 15 U. S. C. § 14 (1926).

[2] "Every patent shall contain . . . a grant to the patentee, his heirs or assigns, for the term of seventeen years, of the exclusive right to make, use, and vend his discovery. . . ." 16 STAT. 201 (1870), 35 U. S. C. § 40 (1926).

[3] Clause 9 reads: "The Radio Corporation hereby agrees to sell to the Licensee and the Licensee hereby agrees to purchase from the Radio Corporation the number, and only the number, of vacuum tubes to be used as parts of the circuit licensed hereunder and required to make initially operative the apparatus licensed under this Agreement. . . . But the sale of such tubes by the Radio Corporation to the Licensee shall not be construed as granting any licenses except the right to sell such tubes for use in, and to use them in, the apparatus made and sold hereunder."

[4] Lord v. Radio Corporation of America, 24 F. (2d) 565 (D. Del. 1928).

[5] Radio Corporation of America v. Lord, 28 F. (2d) 257 (C. C. A. 3d, 1928). Note (1930) 1 AIR L. REV. 132.

proved by the United States Supreme Court in denying a petition for a writ of *certiorari*.[6] Since then the case has been accorded a full trial, the injunction made permanent[7] and the decision of the District Court again affirmed by the Circuit Court.[8] The Supreme Court has recently granted a second writ of *certiorari*.[9]

Section 3 of the Clayton Act prohibits the lease or sale of goods "whether patented or unpatented" on the condition that the lessee or vendee refrain from using or dealing in the goods of a competitor, where the effect "may be to substantially lessen competition or tend to create a monopoly." The "tying clause" device against which the Section was directed[10] usually takes the general form of a stipulation that the vendee or lessee of a patented invention purchase exclusively from the patentee certain unpatented materials for use with the invention. Such requirements as that the vendee buy from the vendor all metallic fasteners for use in a patented button fastener machine,[11] or all ink to be used in a patent mimeograph machine[12] were specifically contemplated by Congress at the time of drafting.[13] The Radio Corporation case seemed to raise the question of whether the prohibition of Section 3 extends to a virtual monopoly of an

---

[6] 278 U. S. 648, 49 Sup. Ct. 83 (1928); rehearing denied, Jan. 3, 1929.

[7] Lord v. Radio Corporation of America, 35 F. (2d) 962 (D. Del. 1929).

[8] Radio Corporation of America v. DeForest Radio Co., 46 F. (2d) — (C. C. A. 3d, 1931) (N. Y. Times, Feb. 13, 1931).

[9] *Supra* note 1.

[10] That the "tying clause" was particularly contemplated is shown by earlier bills proposed in Congress by Mr. Thayer, H. R. 11380 and H. R. 11381, and by Mr. Lenroot, H. R. 15926, which contained an exception "that nothing in this Act shall be considered to prevent any such vendor, lessor, or licensor from requiring that during the continuance of any Letters Patent upon any such article no component or constituent part of the tool, implement, appliance or machine required for use therein be purchased except from the vendor, lessor or licensor, or from requiring that material to be used in the operation of any machine must be obtained from the vendor, lessor or licensor." The bill finally adopted, however, omitted this exception and also the word "license."

[11] Heaton-Peninsular Button Fastener Co. v. Eureka Specialty Co., 77 Fed. 288 (C. C. A. 6th, 1896). The case held that one who sold metallic fasteners for use in the plaintiff's patented machines, which the defendant knew had been sold subject to the restriction, was a contributory infringer.

[12] Henry v. A. B. Dick Co., 224 U. S. 1, 32 Sup. Ct. 364 (1912). This also was a suit for contributory infringement in which judgment was given for the plaintiff on the authority of the button-fastener case. Both of these cases were expressly overruled in Motion Picture Patents Co. v. Universal Film Manufacturing Co., 243 U. S. 502, 37 Sup. Ct. 416 (1917), *infra* note 16.

[13] See the debates in Congress at the time Section 3 was passed, particularly the remarks of Senator Reed, 51 CONG. REC. 63, 14268 (1914); of Senator Walsh, 51 CONG. REC. 14273 (1914); and of Senator Nelson, 51 CONG. REC. 15937 (1914).

article which is an integral part of a patented product rather than a separate product essential to its use. But the courts avoided this problem by declaring that the audion tubes were not such a part of the patented sets as to be included within the statutory monopoly.

Yet even granting that the monopoly did not include the tubes, a further contention, apparently intended by the careful wording of Clause 9, remained to the Radio Corporation. This was that the licensing device was not such a sale or lease as is outlawed by Section 3, but rather an assignment of patent rights such as is specifically permitted by the patent statute. Certainly it is clear that if a patentee reserve to himself the privilege of manufacturing his invention, there can be no valid objection to his equipping it, before sale, with his own unpatented materials or accessories. Then the transfer of the privilege of manufacture coupled with the retention of the right to furnish certain articles might well be interpreted as a partial assignment of the patent monopoly and hence enforceable.[14] Moreover, such a split-up of the patent rights would not increase the scope of the original monopoly. And in another sense, the licensing of several concerns, as in the Radio Corporation arrangement, actually creates a measure of retail competition.

Considered from the angle of the restriction itself, Clause 9 is far less extensive than the ordinary "tying clause" in a lease[15] or sale[16] because the license restriction terminates upon the sale of the article to the consumer. Thus, instead of an attempt to force all users to buy accessories, replacements or materials for future use from the patentee, the replacement market is opened to competitors, such as the DeForest Company, from the instant of the initial sale. A persuasive analogy lies in the control of

---

[14] The Supreme Court has held that the monopoly granted by the patent law is freely assignable in part. Virtue v. Creamery Package Manufacturing Co., 227 U. S. 8, 33 Sup. Ct. 202 (1913). For a general discussion see Lamb, *The Patent Law and the Anti-Trust Law* (1927) 12 CORN. L. Q. 261.

[15] A restriction requiring the lessee to purchase all materials for use in the patented machines leased, and to use the machines exclusively in certain operations and only on articles on which other operations had been performed by the lessor has been held invalid under Section 3. United Machinery Corp. v. United States, 258 U. S. 451, 42 Sup. Ct. 363 (1922). In answering the contention that Section 3 conflicted with the right to assign the patent grant, the Court said: "The patent right confers no privilege to make contracts in themselves illegal, and certainly not to make those violative of valid statutes of the United States." 258 U. S. at 463, 42 Sup. Ct. at 367.

[16] Motion-Picture Patents Co. v. Universal Film Manufacturing Co., *supra* note 12. The Court held invalid a stipulation attached to a patented motion picture machine that it be used solely with the films furnished by the patentee or original vendor.

sales prices which the Supreme Court has granted to patentees. Here it has been held that a patentee in licensing the manufacture of his invention may stipulate its sales price[17] but may not extend such control beyond the first sale.[18]

Contentions such as these had previously induced lower federal courts to hold that Section 3 did not extend to licensing agreements.[19] But in the instant case the courts again sidestepped an issue which seemed clearly presented by the facts, in applying Section 3 against the sale of tubes to licensees rather than against the licensing agreements themselves.[20] Thus the holding was not that the requirement of purchase of tubes from the Radio Corporation was an invalid condition of the license to manufacture, but that prohibition of purchase elsewhere was an invalid condition of the sale of the tubes. Moreover the replacement market as an outlet for competitive products was considered too small to negative the monopoly.[21] It would be interesting to know how the courts would have disposed of an arrangement whereby the instant licensees had instead been designated as agents of the Radio Corporation for the purpose of manufacturing sets. For contracts of agency, as such, are not within the scope of Section 3;[22] and from the legal angle it would seem that a patentee might place the manufacture of his product in the hands of an agent without losing the privilege of furnishing his own accessories before putting the finished product on the market.

Whatever harm has been done the DeForest Company would

---

[17] Bement & Sons v. National Harrow Co., 186 U. S. 70, 22 Sup. Ct. 747 (1902); United States v. General Electric Co., 272 U. S. 476, 47 Sup. Ct. 192 (1926); (1927) 40 HARV. L. REV. 656.

[18] Bauer v. O'Donnell, 229 U. S. 1, 33 Sup. Ct. 616 (1913); Federal Trade Commission v. Beechnut Packing Co., 257 U. S. 441, 42 Sup. Ct. 150 (1922); Munson, *Control of Patented and Copyrighted Articles After Sale* (1917) 26 YALE L.J. 270; Klaus, *Sale, Agency and Price Maintenance* (1928) 28 COL. L. REV. 312, 441; (1918) 86 CENT. L. J. 275; (1918) 22 COL. L. REV. 351; (1922) 35 HARV. L. REV. 772.

[19] Western Electric Manufacturing Co. v. Diamond State Fibre Co., 268 Fed. 121 (D. Del. 1920); Coca Cola Bottling Co. v. Coca Cola Co., 269 Fed. 796 (D. Del. 1920).

[20] "To hold that a contract for the sale of goods is not within the Clayton Act, if it is embodied as a condition or covenant of a license agreement would, I think, be writing into that statute a nullifying limitation and running counter to the views of the Supreme Court so broadly and emphatically expressed." Lord v. Radio Corporation, *supra* note 4, at 567. Nevertheless the condition is not imposed on the sale of the tubes but on the license itself. The word "license" was included in original drafts of Section 3 but omitted in the final wording. *Supra* note 10.

[21] Lord v. Radio Corporation, *supra* note 4, at 568.

[22] Federal Trade Commission v. Curtis Publishing Co., 270 Fed. 881 (C. C. A. 3d, 1921); *cf.* United States v. General Electric Co., *supra* note 17. See Klaus, *op. cit. supra* note 18, at 450.

seem more directly due to the accumulation by the Radio Corporation of an air-tight monopoly on the manufacture of receiving sets than to the operation of Clause 9 of the licensing agreements. This monopoly once removed, the DeForest Company could have found an ample market for its tubes in spite of Clause 9. Nor could the courts then have held the Clause inoperative under Section 3. For the Section specifically postulates a substantial stifling of competition. And the Supreme Court has refused to invalidate a condition in a lease of gasoline pumps that they be used only with gasoline furnished by the lessor, on the ground that the restriction did not eliminate competition with other brands of gasoline.[23] Hence the more logical remedy of the DeForest Company, and others who had been "squeezed out" of the radio tube business, would seem to have rested in an action under the Sherman Law and Section 4 of the Clayton Act to dissolve the Radio Corporation's patent monopoly.

Just such a suit has since been brought by the government and is now pending in the District Court of Delaware.[24] If successful, the same result would be accomplished for the radio tube business as was achieved by the instant injunction. Solution of the problem in this manner would obviate the necessity of a holding which seems tenuously grounded and susceptible to unfortunate projection, in the face of the present patent law. More significantly, such a solution would eliminate the danger, implicit in the instant decisions, that a patentee will be deprived of the privilege of insuring the successful functioning of his device, when the courts allow it to be coupled with accessories essential to its use and inferior to those which he could furnish.

---

[23] Federal Trade Commission v. Sinclair Refining Co., 261 U. S. 463, 43 Sup. Ct. 450 (1923). Accord: Auto Acetylene Light Co. v. Prest-O-Lite Co., 276 Fed. 537 (C. C. A. 6th, 1921) (lease of tanks with stipulation that they be used only with the acetylene gas of the lessor); (1922) 31 YALE L. J. 668; *cf.* Connecticut Telephone & Electric Co. v. Automotive Equipment Co., 14 F. (2d) 957 (D. N. J. 1926) (sale of patented appliances on condition all parts be purchased exclusively from the patentee). In all of these cases the Court stressed the fact that there was no provision prohibiting the lessee or vendee from dealing in the products of a competitor. Such a provision is clearly invalid. Standard Fashion Co. v. Magrane-Houston Co., 258 U. S. 346, 42 Sup. Ct. 360 (1923). In addition, in all of the above cases where the restriction was upheld there was considerable competition in the fields of both patented and unpatented articles.

[24] This suit is brought on the ground that the Radio Corporation has acquired an illegal monopoly by virtue of cross-licensing agreements and other patent pooling devices. Such large patent pools have been held illegal. Standard Sanitary Manufacturing Co. v. United States, 226 U. S. 20, 33 Sup. Ct. 9 (1912). A possible defense to such an attack would seem to be proof that the acquisition of patents on competing combinations had made possible the manufacture of complete sets embodying the best factors and devices of each combination, so that the public had been benefited by the marketing of a greatly superior product.

Judicial disposition of the radio tube litigation, however, indicates the zeal of the courts to carry out the spirit of the anti-trust laws, even at the expense of whatever advantages might lie in a less narrow application of the patent statute and its irreconcilable principles. Not only the dubious ruling as to Clause 9 of the licensing agreement, but also the cursory dismissal of the claim that the tubes were included in the patents, bear witness to the tendency. For the decision that the tubes were not so included, though apparently inevitable and automatic, might easily have been settled to the contrary in accordance with the descriptions in the patent claims [25] and with prior court rulings. Thus it has been held that a patent on baking powder covers the separate unpatented ingredients [26] and that a patent on a combination of phonograph and needle covers the unpatented record,[27] so that unlicensed sale of the ingredients or the records with the knowledge that they are to be used in the patented combination amounts to contributory infringement.

In the past, the tendency to confine the scope of patent monopolies had been apparent only where the anti-trust laws were specifically considered.[28] But the attitude of the Supreme Court toward the present litigation and its decision in the recent contributory infringement case of *Carbice Corporation v. American Patents Development Corporation* [29] seem to indicate that, in that Court at least, the tendency has developed into a general policy with regard to the patent law. However useful such a policy

[25] The claim for the Alexanderson patent, one of those acquired by the Radio Corporation, would seem to bear out the contention that the tube is an integral part of the patented circuit. It is described as follows: "A tuned receiving system for detecting sustained oscillations of a given frequency comprising a plurality of circuits resonant to the frequency of the oscillations to be detected and arranged in cascade, relay devices (tubes) joining each of said circuits to another comprising an evacuated envelope, an electron-emitting cathode, a co-operating anode, and a grid, said device (tube) being connected to one of said circuits at the cathode and grid and to another circuit at the cathode and anode and a local source of energy in the second circuit." See, Thacher, J., in Radio Corporation et al. v. E. J. Edmond & Co., 20 F. (2d) 929, 930 (S. D. N. Y. 1927).

[26] Rumford Chemical Works v. New York Baking Powder Co., 136 Fed. 873 (S. D. N. Y. 1905).

[27] Leeds & Catlin Co. v. Victor Talking Machine Co., 213 U. S. 325, 29 Sup. Ct. 503 (1909).

[28] See Motion Picture Patents Co. v. Universal Film Co., *supra* note 12 at 517, 37 Sup. Ct. at 421; United Shoe Machinery Co. v. United States, *supra* note 15.

[29] U. S. Daily, Mar. 10, 1931, at 70. This case holds that a patent covering a special combination container for ice cream and dry-ice did not prevent the defendant from selling the unpatented dry ice with the knowledge it would be used in the plaintiff's combination. With regard to the litigation in Lord v. Radio Corporation the Court said: "The attempt to use the patent monopoly to restrain commerce is not only beyond the scope of the grant, but also a direct violation of the anti-trust laws."

might be in fostering free competition, it cannot but discourage large industries from investing capital in the scientific research and extensively equipped laboratories which have been so productive of invention in the last decade. If opposition springs from the fact that industrial capital thus reaps a large share of the inventor's reward, a better-considered remedy lies in accommodation of the patent laws to the technological and financial developments which have completely revolutionized industry since the patent act was passed.

TAXABILITY OF GAIN DERIVED FROM THE LIQUIDATION OF A LIABILITY AT LESS THAN FACE VALUE

A COMMON feature of depressed financial markets is the quotation of corporate bonds at prices substantially below par. A purchase by a corporation of its own bonds at such a time results in a saving of the difference between the par and market value of the bonds, a saving which, according to accounting practice, is transferred to the "surplus" of the corporation.[1] Yet any corporation or other enterprise whose cash position permits it to take advantage of distress selling of its own securities, later finds itself confronted with the question of whether the resulting increase in its surplus is taxable income under the Federal Income Tax Law.

This question was recently answered in the negative in *Kirby Lumber Co. v. United States*,[2] where it appeared that the corporation issued bonds at par and later in the same year retired them after repurchasing them on the open market at less than par. The Court of Claims held that a difference of $137,521.30 between the par value and repurchase price of the bonds did not constitute taxable income. Considerable authority for this decision may be found in similar rulings of the Board of Tax Appeals where the same question has arisen with respect to bonds,[3] pre-

[1] The Interstate Commerce Commission so directs. See, for example, CLASSIFICATION OF INCOME, PROFIT AND LOSS, AND GENERAL BALANCE SHEET ACCOUNTS FOR STEAM ROADS (Interstate Commerce Commission, 1914) 34, § 607; UNIFORM CLASSIFICATION OF ACCOUNTS FOR ELECTRIC UTILITIES (Illinois Commerce Commission, 1923) 56, Account No. 503; SUNLEY AND PINKERTON, CORPORATION ACCOUNTING (1931) 259.

[2] U. S. Daily, Dec. 5, 1930, at 3041 (Ct. Cl. 1930).

[3] Independent Brewing Co., 4 B. T. A. 870 (1926) (IX-1 Cum. Bull. 68); New Orleans, Texas & Mexico Ry., 6 B. T. A. 436 (1927) (VII-1 Cum. Bull. 39); Houston Belt & Terminal Ry., 6 B. T. A. 1364 (1927) (VII-2 Cum. Bull 48); Indianapolis Street Ry., 7 B. T. A. 397 (1927) (VII-1 Cum. Bull. 38); National Sugar Manufacturing Co., 7 B. T. A. 577 (1927) (VII-1 Cum. Bull. 39); General Manifold & Printing Co., 12 B. T. A. 436 (1928) (IX-1 Cum. Bull. 65); Douglas County Light & Water Co., 14 B. T. A. 1052 (1929); Eastern S. S. Lines, 17 B. T. A. 787 (1929) (IX-1 Cum. Bull.

ferred stock[4] and compositions with general creditors.[5] But the frequent dissent from the position adopted by the majority of the board[6] and the persistent refusal of the Commissioner of Internal Revenue to alter the "Regulation" declaring a contrary rule for corporate bonds,[7] prompts a consideration of both the authorities and the accounting problems involved.

All the authorities regarded as controlling the instant case have directly or indirectly been predicated upon the decision of the United States Supreme Court in *Bowers v. Kerbaugh-Empire Co.*[8] There an American corporation in 1913 borrowed from a German bank an amount of money repayable in marks or their equivalent in the United States. The bank becoming an enemy alien upon the outbreak of war with Germany, the obligation was settled by payment to the Alien Property Custodian of a sum substantially below the amount of American money borrowed.[9] The Court ruled that no taxable income had been realized from this transaction. Ostensibly this decision was based upon the definition of income established in *Eisner v. Macomber*[10] as "gain derived from capital, from labor, or from both combined, provided it be understood to include profit gained through a sale or conversion of capital." But the particular stress laid upon the presence of past losses in excess of the amount of money borrowed indicates that this was not the sole basis of the

---

64); North American Mortgage Co., 18 B. T. A. 418 (1929); American Tobacco Co., 20 B. T. A. 591 (1930); Houghton & Dutton Building Trust, 20 B. T. A. 586 (1930). References in the parentheses are to the contrary holdings of the Commissioner of Internal Revenue. See *infra* note 6.

[4] Liberty Agency Co., 5 B. T. A. 778 (1926).

[5] Meyer Jewelry Co., 3 B. T. A. 1319 (1926); John F. Campbell Co., 15 B. T. A. 458 (1929) (VIII-2 Cum. Bull 60); Simmons Gin Co., 16 B. T. A. 793 (1929) (IX-1 Cum. Bull. 75), *aff'd*, 43 F. (2d) 327 (C. C. A. 10th, 1930); Eastside Manufacturing Co., 18 B. T. A. 461 (1929).

[6] To most of the cases one member, Sternhagen, dissented without opinion. He expresses himself, however, in National Sugar Manufacturing Co., *supra* note 3, at 578, and in John F. Campbell Co., *supra* note 5, at 460. As to the non-acquiescence of the Commissioner of Internal Revenue see *supra* notes 3 and 5.

[7] See U. S. TREAS. REG. 74, Art. 68 (1929): Sale and retirement by corporation of its bonds—(1) (a) If bonds are issued by a corporation at their face value, the corporation realizes no gain or loss. . . . (c) If, however, the corporation purchases and retires any of such bonds at a price less than the issuing price or face value, the excess of the issuing price or face value over the purchase price is gain or income for the taxable year." In regard to cancellation of a debt see *infra* note 26.

[8] 271 U. S. 170, 46 Sup. Ct. 449 (1926). See adverse criticism in (1925) 34 YALE L. J. 334; (1925) 25 COL. L. REV. 110; *cf.* MONTGOMERY, INCOME TAX PROCEDURE (1927) 327, 328: "It is unfortunate that the opinion is not clearer."

[9] The settlement was based on a valuation of the mark at 2½ cents. The saving amounted to $684,456.18.

[10] 252 U. S. 189, 207, 40 Sup. Ct. 189, 193 (1920).

Bowers decision; for if the intention was to view this profit as in no wise taxable income, then the further discussion of the preponderance of past losses is mere surplusage. Any attempt to offset past losses against the profit seems necessarily to assume a presently taxable gain.

Admitting with the Court that "income" may be defined as in the *Eisner* case, the exclusive application of this definition to a gain derived from the liquidation of a liability at less than face is hardly justifiable when viewed in the light of the purpose of the Federal Income Tax law.[11] The net effect of the repurchase transaction is a reduction of liabilities accompanied by a corresponding increase in net worth.[12] This increase, while strictly not derived either from invested capital or labor, is nevertheless a gain presently realized which not only increases the book value of the corporate stock but may even be available for dividend distribution. The fallacy of not taxing such a gain is apparent when the transactions involved take place over a period of years. In the determination of net income in a particular year, gross income is reduced by costs and expenses valued at the amount paid or expected to be paid.[13] The net income so determined is then taxable. If later the indebtedness is settled by part payment and cancellation of the balance, these liabilities are actually liquidated at less than the original estimate, *i. e.*, that used in computing the tax. The difference between the estimated and actual cost should therefore be treated either (1) as a reduction of the cost in the year in which the estimate was made, or else (2) as income in the year in which the indebtedness was in fact cancelled.[14] To do otherwise allows the taxpayer, in computing

[11] U. S. Const. Amend. XVI. See Merchants' Loan & Trust Co. v. Smietanka, 255 U. S. 509, 516, 41 Sup. Ct. 386, 387 (1921) re "the comprehensive last clause [in the Revenue Act] 'gains or profits and income derived from any source whatever.'" *Cf.* Doyle v. Mitchell Brothers Co., 247 U. S. 179, 185, 38 Sup. Ct. 467, 469 (1918) "[income] conveying rather the idea of gain or increase arising from corporate activity."

[12] The actual result is a decrease in liabilities of the par value of the bonds accompanied (1) by a decrease in assets to the amount of cash paid and (2) by an increase in net worth of the difference.

[13] See the excellent dissenting opinion of Sternhagen in John F. Campbell Co., *op. cit. supra* note 5, at 461: "The assumptions of the accrual system which justify its recognition as a means of arriving at taxable income include the assumption that when a deduction is taken for a cost incurred there is a genuine anticipation of payment, and since the payment will surely in future be made, it is entirely fair that the deduction be made when the liability accrues instead of when paid, so long as the system adopted be consistent and free from material distortion."

[14] *Ibid:* "Where a deduction has been enjoyed upon the assumption that a liability will be met to its full extent and the assumption subsequently proves erroneous, a proper adjustment should be made by way of either restating the deduction for 1920 or treating the amount subsequently remitted as a gain for 1921."

his tax, to deduct the entire face amount of a liability which he subsequently pays only in part.

The same argument applies where losses have occurred in prior years which have already been deducted from net income at their face amount. By repayment of the obligation at less than face it is found that the net losses are not of the magnitude believed when the tax was computed. Again one of two results should follow: (1) the amount of loss deducted in the year when it occurred should be reduced and the tax return adjusted accordingly, or (2) the saving should be added to the income in the year in which it is realized.

From an administrative point of view, to reopen tax returns years after they have been filed is hardly feasible. Moreover, analysis reveals two elements involved in the normal credit transaction: (1) the securing of funds or credit and the subsequent repayment of the obligation, and (2) the investment of the fund or use of the property obtained on credit. Thus there are two possibilities of gain to the debtor; first, by a profitable investment or use of the funds or property, and second, by the repayment, for some reason, of less than the amount borrowed. These two transactions, the one of lending and borrowing and the other of investment or productive use, have no necessary relation to one another. The statement of the Supreme Court that "the mere diminution of loss is not gain, profit or income" [15] is true in so far as it applies to the net returns for a given year. But when applied to returns filed over a period of years it should not dispense with the requirement that profits and losses be separately reported.

An examination of the Board of Tax Appeals cases reveals that the decisions have not only followed the *Bowers* case on its facts but have extended its scope to cases in which no prior losses were shown to have occurred.[16] As if to demonstrate that "hard cases make bad law" the earliest bond repurchase case in the Board of Tax Appeals was *Independent Brewing Co.*[17] where it appeared that the repurchased bonds were secured by a mortgage on properties which, although greatly depreciated by reason of the advent of prohibition, would not show a tax deductable loss until the depreciation was realized by their sale. Taxing the profit here would have forced the payment of a large tax immediately whereas the corporation would have to wait in-

[15] Bowers v. Kerbaugh-Empire Co., *supra* note 8, at 175, 46 Sup. Ct. at 451.

[16] See National Sugar Manufacturing Co., *supra* note 3. In most of the cases cited *supra* note 3 there were no prior losses. In Kirby Lumber Co., 19 B. T. A. 1046 (1930), losses were shown in 1925. The Commissioner reduced the loss by the amount of gain made through the repurchase of bonds. The court held this error. Thus there is no "diminution of loss" whatever although that was the theory behind the Bowers case.

[17] *Supra* note 3.

definitely before it could offset the corresponding, though as yet unrealized, losses. Faced with this situation the Board held (four members dissenting) that no taxable income was derived from the repurchase of the bonds. The unfortunate situation of one taxpayer, however, hardly justifies the adoption of a rule which, as pointed out above, functions badly in the reverse situation occuring more frequently, *i. e.*, where the losses have been realized and already deducted from the taxable income in past years or where no losses whatever have been incurred.

Repurchase transactions taking place within an affiliated group have been held to give rise to no taxable gain.[18] Since such transactions are merely capital adjustments the resulting profits or losses may reasonably be regarded as bookkeeping entries only.[19] Even where a corporation purchases the bonds of another corporation below par and later acquires either all the assets or capital stock of that corporation, a subsequent retirement of the bonds purchased may likewise be reasonably regarded as only a capital transaction.[20] Here the net effect of the retirement of the bonds is to reduce the cost of the subsidiary to the purchasing corporation. A necessary corollary, however, is that the books of the purchasing corporation correctly show the actual cost of the subsidiary and not the cost as determined when the bonds are included at par.

The Treasury Regulations specify the method of computing the amount of gain derived from a repurchase transaction.[21] Because of differences between the interest rate agreed upon in the bond contract and the market rate of interest, corporations frequently issue their bonds above par where the bond rate is higher than the market rate, or below, when the reverse situation obtains. In either case, to maintain the investor's return at the market rate of interest, the value of the bonds approaches par as the maturity date nears. This difference between present market value and par represents the unamortized discount or premium and the adjustment of the bond to the market rate of interest.[22] Thus a gain from the repurchase of bonds occurs whenever the corporation buys at less than this actual or present value (irrespective of par) and the amount of the gain is to be meas-

---

[18] U. S. TREAS. REG. 75, Art. 31 (1930). Liberty Agency Co., 5 B. T. A. 778 (1926); MONTGOMERY, INCOME TAX PROCEDURE (1929) 36.

[19] But carefully distinguish the case where a subsidiary buys its own bonds from the parent from the case where the parent buys bonds of a subsidiary in the open market.

[20] Chicago, Rock Island & Pacific Ry., 13 B. T. A. 988, 1026 (1928); *cf.* American Seating Co., 14 B. T. A. 328 (1928).

[21] U. S. TREAS REG. 74, Art. 68, §§ 2-3 (1929).

[22] 2 KESTER, ACCOUNTING THEORY AND PRACTICE (2d ed. 1925) 201. For a technical discussion of the theory and methods of amortization in detail see 2 FINNEY, PRINCIPLES OF ACCOUNTING (1927) c. 44.

ured by this difference.

With one exception no difference in the rule should be made where a corporation repurchases its own bonds for investment purposes only and not for immediate retirement.[23] From an administrative point of view, it would seem advisable to adopt a single method of taxation for all types of transactions involving the repurchase of a company's own bonds, instead of setting up a distinction based upon the nebulous idea of intent. To defer taxation until the bonds are actually cancelled causes confusion especially with long term obligations, since a considerable period of time may intervene between repurchase and retirement. This would require later examination of the books and records kept during the entire period and a tracing of each bond or group of bonds through a great many transactions. Furthermore if the bonds are resold it will be because the corporation needs money. Such a sale will take place with reference to current money conditions and the resale price will bear no relation, as a gain or loss, to the price at which the bonds were repurchased. The difference between the resale price and par, representing only the adjustment of the bond rate to the market rate of interest, should be amortized over the period which the bonds have yet to run and be deducted as interest during that period.[24]

The one exception which should be made to this rule arises when a corporation can show positively that the bonds were repurchased merely to afford a means for temporary use of temporarily idle money, *i.e.*, money for which the corporation will obviously have use in the relatively immediate future, as for the payment of maturing interest or debts. The question of retirement is not concerned in such a transaction. Cases falling within this exception should be limited to those where the resale would take place within a comparatively short time, thus obvia-

[23] The Board of Tax Appeals makes no distinction whatever between bonds purchased for retirement or investment: no taxable income is received in either case. Petaluma & Santa Rosa R. R., 11 B. T. A. 541 (1928). The Commissioner acquiesced in this decision with regard to bonds repurchased and held for investment. VII-2 Cum. Bull. 31. And see, in accord, MONTGOMERY, INCOME TAX PROCEDURE (1927) 330.

[24] For example, a corporation, having originally issued 5% bonds at their par value of $100, repurchases some of them at $86. The corporation will hardly resell at $91 merely because it can make a "profit" over the repurchase price of $86. Rather the resale price is calculated to yield a 6% return to the investor. The bonds cannot be sold at a higher price and correspondingly smaller yield nor, on the other hand, is there any reason why the corporation should give the investor a larger yield, providing that the bonds can be readily sold. It would appear, therefore, that the proper handling of the transaction for tax purposes is to tax the corporation upon a gain of $14 upon the repurchase of the bonds, and to permit it to amortize the difference between the resale price and par, deducting it as interest paid over the period which the bonds have yet to run.

ting the administrative difficulties which beset a long delay before retirement. This exception is strictly in accord with the accounting practice of carrying such bonds at their *cost* price without profit to the corporation.[25] Essentially they are treated as if the obligation of another corporation.

Those cases in which a debtor settles with his general creditors for a fraction of the face amount of his debts present further difficulties. Whether the debtor is solvent or insolvent may conceivably make a difference in result. The Treasury Regulations on the point, which in general beg the question, are specific in holding a gift those cases where "a creditor merely desires to benefit a debtor and without any consideration therefor cancels the debt." [26] That the release of part of a debt upon the payment of part is any less a gift is difficult to perceive. Yet, although theoretically the taxable nature of the item does not change with the circumstances of the debtor, policy considerations may well dictate a more lenient rule in behalf of the insolvent.[27] The Board of Tax Appeals has held, following the "rule" of the *Bowers* case, that release of a debt gives rise to no taxable income.[28] And a similar result has been reached by a Circuit Court of Appeals [29] which held that a release of debt to a corporation by its sole shareholder was not "income" but a capital contribution.

The final determination of the taxability of a gain realized from the discharge of a debt at less than its face amount lies with the Supreme Court. It is not too much to hope that that Court, if it will not directly overrule the *Bowers* case, will at least confine it to its specific facts and terminate the unwarranted extensions which now result in a considerable loss of what should be taxable income.

---

[25] FINNEY, *op. cit. supra* note 22, at c. 43, p. 9; KESTER, *op. cit. supra* note 22 at 179. In this situation profits and losses on the resale are computed with reference to the purchase price.

[26] "The cancellation and forgiveness of indebtedness may amount to a payment of income, to a gift, or to a capital transaction, dependent on the circumstances." U. S. TREAS. REG. 74, Art. 64 (1929). See the comment on this article, 1 STANDARD FEDERAL TAX SERVICE (C. C. H. 1931) par. 77.04.

[27] This is suggested in one case in which the court, by way of dictum, said: "There is a distinction between a release or discharge of a liability to a solvent and to an insolvent debtor." Commissioner of Internal Revenue v. Simmons Gin Co., 43 F. (2d) 327, 329 (C. C. A. 10th, 1930).

[28] The cases are cited *supra* note 5. That the solvency or insolvency of the debtor is immaterial see Simmons Gin Co., 16 B. T. A. 793, 798 (1929).

[29] United States v. Oregon-Washington R. R., 251 Fed. 211 (C. C. A. 2d, 1918).

INDIRECT CENSORSHIP OF RADIO PROGRAMS

THE only express standard by which the Federal Radio Commission is governed in the exercise of its licensing authority is "public interest, convenience or necessity."[1] In its initial task of distributing the limited number of "channels" among the numerous applicants for licenses and in its later work of providing an equal allocation of broadcasting service, both of transmission and reception, to each of the five "zones,"[2] the Commission found that "public interest, convenience and necessity" required first the elimination of the various types of interference such as heterodyning, cross-talk, and blanketing, and the creation of a fairly distributed, well diversified and regularly scheduled broadcasting service.[3] As yet the question as to what a station may broadcast has not received a great deal of attention; but in passing upon an application for the renewal of a license it has

[1] This phrase occurs with variations in Sections 4, 9, 11 and 21 of the Radio Act of 1927. 44 STAT. 1163, 1166, 1167, 1170 (1927), 47 U. S. C. A. §§ 84, 89, 91, 101 (Supp. 1930). See Caldwell, *The Standard of Public Interest, Convenience or Necessity as Used in the Radio Act of 1927* (1930) 1 AIR L. REV. 295, 297; SECOND ANNUAL REPORT OF FEDERAL RADIO COMMISSION (Supp. 1928) 166 [hereinafter cited 2d A. R. F. R. C. (Supp. 1928)]. The phrase has a public utility origin. From the transmission standpoint broadcasting stations are not and should not be treated as public utilities. To do so would deprive such stations of a beneficial power of censorship over their own programs. From the standpoint of reception, however, they are subject to an obligation corresponding to the obligation of public utilities to render adequate service. See In the matter of the application of Great Lakes Broadcasting Co., No. 4900, reprinted in 3d A. R. F. R. C. (1929) 32; Ashby, *Legal Aspects of Radio Broadcasting* (1930) 1 AIR L. REV. 330, 346; W. JEFFERSON DAVIS, RADIO LAW (2d ed. 1930) 66; STEPHEN DAVIS, LAW OF RADIO (1927) 105-7. It has been suggested that considerable assistance in interpreting the standard may be found in the analogy of the public utility cases. Caldwell, *op. cit. supra*, at 317. On the other hand since the standard must be applied to a variety of types of stations it must receive a more liberal interpretation than in the case of public utilities. (1929) 54 A. B. A. REP. 456; W. JEFFERSON DAVIS, RADIO LAW (2d ed. 1930) 184; Comment (1929) 39 YALE L. J. 245, 251.

[2] Section 2 of the Act of 1927 divided the country into five zones. Section 9 of the Act was amended by the Act of 1928, 44 STAT. 373 (1928), 47 U. S. C. A. § 89 (Supp. 1930), to provide for equality of service among the zones. This amendment, known as the Davis Amendment, necessitated General Order No. 40 (as amended by General Order No. 87) by which 40 cleared channels, 44 regional channels and 6 local channels were established for broadcasting purposes. See Ashby, *op. cit. supra* note 1, at 338; 2d A. R. F. R. C. (1928) 48.

[3] See 2d A. R. F. R. C. (Supp. 1928) 166. There has been an attempt to prevent duplication of like service in the same community. Where one community is underserved and another is receiving duplication of the same order of programs the second community is given preference over the former. The Davis Amendment, *supra* note 2, was a partial limitation upon the power of the Commission in applying the standard.

become increasingly necessary to take this into account, principally through a consideration of the character of past programs.[4]

In determining whether the programs of a particular station have met the test of "public interest, convenience or necessity" the Commission has felt constrained to consider carefully Section 29 of the Act of 1927, which forbids to the Commission the power of "censorship" or interference with the "right of free speech."[5] The term "censorship" when used to denote interference with the constitutional guaranty of freedom of speech has generally been interpreted to mean "previous restraint."[6] Yet although the Commission may have no power to scrutinize and reject programs prior to their release, the power to revoke or refuse the renewal of a license is in many cases so effective a means of "censorship" as to make unconvincing any legalistic distinction between "previous restraint" and a refusal to renew a license because of the character of past programs.[7] As a practical matter the prohibition against "censorship," in the sense of prohibiting a scrutiny and rejection of programs prior to their broadcast, is justified by the administrative difficulties which would be involved in such "censorship."[8] Furthermore there is less likelihood of an abuse of discretion in applying the test of "public interest, convenience or necessity" when the Commission

[4] It is difficult to determine to what extent the Commission has considered the character of the past programs of an applicant for renewal of a license. Statement of facts and grounds for decision are not filed unless the case is appealed to the Court of Appeals of the District of Columbia. Section 16 of the Act of 1927; 4th A. R. F. R. C. (1930) 41. The Commission may, among other reasons, be influenced by the lack of financial responsibility, the untrustworthiness or poor technical equipment of the applicant. See 2d A. R. F. R. C. (Supp. 1928) 153, 169. In January 1929 Commissioner Robbins testified that the Commission has been troubled by complaints as to the use of the radio for the perpetration of fraudulent schemes, the urging of boycotts and unfair advertising. HEARINGS ON H. R. 15430 (70th Cong. 2d Sess. 1929) 8. The Commission has to some extent been guided by the reaction of the public to the broadcasts of certain stations, as exhibited in the thousands of communications which come to it annually. 2d A. R. F. R. C. (Supp. 1928) 154. In the beginning it was apparently felt that the character of the programs could be controlled to a large extent by the force of public opinion and the censorship powers of the stations themselves. See address of Commissioner Bellows, April 29, 1927, reprinted in 1st A. R. F. R. C. (1927) 6.

[5] In come cases the Commission has ignored complaints and its own opinion on the quality of the programs for fear less it should overstep the powers given to it and violate the prohibition against censorship. See 2d A. R. F. R. C. (Supp. 1928) 160.

[6] See 2 COOLEY, CONSTITUTIONAL LIMITATIONS (8th ed. 1927) 884; Patterson v. Colorado, 205 U. S. 454, 462, 27 Sup. Ct. 556, 562; Rosenberg, *Censorship in the United States* (1928) 32 LAW NOTES 49, 50.

[7] The usual term of a license is 90 days, though it may be less. See W. JEFFERSON DAVIS, RADIO LAW (2d ed. 1930) 140.

[8] See ZOLLMAN, LAW OF THE AIR (1927) 108.

is limited simply to refusing or revoking a license than if it were empowered to delete or modify programs prior to their intended release. The prohibition against "censorship" acts as a caution to the Commission to consider the general character of the service rendered by the station instead of the disapproved but mooted character of a particular program. It is significant that in the few cases where a real question of "censorship" has been involved and adverse action taken upon an application for a renewal of a license, the decisions were not based upon the Commission's disapproval of the views expressed in a particular program or series of programs but rather on the ground that the programs indicated that the station was being devoted largely to the purely personal interests of the licensee or another without any attempt at public service.[9] Whatever may be the legal significance of an immunity from "censorship" or interference with the "right of free speech" standing alone, in the field of radio such immunity is so qualified by the requirement that the programs meet the test of "public interest, convenience or necessity" as to amount to little more than a right that the Commission shall act reasonably and without discrimination in the exercise of its licensing authority.

Because of the excessive number of applicants and the limited number of broadcasting channels, the standard of "public interest, convenience or necessity" becomes a determination of the relative public importance of the several programs broadcast.[10] This cannot be overemphasized. The question is not primarily how innocuous the program may be but to what extent it serves a public need by providing unduplicated and wholesome entertainment or is of educational or aesthetic value. Competition between stations will tend in some degree to eliminate those stations which do not serve the interests of the public at large. Each station by noting the reaction of its listeners will seek to gain greater popularity by discontinuing such programs as react unfavorably upon the public. To some extent each listener

---

[9] See statement of the Commission relative to putting four stations on probation. 2d A. R. F. R. C. (Supp. 1928) 159. See also Schaeffer v. Federal Radio Commission, No. 5228 (1930). The removal of station *KTNT* from the air has recently been recommended by Chief Examiner Yost for the reason that it has been used as a "mere adjunct" of the owner's business. See U. S. Daily, Mar. 10, 1931, at 72.

[10] See Caldwell, *op. cit. supra* note 1, at 317; (1929) 54 A. B. A. REP. 460; the Head-of-the-Lakes Broadcasting Co. v. Federal Radio Commission, No. 4976 (1928), reprinted in 3d A. R. F. R. C. (1929) 36. This does not mean that each applicant need not demonstrate its own merits rather than rely on the defects of another. Missouri Broadcasting Corp. v. Federal Radio Commission, No. 5204 (1930). On the question of the weight given to priority of establishment on a specified channel see, Great Lakes Broadcasting Co. v. Federal Radio Commission, 37 F. (2d) 993 (Ct. of App. D. C. 1930); Chicago Federation of Labor v. Federal Radio Com-

by the mere turning of the dial becomes a censor.[11] In many cases, however, the competitive system has broken down and the public been placed at the mercy of an unscrupulous broadcasting station. In these cases the Commission must interpose and act in behalf of the interests of the radio public.

In the regulation of some aspects of radio broadcasting the Commission has apparently had little difficulty in justifying either a refusal to renew a license or a relegation of a licensee to an inferior place on the air. There seems to be no sound objection to eliminating or allotting inferior privileges to those stations which do not maintain regular schedules,[12] fail consistently to announce call numbers,[13] indulge in personal abuse with competing stations,[14] permit personal attacks on the broadcaster's enemies,[15] allow the use of indecent or defamatory language,[16] indulge excessively in "direct advertising" [17] or devote their time to a service which is readily available to the public in another form, such as constant playing of phonograph records.[18] There

mission, 41 F. (2d) 422 (Ct. of App. D. C. 1930); 1 AIR L. REV. 277, 419.

[11] See In the matter of Great Lakes Broadcasting Co., No. 4900, reported on appeal in 37 F. (2d) 993 (Ct. of App. D. C. 1930). See excerpts from statement of the Commission's grounds for decision in this case, 3d A. R. F. R. C. (1929) 32. In Schaeffer v. Federal Radio Commission, No. 5228 (1930), the Commission said: "It is a reassuring fact that usually only those broadcasting stations which first establish themselves in the confidence of the public whom they undertake to serve are successful in establishing themselves on a sound financial basis. ... Where it is shown, as in the case of Station *KVEP*, that the public had failed to lend its aid for the station's support there is some indication that the legislative standard is not being met."

[12] See Technical Radio Laboratory v. Federal Radio Commission, No. 4835, 3d A. R. F. R. C. (1929) 31, *aff'd*, 36 F. (2d) 111 (Ct. of App. D. C. 1929).

[13] This was one of the reasons for the recommended removal of the Debs Memorial Radio Fund, Inc. Station from the air. See U. S. Daily, Mar. 4, 1931, at 11.

[14] Station *WRAK* was put on probation for this reason. 2d A. R. F. R. C. (Supp. 1928) 159.

[15] This was one of the reasons for the refusal of the Commission to renew the license of *WCOT*. 2d A. R. F. R. C. (Supp. 1928) 152.

[16] See *supra* note 14; § 29 of the Act of 1927.

[17] In reducing the power of *WCRW* from 500 to 100 watts, the Commission said: "Manifestly this station is one which exists chiefly for the purpose of deriving an income from the sale of advertising of a character which must be objectionable to the listening public and without making much, if any, endeavor to render any real service to that public." 2d A. R. F. R. C. (Supp. 1928) 156. By "direct" advertising is usually meant the mention of specific commodities, the quoting of prices, and the soliciting of orders to be sent directly to the advertiser or the radio station. By "indirect" advertising is usually meant advertising calculated simply to create or maintain good will toward the advertiser. 2d A. R. F. R. C. (1928) 19.

[18] See statement of the Commission in announcing its decision to revoke the license of *WJBA* and reduce the power of *WCRW*. 2d A. R. F. R. C.

is here no question of freedom of speech and the Commission is well qualified to investigate and control such features of program service.

A more difficult problem has arisen when the Commission has been called upon to curb a station used almost exclusively for the spreading of "propaganda." [19] Here it has acted cautiously for fear of running counter to the prohibition against censorship [20] and yet it has expressed the view that if the question were raised now for the first time it would not license any propaganda station.[21] It is the belief of the Commission that the licensing of any station which caters principally to the interests of a pricate individual or a particular group gives it an unfair advantage over others and results in limiting stations which serve the interests of the public in general. The solution of this problem would seem to lie in assuring such creeds, doctrines and beliefs a place on the air only if the stations which they operate are in general devoted to the service of the public at large rather than to the broadcasting of their particular propaganda. If the Commission acts without discrimination in curbing these stations there would seem to be no reason to fear the prohibition against "censorship" contained in the Act.

A still more troublesome problem confronting the Commission is the regulation of radio advertising. Broadcasting stations in this country are supported for the most part by advertisers and a certain part of such advertising is offensive to the listening public. The Commission has said that "advertising should be only incidental to some real service rendered to the public and not the main object of the program." [22] On the other hand the

(Supp. 1928) 155. The Commission recognized, however, that in some of the smaller towns and farming communities the situation was not the same as in the cities where large resources of program material are available.

[19] An example of a propaganda station is *WEVD* in New York, the mouthpiece of the Socialist Party; another is *WIBA* in Madison, spokesman for the LaFollette progressive movement.

[20] Concerning the stations referred to *supra* note 19, the Commission said: "Wherever the evidence is shown that a particular station is serving as a mouthpiece for a substantial religious or political minority, no matter how much the individual members may disagree with the views of that minority, the commission has taken action favorable to the station." 2d A. R. F. R. C. (Supp. 1928) 160.

[21] 3d A. R. F. R. C. (1929) 35. Under the law prior to the Act of 1927 the Secretary of Commerce had no power to distinguish between stations or even to refuse a license to any station. Hoover v. Intercity Radio, 286 Fed. 1003 (Ct. of App. D. C. 1923). As a result there are a number of stations operated by religious or similar organizations. These stations are generally put on part time or inferior channels. Radio audiences are peculiarly sensitive to and resentful toward obvious propaganda. See *Radio Censorship*, 114 INDEPENDENT 583 (May 23, 1925), partially reprinted in BEMAN, CENSORSHIP OF SPEECH AND THE PRESS (1930) 87.

[22] 2d A. R. F. R. C. (1928) 168, reprinted in W. JEFFERSON DAVIS, RADIO LAW (2d ed. 1930) 145.

Commission has recognized that:

"If a rule against advertising were enforced the public would be deprived of millions of dollars worth of programs which are given out by concerns simply for the resultant good will which is believed to occur to the broadcaster or the advertiser by the announcement of his name and business in connection with programs." [23]

At the present time it would seem impossible for the Commission to do more in remedying the commercialized character of the programs than simply to give to those stations which show themselves technically and financially qualified to render superior programs a preference in the assignment of "channels" and to eliminate as nearly as possible "direct advertising."[24] If radio programs are to be improved in their educational and entertainment value by the elimination of the tint of commercialism the impetus for such improvement probably must come in a large measure from the radio public through its power of indirect censorship over the stations themselves.[25]

A clearer case for administrative regulation arises when a station permits the broadcast of false and misleading advertising or programs which are positively harmful to the public welfare. An instance of the latter occurred in the recent case of *KFKB Broadcasting Inc. v. Federal Radio Commission.*[26] Station *KFKB* was controlled by a certain doctor who operated it to further the interests of a pharmaceutical association and a hospital which he controlled. Over this station the doctor prescribed treatments for patients whom he had never seen, basing his diagnosis upon the symptoms recited to him by the patient in letters addressed to the station. The prescriptions usually recommended were designated by number and procurable only

[23] 3d A. R. F. R. C. (1929) 35.

[24] The National Committee on Education by Radio has urged that college and university broadcasting stations should be given a preference in the assignment of channels and thus "help to offset the present tendency toward centralization and net work monopoly." U. S. Daily, Mar. 9, 1931, at 54.

[25] According to a recent survey by Commissioner Lafount more than ten per cent of the "time on the air" of American broadcasting stations is devoted to programs educational in character. Out of 605 licensed stations as of Feb. 1, 1931, there are 51 "educational stations." U. S. Daily, Mar. 10, 1931, at 65. "A safeguard which some of the leading stations employ, is the association with the station of an advisory board made up of men and women whose character, standing, and occupation will insure a well rounded program best calculated to serve the greatest portion of the population in the region to be served." 3d A. R. F. R. C. (1929) 35. See *supra* note 11.

[26] U. S. Daily, Feb. 9, 1931, at 3760 (Ct. of App. D. C. 1931). Commissioner Lafount has characterized this decision as a precedent long awaited and long needed in the realm of radio law.

from the pharmaceutical association. The Court of Appeals of the District of Columbia upheld the Commission's order denying the renewal of the station's license on the ground that the station was being conducted only in the personal interest of a doctor indulging in a practice "inimical to public health and safety."

Though the facts of this case clearly justified a refusal to renew the license the question arises as to how far the Commission will go into the limitless field of censoring advertising and judging the quality of the product advertised. Newspapermen insist that advertising barred by the representative newspapers—including programs featuring "seers, gold brick promoters and quack doctors"—is common over almost every radio station.[27] The air has been used as a medium for conducting lotteries, advertising fraudulent securities and urging boycotts.[28] One means of controlling advertising of such a character is through the issuance of cease and desist orders by the Federal Trade Commission.[29] If the Federal Radio Commission undertakes to pass upon the quality of advertising and the authenticity or safety of the advertised product it may open up for itself a field of activity too vast to be handled by its present organization. The Commission will probably be forced to limit its attempts to control advertising to those cases where the station appears to be operated in furtherance of purely private interests or is used as a medium for patently fraudulent or harmful practices. By such limitation the Commission will avoid the determination of collateral issues of fact and law which it is not qualified to handle and which may more properly come within the domain of the Federal Trade Commission or the Department of Justice. By making the most of the *KFKB* decision, however, the Commission should be able to effect a long needed regulation of radio programs, a regulation which should be limited only by the magnitude of the task and by the requirement that at all times such regulation be undiscriminating.

[27] See VARIETY (Mar. 11, 1931) 65.

[28] HEARINGS ON H. R. 15430 (70th Cong. 2d Sess. 1929) 8. On Feb. 26, 1931 Senator McNary introduced a bill (S. 6240) at the instance of the National Editorial Association to prohibit lotteries or other schemes offering prizes dependent upon chance. This was intended to eliminate discrimination against newspapers and other periodicals which may not accept such advertisements under the postal regulations. U. S. Daily, Feb. 27, 1931, at 3967. A similar bill is pending in the House.

[29] Federal Trade Commission v. Winsted Hosiery Co., 258 U. S. 483, 42 Sup. Ct. 384 (1922). See Handler, *False and Misleading Advertising* (1929) 39 YALE L. J. 22, 42. That body, however, has recently been refused the power to pass upon the authenticity and safety of an advertised product where there is no question of "unfair competition." Raladam v. Federal Trade Commission, 42 F. (2d) 430 (C. C. A. 6th, 1930). See Comment (1931) 40 YALE L. J. 617.

SUPERVISION OF RAILROAD REORGANIZATION EXPENSES BY THE INTERSTATE COMMERCE COMMISSION

THE regulation of railroad reorganizations has been characterized as one of the most difficult and unsuccessful functions of the Interstate Commerce Commission.[1] The Commission is not expressly authorized to control reorganizations, but its approval is necessary under Section 20(a) of the Transportation Act[2] for the issue of securities by the new company in accordance with the reorganization plan. Thus jurisdiction is acquired after long and delicate negotiations have at last crystallized into agreements approved by the courts—when a denial of the application means that the receivership must be indefinitely continued and the work of reorganization undertaken anew. Placed in this difficult position, the Commission has sometimes seemed to act against its better judgment, giving reluctant authorization to reorganizations of which it did not really approve.[3] Some opportunity for more flexible and effective control is afforded by the provision of Section 20(a) which allows the application to be granted "upon such terms and conditions as the Commission may deem necessary or appropriate." Representative of the general situation is the attempt to control by this means the "expenses" and fees of reorganization managers and committees.

In the *Missouri-Kansas-Texas Reorganization* of 1922 the Commission first took jurisdiction over reorganization expenses, saying, "There is involved an important question of public inter-

---

[1] "In administering the provisions of the transportation act of 1920, which impose upon us the duty of supervising the issue of securities by railroad companies, we are faced by no more difficult problem than in connection with reorganizations following receiverships. In the past such reorganizations have largely been a matter of bargain and trade between groups of security holders without adequate consideration of the paramount public interest, so that the results have often been consistent neither with the public interest nor even with sound business principles, and recurring receiverships have been far from uncommon. In this very case our records show that this is not the first receivership through which the property has passed." Eastman dissenting in Missouri-Kansas-Texas Reorganization, 76 I. C. C. 84, 108 (1922).

"Perhaps the strongest objection that can be made to the Commission's policy is in connection with reorganizations. Undoubtedly cases of this sort are difficult to handle, since failure to approve of a plan will undo the labor of years, prolong the receivership, and involve further expensive negotiations between the various classes of security holders." LOCKLIN, REGULATION OF SECURITY ISSUES (1925) 16; *ibid.* c. 10.

[2] 41 STAT. 494 (1920), 49 U. S. C. § 20(a) (1929).

[3] *Cf.* Securities of the Chicago & Eastern Illinois Ry., 67 I. C. C. 61 (1921); Missouri-Kansas-Texas Reorganization, *supra* note 1; Reorganization of Georgia & Florida Ry., 117 I. C. C. 473 (1926); Chicago, Milwaukee & St. Paul Reorganization, 131 I. C. C. 673 (1928).

est."[4] The public interest was there not difficult to discover, for the expenses were plainly included within the capitalization of the new company, thus swelling fixed charges and increasing the rate base. The assenting security holders of the old company received bonds of the new up to the full amount of their cash assessments, out of which were paid the fees of the reorganization managers and their counsel. Commissioner McManamy, dissenting from the order which determined the fees, suggested that a method should be devised whereby the capital structure of the new company would not be burdened with the costs of reorganization.[5] Commissioner Eastman, fearing that means would be found for accomplishing much the same result by indirection, said, "Whatever the apparent method of providing for them, such expenses will continue to be a matter of vital public concern."[6]

The method adopted in the reorganization of the Chicago, Milwaukee, & St. Paul[7] is apparently in accord with Commissioner McManamy's suggestion. In return for one share of common stock of the old company and a cash assessment of $28, each depositing shareholder received one share of no-par common stock in the new company and $24 in bonds. Out of the $4 fund thus secured $2.50 was set aside to pay the actual expenses of reorganization,[8] any balance to be paid to the new company; and $1.50 to provide for the compensation of managers, committees and counsel, any balance to be paid to the new company or the shareholders as the managers should decide. The Commission granted the application to issue the new securities upon the express condition that no amounts should be paid out of the $4 fund "unless and until authorized by due order of the Court or by this Commission." The securities were issued and reorganization consummated, but the Supreme Court decided, Stone, Brandeis and Holmes dissenting, that "the condition in respect to the special fund of $1.50 was properly set aside and its enforcement enjoined by the court below."[9]

---

[4] 76 I. C. C. at 106 (1922).

[5] Missouri-Kansas-Texas Reorganization, 99 I. C. C. at 341 (1925). *Cf.* Acquisition Stock Issue by Northern Colorado & Eastern R. R., 86 I. C. C. 617 (1924); Reorganization of Georgia & Florida Ry., *supra* note 3; Kansas City, M. & O. Reorganization, 145 I. C. C. 339 (1928).

[6] 99 I. C. C. at 340.

[7] *Supra* note 3.

[8] These expenses included costs of foreclosure, court allowances, engraving, charges of corporate trustees, etc.

[9] United States v. Chicago, Milwaukee, St. Paul & Pacific R. R., 51 Sup. Ct. 159 (1931). Chief Justice Hughes took no part in the consideration of the case. The Court held that the order of the Commission authorizing the securities continued operative even though the condition was annulled, using as an analogy the rejection by the Court of an unconstitutional condition imposed by a state upon the grant of a privilege, and citing Frost

The opinion of the Court justified the decision on the ground that the condition related to matters beyond the jurisdiction of the Commission because entirely outside the realm of interstate commerce.[10] Were the argument limited to Section 20(a), it might be supported on the theory that the expense fund was not capitalized in the security issue which the Commission was asked to authorize. But even this contention is doubtful, since the whole $4 fund may be regarded as part of the price of no-par common stock, "short circuited" through the hands of the reorganization managers.[11] More dangerous and less defensible is the proposition that the agreement creating the fund was beyond the realm of interstate commerce. Dangerous because it would cripple any attempt of the Commission or Congress to devise more effective methods of controlling railroad reorganizations; indefensible because it disregards the principle of the decisions which have sustained and interpreted the Transportation Act of 1920.

Provisions of the recapture,[12] joint rate,[13] and intra-state rate [14] clauses have all been justified by their tendencies to assure an efficient transportation system. The Act also recognized that one requisite of adequate service was the rehabilitation of railroad credit in order that sufficient capital might be secured.[15] Almost synonomous with the rehabilitation of credit is the protection of the investor from such exploitation as has disgraced the history of railroad finance.[16] Not only is this desirable

v. Railroad Commission of California, 271 U. S. 583, 46 Sup. Ct. 605 (1926). Justice Stone challenged the analogy on the ground that the state could take further action, such as withdrawing or restricting the privilege, whereas the Commission was deprived of all further jurisdiction.

[10] The district court held that the disposal of the $2.50 fund was within the jurisdiction of the Commission because the plan provided that any balance left after the payment of expenses should go to the new company. "So though no part of the $2.50 was to be capitalized by the issuance of new bonds, such part of the same as remained after the payment of foreclosure expenses did become part of the property back of the preferred and common stock." Chicago, Milwaukee & St. Paul R. R. v. United States, 33 F. (2d) 582, 588 (N. D. Ill. 1929).

[11] See dissenting opinion of Justice Stone in the principal case, 51 Sup. Ct. at 166.

[12] Dayton Goose Greek Ry. v. United States, 263 U. S. 456, 44 Sup. Ct. 169 (1924).

[13] New England Division's Case, 261 U. S. 184, 43 Sup. Ct. 270 (1923).

[14] Railroad Commission of Wisconsin v. Chicago, B. & Q. R. R., 257 U. S. 563, 42 Sup. Ct. 232 (1922).

[15] See United States v. Guaranty Trust Co., 280 U. S. 478, 483, 50 Sup. Ct. 212, 213 (1930); Burgess, *Federal Regulation of Railway Management and Finance* (1924) 37 HARV. L. REV. 705, 721.

[16] The Commission in recommending that it be given the power to regulate railway securities stressed the importance of making them more secure investments for the public. See 21ST ANNUAL REPORT OF THE I. C. C.

in order to encourage confidence in railroad securities, but it seems also the logical converse of a theory of government which limits the investor in public utilities to a "fair" return on his investment.[17] Nor does protection seem any the less appropriate when bankers have constituted themselves protective committees and reorganization managers, and the security holder is faced with the alternative of either accepting their terms or relinquishing his equity in the business.[18] The exercise of the commerce power in such a situation seems no more paternalistic than the use of "Blue-sky" laws to prevent fraud and imposition in the sale of corporate securities.[19] Thus federal regulation of reorganization negotiations appears as a legitimate part of a larger function: the protection of the investor in railway securities for the purpose of fostering interstate commerce.

To the Court's second objection that the condition imposed by the Commission violated the guarantees of the Fifth Amendment it might be answered that the "federal police power" has often been allowed to seriously curtail rights of property.[20] But

(1907) 22 *et seq.* The recommendation was repeated every following year until 1918. Abuses in railroad finance were revealed in investigations conducted by the Commission. The New England Investigation, 27 I. C. C. 560 (1913); Financial Investigation of the New York, New Haven & Hartford R. R., 31 I. C. C. 32 (1914); Financial Transaction of Chicago, Rock Island & Pacific Ry., 36 I. C. C. 43 (1915); In re Pere Marquette R. R. and C. H. & D. Ry., 44 I. C. C. 1 (1917); Chicago, Milwaukee & St. Paul Investigation, 131 I. C. C. 615 (1928).

[17] State courts have sometimes spoken of the purpose of public utility statutes and the duty of Public Service Commissions to protect investors in public utility securities. See People ex rel. Delaware & Hudson Co. v. Stevens, 197 N. Y. 1, 10, 90 N. E. 60, 63 (1909); Bulkely v. New York, New Haven & Hartford R. R., 216 Mass. 432, 436, 103 N. E. 1033, 1035 (1914).

[18] In the Missouri-Kansas-Texas Reorganization hearing before the Commission, counsel for the reorganization managers said, "I attach less importance to the approval by the depositors than to the approval by the various committees. The depositors had no choice but to deposit or reject the plan . . ." 99 I. C. C. at 333. But Commissioner Eastman in his dissent pointed out that the weight of the approval of the Committees to the agreement fixing the compensation of the managers was impaired by the fact that the managers were the sole judges of the compensation of the committees. 99 I. C. C. at 334. The observations apply equally to the Chicago, Milwaukee, & St. Paul Reorganization.

[19] *Cf.* Hall v. Gieger-Jones Co., 242 U. S. 539, 37 Sup. Ct. 217 (1916). Somewhat comparable to the protection of the investor from financial hazards seems the protection of the bank depositor. *Cf.* Noble State Bank v. Haskell, 219 U. S. 104, 31 Sup. Ct. 186 (1911); Abie State Bank v. Weaver, 51 Sup. Ct. 252 (1931).

[20] In Board of Trade of City of Chicago v. Olsen, Chief Justice Taft characterized a federal statute, which purported to regulate the board of trade as a part of interstate commerce, as "a reasonable regulation in the exercise of the police power of the National Government." 262 U. S. 1, 41, 43 Sup. Ct. 470, 479 (1923). For other recent cases wherein the com-

the objection seems to be further invalidated by current legal theory concerning reorganization agreements. The relationship between depositing stockholders and their reorganization managers has been treated as fiduciary rather than purely contractual.[21] The depositor has been able, on mere suspicion of wrongdoing, to call the managers to account in equity for their expenditures,[22] and vainly have the latter attempted to contract out of liability for mishandling funds entrusted to their care.[23] The trust theory, as thus developed, seems applicable to the $1.50 fund created by the St. Paul agreement, for it was collected by the reorganization managers, not as their compensation, but as the source out of which they were to pay themselves a certain percentage of the amount of bonds outstanding, the protective committees and counsel reasonable fees for their services, and the new company or the stockholders any balance remaining. At those "reasonable fees," which were left entirely to the discretion of the reorganization managers and which they could have been called upon to justify in a court of equity, the order of the Commission seems to have been particularly directed. Thus the imposition of the condition in question, instead of being, as the Court intimates, an interference with liberty of contract, was but the extension of the jurisdiction of the Commission over matters otherwise left to judicial determination.

This difficulty of concurrent jurisdiction is present in most railroad reorganizations. The divided authority exercised by court and commission has perhaps militated against vigorous regulation by either. Certainly the Commission has been criticized both from within and without for its passive attitude, and it has been suggested that a more constructive policy might be developed if the plans of the reorganization managers were submitted to the Commission before being approved by the share-

---

merce power has seemed to operate quite independently of the Fifth Amendment *cf.* Tagg Bros. & Moorhead v. United States, 280 U. S. 420, 50 Sup. Ct. 220 (1929); Texas & N. O. R. R. v. Brotherhood of Railway & Steamship Clerks, 281 U. S. 548, 50 Sup. Ct. 427 (1930) and Comment (1930) 40 YALE L. J. 92.

[21] Rodgers, *Rights and Duties of the Committee in Bondholders' Reorganizations* (1929) 42 HARV. L. REV. 899, 922; Note (1928) 41 HARV. L. REV. 377.

[22] Mawhinney v. Bliss, 117 App. Div. 255, 102 N. Y. Supp. 279 (1st Dep't 1907); *cf.* Mills v. Potter, 189 Mass. 238, 75 N. E. 627 (1905); Parker v. New England Oil Corp., 4 F. (2d) 392 (D. Mass. 1924), 8 F. (2d) 392 (D. Mass. 1925), 13 F. (2d) 158 (D. Mass. 1926), 16 F. (2d) 838 (C. C. A. 1st, 1927), 19 F. (2d) 903 (C. C. A. 1st, 1927). But *cf.* Venner v. Fitzgerald, 91 Fed. 335 (C. C. S. D. N. Y. 1899).

[23] Industrial & General Trust Ltd. v. Tod, 180 N. Y. 215, 73 N. E. 7 (1905); See Carter v. First National Bank of Pocahontas, 128 Md. 581, 591, 98 Atl. 77, 80 (1916).

holders or the court.[24] The possibilities of such development are considerably diminished by the decision of the Supreme Court, which seems to remove the whole field of reorganization negotiations from the jurisdiction of the Commission.[25] The result raises sharply the question whether these negotiations should be left to the conduction of self-appointed and interested bankers, who reap large profits though they furnish no capital and assume small risks.[26] The ineffectiveness of the present system is itself support for the suggestion that the authority of the Commission should be expressly extended to the end that the reorganization of railroads may be conducted by experts as "work done in the administration of a public trust." [27]

LIABILITY OF INSURANCE COMPANIES TO SETTLE

POLICIES for liability insurance generally impose upon the insurance company the duty of defending a suit against the insured. This duty usually carries with it the exclusive control of the action and the privilege of settling the suit.[1] If, however, the underwriter refuses to defend a claim which is later held to be covered by the policy, settlement or defense by the insured has been held not to discharge the underwriter.[2] Once the un-

---

[24] See dissenting opinions of Commissioner Eastman in Denver & Rio Grande Western Reorganization, 90 I. C. C. 141 (1924), and in Chicago, Milwaukee & St. Paul Reorganization, *supra* note 3. See also *supra* note 1.

[25] It has also been suggested that the decision may have an unfortunate effect upon forthcoming railroad consolidations. *A Bad Omen for Railroad Consolidation* (1931) 55 THE NEW REPUBLIC 313.

[26] In the Chicago, Milwaukee, & St. Paul agreement the compensation of the Committees and managers was contingent upon the success of the plan, thus placing upon them the risk of loss of time and their own office expenses. But they did not underwrite the issue of new securities or perform any essential banking functions.

[27] See Commissioner Eastman's dissent in Missouri-Kansas-Texas Reorganization, 99 I. C. C. at 341.

[1] It has been queried whether these claims are not in effect agreements of maintenance and so void. 77 CENT. L. J. 369. But "the validity of the clause in these contracts that prohibits the insured from settling without the consent of the insurer . . . appears everywhere to have been recognized by the courts, and although we have not found any particular discussion of this question in the cases, it would seem to necessarily follow . . . that they are not regarded as opposed to sound public policy." General Accident Assurance Corp. v. Louisville Home Telephone Co., 175 Ky. 96, 104, 193 S. W. 1031, 1034 (1917); *cf.* Gould v. Brock, 221 Pa. 38, 69 Atl. 1122 (1908). See Note (1923) 8 MINN. L. REV. 151.

[2] St. Louis Provision Co. v. Maryland Casualty Co., 201 U. S. 173, 26 Sup. Ct. 400 (1906). *Cf.* Attleboro Manufacturing Co. v. Frankfort Insurance Co., 171 Fed. 495, 499 (D. Mass. 1909); Southern Railway News Co. v. Fidelity Co., 26 Ky. L. Rep. 1217, 83 S. W. 620 (1904); In re

derwriter assumes the management of a case,[3] any voluntary act by the insured preventing a full defense,[4] or even a failure to cooperate in the defense,[5] has been held to discharge the underwriter from any liability. This protection afforded underwriters has been justified as necessary to prevent collusion between the injured and the insured.[6] To the query whether the interests of the assured are in all respects sufficiently guarded by the stipulations in the contract the courts have answered, "The insured had the same right that other individuals have to make their own contracts." [7]

Empire State Surety Co., 214 N. Y. 553, 108 N. E. 825 (1915); United States Fidelity Co. v. Pressler, 185 S. W. 326 (Tex. Civ. App. 1916); Bradley v. Standard Insurance Co., 46 Misc. 41, 93 N. Y. Supp. 245 (Sup. Ct. 1904). Inaction by the insurer privileges the insured to act as if the insurer had refused to act. Interstate Casualty Co. v. Wallins Creek Coal Co., 164 Ky. 778, 176 S. W. 217 (1915). But *cf.* Carthage Stone Co. v. Travelers' Insurance Co., 186 Mo. App. 318, 172 S. W. 458 (1915). The amount recovered by the injured in such a suit is then the *prima facie* liability of the insurer in a suit by the insured. St. Louis Provision Co. v. Maryland Casualty Co., *supra;* Butler v. American Fidelity Co., 120 Minn. 157, 139 N. W. 355 (1913). But the insured cannot recover from the underwriter the costs of defending a groundless claim. Cornell v. Travelers' Insurance Co., 175 N. Y. 239, 67 N. E. 578 (1903); Nesson v. United States Casualty Co., 201 Mass. 71, 87 N. E. 191 (1909). *Contra:* Knoxville Brick Co. v. Empire State Surety Co., 126 Tenn. 402, 150 S. W. 92 (1912). Consequently policies now bind the underwriter to defend suits "although such suits . . . are wholly groundless, false or fraudulent." *Cf.* Douglas v. United States Fidelity & Guaranty Co., 81 N. H. 371, 127 Atl. 708 (1924).

[3] Once undertaken, the defense cannot be withdrawn even though the claim be groundless or not covered by the policy. This is predicated on the theory that either (1) the insurer is bound by his election to defend, Brassil v. Maryland Casualty Co., 210 N. Y. 235, 104 N. E. 622 (1914); Sachs v. Maryland Casualty Co., 170 App. Div. 494, 156 N. Y. Supp. 419 (2d Dep't 1915); or (2) the insurer is estopped to deny that the accident is not within terms of the policy, Flen Falls v. Travelers' Insurance Co., 162 N. Y. 399, 56 N. E. 897 (1900); Canning Co. v. Guaranty & Accident Co., 154 Mo. App. 327, 133 S. W. 664 (1911). See (1916) 16 COL. L. REV. 257.

[4] American Surety Co v. Ballman, 104 Fed. 634 (E. D. Mo. 1900); Eaton v. Lyman, 26 Wis. 61 (1870). Payment of a judgment by the insured before appeal discharges the insurer. Fidelity & Casualty Co. v. Marchand, [1924] 4 D. L. R. 157 (Can. Sup. Ct. 1923). But that it should not in jurisdictions where payment of a judgment does not preclude appeal, see (1924) 38 HARV. L. REV. 1115. *Cf.* Brassil v. Maryland Casualty Co., *supra* note 3.

[5] Coleman v. Amsterdam Casualty Co., 247 N. Y. 271, 160 N. E. 367 (1928); Guerin v. Indemnity Casualty Co., 107 Conn. 649, 142 Atl. 268 (1928); VANCE, INSURANCE (2d ed. 1930) 916.

[6] See Wisconsin Zinc Co. v. Fidelity Co., 162 Wis. 39, 48, 155 N. W. 1081, 1085 (1916); *cf.* Pickett v. Fidelity Co., 60 S. C. 477, 38 S. E. 160 (1901); Rumford Falls Paper Co. v. Fidelity Co., 92 Me. 574, 43 Atl. 503 (1899).

[7] Rumford Falls Paper Co. v. Fidelity Co., *supra* note 6.

Yet an unresolved conflict as to the full extent and the legal basis of the underwriter's duty to protect these interests of the insured has arisen where a refusal of the underwriter to accept a proffered settlement within the face of the policy has been followed by a judgment greatly in excess of the policy.[8] Under such circumstances the court is faced with several practical considerations. The projected settlement will be advantageous to the insured whose responsibility above the amount of the policy is unlimited. On the other hand where such a settlement approximates the maximum coverage of the policy it may frequently be to the advantage of the underwriter to contest the action and force the insured to risk an adverse judgment in excess of the policy.[9] But since judgments generally do not exceed the face of the policy, the "privilege of settlement" which the insured "freely" granted the underwriter may well be construed as giving the underwriter just such an advantage.[10]

This was the view taken in a recent Mississippi case in which the court refused to find the underwriter bound to an absolute duty to accept a compromise within the face of the policy while appealing a judgment in excess thereof.[11] The insured brought his action in tort, merely claiming the failure to settle, *ipso facto*, to be negligence. The court found the action to be circumscribed by the contract, however, and held the insured had no right to complain since the underwriter had performed its duty of defense and could not be held for the excess of the judgment over the policy simply because it had not exercised its privilege to settle. In refusing to allow an action in tort, the court finds support in the New York rule presented in *Best Building Co. v. Employers' Liability Assurance Corporation*:[12] "The contract of the parties must measure the liability in the absence of fraud or bad faith. ... There is no implied obligation in the insurance policy in this case that the company must or will settle according to the offer made."[13] Courts generally hold with New York that

[8] This is illustrated in the recent cases of Hilker v. Western Automobile Insurance Co., 231 N. W. 257 (Wis. 1930); Georgia Casualty Co. v. Cotton Mills Products Co., 132 So. 73 (Miss. 1931); Stowers Furniture Co. v. American Indemnity Co., 15 S. W. (2d) 544 (Tex. Comm. App. 1929).

[9] *Cf.* VANCE, INSURANCE (2d ed. 1930) 917.

[10] Moreover, the cost of compromising claims which would be defeated if litigated might be passed on to the insured in the form of higher premiums.

[11] Georgia Casualty Co. v. Cotton Mills Products Co., *supra* note 8. An offer to settle a judgment of $12,500 for $9,000 was rejected by the underwriter (of a $10,000 policy) and an appeal was pressed. The judgment was affirmed. Mills Products Co. v. Oliver, 153 Miss. 362, 121 So. 111 (1929). The present suit was brought on an agreed statement of facts.

[12] 247 N. Y. 451, 160 N. E. 911 (1928).

[13] *Ibid.* 455, 160 N. E. at 912. *Cf.* Auerbach v. Maryland Casualty Co.,

this "option" to settle imposes no duty to settle.[14]

A Texas court, however, faced with a similar case,[15] followed the minority lead of *Douglas v. United States Fidelity Co.*[16] In the *Douglas* case the underwriter was regarded as having "contracted to take charge of the defense of the claim," so that the contract "created a relation out of which grew the duty to use care when action was taken." [17] The underwriter, having undertaken the defense, by that fact alone is generally held responsible for a negligent handling of the case,[18] and courts adopting the minority rule place the underwriter under a duty of due care to settle, as it is privileged to do, if such a course be prudent.[19]

But the recent Wisconsin case of *Hilker v. Western Automobile Insurance Co.*,[20] while in accord with the *Douglas* case in its result, maintains a closer adherence to contractual principle, and indicates a possible mode of relaxing the rule in the *Best* case. In the *Hilker* case, the court, overruling an earlier Wisconsin decision,[21] held that the insurance company by contracting to defend or settle became the agent of the insured; [22] as such the un-

236 N. Y. 247, 140 N. E. 577 (1923); McAleenan v. Insurance Co., 173 App. Div. 100, 159 N. Y. Supp. 401 (1st Dep't 1916), *aff'd*, 219 N. Y. 563, 114 N. E. 114 (1916); Streat Coal Co. v. Frankfort General Insurance Co., 237 N. Y. 60, 142 N. E. 352 (1923); Brunswick Realty Co. v. Frankfort Insurance Co., 99 Misc. 639, 166 N. Y. Supp. 36 (Sup. Ct. 1917); Drilling v. New York Life Insurance Co., 234 N. Y. 234, 137 N. E. 314 (1922).

[14] Rumford Falls Paper Co. v. Fidelity Co., *supra* note 6; New Orleans & Carrollton R. R. v. Maryland Casualty Co., 114 La. 153, 38 So. 89 (1905); Schmidt v. Insurance Co., 224 Pa. 286, 90 Atl. 653 (1914); Wakefield v. Globe Indemnity Co., 246 Mich. 645, 225 N. W. 643 (1929), noted in (1929) 39 YALE L. J. 284; Fenton v. Fidelity, 36 Ore. 283, 56 Pac. 1096 (1899); Ross v. American Employer's Liability Insurance Co., 56 N. J. Eq. 41, 38 Atl. 22 (1897); Davies v. Maryland Casualty Co., 89 Wash. 571, 154 Pac. 1116 (1916); Mendota Electric Co. v. New York Indemnity Co., 175 Minn. 181, 221 N. W. 61 (1928); Wynnewood Lumber Co. v. Travelers' Insurance Co., 173 N. C. 269, 91 S. E. 946 (1917).

[15] Stowers Furniture Co. v. American Indemnity Co., *supra* note 8. An offer by the injured to settle for $4000 was rejected by the underwriter of a $5000 policy who refused to pay more than $2500. Judgment was rendered for $14,107.15. The insured charged that in the light of the evidence it was imprudent for the underwriter to refuse to settle.

[16] *Supra* note 2.

[17] *Ibid.* 376, 127 Atl. at 711.

[18] Attleboro Manufacturing Co. v. Frankfort Insurance Co., *supra* note 2; Anderson v. Southern Surety Co., 107 Kan. 375, 191 Pac. 583 (1920).

[19] Cavanaugh v. General Assurance Corp., 79 N. H. 186, 106 Atl. 604 (1919); Attleboro Manufacturing Co. v. Frankfort Insurance Co., *supra* note 2; *cf.* Brown & McCabe v. London Guarantee & Accident Co., 232 Fed. 298 (D. Ore. 1915).

[20] *Supra* note 8.

[21] Wisconsin Zinc Co. v. Fidelity Co., *supra* note 6.

[22] Agency can be contracted for if the parties so desire even though the

derwriter was required to conform to a standard of good faith in performing its duty of defense. Then, by presenting the issue of "bad faith" to the jury, the duty of settling when prudent was implied from the duty to defend, for the underwriter was held to "that degree of care and diligence which a man of ordinary care and prudence would exercise in the management of his own business, were he investigating and adjusting such claims." [23]

The Wisconsin court may be right in its contention that the tendency of the law is to extend the liability of insurance companies, but it is doubtful whether courts committed to the strict contract rule will overcome their reluctance to find bad faith, and thus adopt the jury test here advocated. Even in cases where the underwriter has admitted that offers to settle were reasonable and yet refused to accept the settlement unless the insured would contribute, such coercion of the insured has not been held to be bad faith since the underwriter was merely exercising its legal rights in going to trial.[24] Thus intrenched in their contention that the underwriter must be allowed a free hand in refusing to accept an offered settlement which it considers disadvantageous, the courts adopting the New York rule, having already denied a jury test by rejecting the negligence action, are not likely to admit it under the guise of "bad faith." [25]

Even in these jurisdictions, however, the insured is not altogether helpless. Policies may be made to provide for an increased coverage where the underwriter, having the opportunity to settle, elects to defend.[26] Failing this, the insured may settle with the injured for the amount of a possible judgment in excess of the policy.[27] The courts appear willing to brush aside the contention that a part settlement might be held to estop the underwriter from denying liability in a subsequent suit under

interests of the agent are adverse to those of his principal; the conduct of the agent is subjected to "close scrutiny" to determine whether he acted in bad faith toward the principal. 231 N. W. at 260.

[23] *Ibid.* 261.

[24] Auerbach v. Maryland Casualty Co., *supra* note 13; Levin v. New England Casualty Co., 101 Misc. 402, 166 N. Y. Supp. 1055 (Sup. Ct. 1917). But *cf.* Streat Coal Co. v. Frankfort General Insurance Co., *supra* note 13. The minority courts are *contra:* Brown & McCabe v. London Guarantee & Accident Co., *supra* note 19.

[25] "Is a jury to say that the insurance company was guilty of negligence in choosing to try out such a question in the courts rather than to settle? This question suggests the wisdom of adhering to the contract of insurance which the parties have made." Best Building Co. v. Employer's Liability Assurance Corp., *supra* note 12, at 456, 160 N. E. at 912.

[26] Georgia Life Insurance Co. v. Mississippi Central R. R., 116 Miss. 114, 76 So. 646 (1917).

[27] General Assurance Corp. v. Louisville Home Telephone Co., *supra* note 1; *cf.* London Guaranty & Accident Co. v. Mississippi Central R. R., 97 Miss. 165, 52 So. 787 (1910); McAleenan v. Insurance Co., *supra* note 13.

the policy.[28] It now appears general practice for the insured to make some contribution to the underwriter for relinquishing its option to defend, even where the proposed settlement is acceptable to all parties.[29] The burden of settling for the excess would probably be no greater were the insured compelled to settle alone, leaving the underwriter to fight the case up to the face of the policy. To one not too subject to the niceties of legal theory, however, the decision of a minority court holding an underwriter's coercing an insured into contributing to a settlement for less than the face of the policy to be "lack of good faith" [30] seems most equitable. If the majority courts should accept this definition of "bad faith," the rule of construction in the *Best* case could provide all that is desired in the negligence actions allowed in other jurisdictions, while still guarding the underwriter against the dangers of the jury in tort actions.

[28] *Cf.* McAleenan v. Insurance Co., *supra* note 13.

[29] *Cf.* Levin v. New England Casualty Co., *supra* note 24.

[30] Brown & McCabe v. London Guarantee & Accident Co., *supra* note 19. See (1918) 18 COL. L. REV. 369; (1916) 26 YALE L. J. 74.