THE ADEPTION OF LEGACIES OF STOCKS AND BONDS

"ONE must consider it in the same manner as if a testator had given a particular horse to A. B. if that horse died in the testator's lifetime, or was disposed of by him, then there is nothing upon which the bequest can operate," observed Lord Thurlow a century and a half ago in Stanley v. Potter.¹ Not that there was a horse involved in that case. The Lord Chancellor was deciding that where a bond, received as security for a debt, had been bequeathed by the creditor in his will, and the debt paid off before his death without the will having been changed, the legatee of the bond should receive nothing in its place. A week later, in Humphreys v. Humphreys,² he elaborated his reasoning, saying that "he was satisfied from the consideration he had given the cases on this subject on a former occasion,³ that the only rule to be adhered to was to see whether the subject of the specific bequest remained in specie at the time of the testator's

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¹ 2 Cox Eq. Cas. 180, 182, 30 Eng. Reprint 83, 84 (1789).
² 2 Cox Eq. Cas. 184, 30 Eng. Reprint 85 (1789).
death; for if it did not, then there must be an end of the be-
quest . . . and therefore that so far as the £2000 stock sold by
the testator in his lifetime, the legacy in this case was gone."

The words cast a new principle into clear form. Thereafter
the question of the ademption, or failure, of a specific legacy of
a security was to be a simple one of fact as to the existence of
the subject bequeathed, whereas previously the intention of the
testator had been an important consideration. The inclusion of
horses and stocks within one category had been easy and natural,
and the rule thus extended became the law not only in England
but in the majority of American states as well.

Lord Thurlow hoped, of course, that he had found a way to
avoid confused and dangerous inquiries into the wishes of the
testator. The hope proved false. Too many cases arose in
which justice or the quite obvious intent of the testator demanded
that the legacy be effectuated although the subject was gone.
Clearly, it had always been possible to class many bequests of
that character with general legacies, which are typified by simple

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4 Humphreys v. Humphreys, supra note 2, at 185, 30 Eng. Reprint at 85.
5 It appears inchoately in Ashburner v. Mauguirre, supra note 3; see (1930)
18 CAL. L. REV. 711.
6 At the beginning of the seventeenth century Swinburne wrote: "... if
the testator . . . unwillingly alienated the thing . . . bequeathed, this is no
ademption . . . unlesse . . . the testator did purpose by the same alienation to
take away the legacie . . . But if the Testator . . . of his owne accord . . .
alienate the thing bequeathed . . . this is an ademption . . . for it is suffi-
cient in last wils, for the revoking of a legacie, that the Testators mean-
ing do appeare even by an act, otherwise insufficient." SWINBURNE, TESTA-
MENTS AND LAST WILLS (1635) pt. 7, 192. See also Partridge v. Partridge,
Cas. t. Tal. 226, 227 (1736); Hambling v. Lister, Amb. 401, 402 (1761); 2
JARMAN, WILLS (7th ed. 1930) 1053.
7 Harvard Unitarian Society v. Tufts, 151 Mass. 76, 23 N. E. 1006 (1890);
see Shaw, C. J., in Richards v. Humphreys, 32 Mass. (15 Pick.) 133, 135
(1833); 2 PAGE, WILLS (2d ed. 1926) § 1335; cf. Walton v. Walton, 7 Johns.
Ch. 253 (N. Y. 1823); White v. Winchester, 23 Mass. (6 Pick.) 48 (1827).
An ademption is sometimes said to take place when a legacy is satisfied by
a gift or advancement. More usually the word is reserved for the situation
which will be the exclusive concern of this note, that is, where the subject
of the bequest has been extinguished by alienation, destruction, or altera-
tion. See (1924) 24 COL. L. REV. 405.
8 In Stanley v. Potter, supra note 1, at 182, 30 Eng. Reprint at 84, Lord
Thurlow said, "I do not think that the question in these cases turns on the
intention of the testator. The idea of proceeding on the animus adimendi
has introduced a degree of confusion in the cases which is inexplicable, and
I can make out no precise rule from them upon that ground . . . I believe
it will be a safer and clearer way to adhere to the plain rule . . . I see no
end to the confusion arising from the following any other line." In Hum-
phreys v. Humphreys, supra note 2, at 185, 30 Eng. Reprint at 85, he re-
peated it: "... the idea of discussing what were the particular motives and
intention of the testator in each case, in destroying the subject of the be-
quest, would be productive of endless uncertainty and confusion . . ."
gifts of money and are not subject to ademption. Resort to this expedient was difficult, however, because too often the will referred plainly to the particular security. Moreover, it was unsatisfactory because general legacies are the first to abate in the event of a deficiency of assets. To cope with the situation properly it was necessary to resort to a new concept, that of the demonstrative legacy. Such legacies were held to be liable neither to ademption nor to abatement ratably with general legacies, and although a particular security might be referred to, the reference was interpreted as a mere indication of a convenient fund. Since the testator's intent had always been the basic factor in making a legacy specific, it then became possible in many cases to prevent ademption by holding that the maker of the will had had in mind a demonstrative and not a specific legacy. But unfortunately for what was in substance a return to the original considerations of intent in relation to ademption, the classification of bequests, though nominally referrable to the testator's wishes, had long been a highly technical matter. While that fact had been unimportant so long as the

9 POMEROY, EQUITY JURISPRUDENCE (4th ed. 1918) § 1132.
10 POMEROY, loc. cit. supra note 9; 4 SCHOUER, WILLS, EXECUTORS AND ADMINISTRATORS (6th ed. 1923) § 3057.
11 POMEROY, op. cit. supra note 9, §§ 1135, n. 2, 1136, 1137, 1138, 1139.
12 The device originated in Roman law. See Walton v. Walton, supra note 7, at 262; Walls v. Stewart, 16 Pa. 275, 281 (1351); 1 ROBER, LEGACIES (4th ed. White, 1847) 192. As distinguished from the ordinary pecuniary or general legacy liable to abatement, it seems to have been in some degree of use by English judges at the time of Lord Camden's opinion in Attorney-General v. Parkin, Ambler 566 (1769); at least it is referred to by name and criticized by Lord Thurlow in Ashburner v. Macguire, supra note 7, at 108, 111, 29 Eng. Reprint at 63, 64, and though repudiated by him in Stanley v. Potter, supra note 1, it is resorted to again in Coleman v. Coleman, 2 Ves. 639 (1795), and by name in Gillaume v. Adderley, 13 Ves. 381, 389 (1808).
13 See Walton v. Walton, supra note 7, at 262; Walls v. Stewart, supra note 12, at 281; 3 POMEROY, op. cit. supra note 9, § 1133.
14 Pawlet's Case, T. Raym. 335 (1679).
15 Gillaume v. Adderley, supra note 12.
16 Speaking of the decision in Stanley v. Potter, supra note 1, Chancellor Kent said: "But I apprehend the words of Lord Thurlow are to be taken with considerable qualification; and that it is essentially a question of intention, when we are inquiring into the character of the legacy, upon the distinction taken in the civil law, between a demonstrative legacy, where the testator gives a general legacy, but points out the fund to satisfy it, and where he bequeaths a specific debt. In Coleman v. Coleman, Lord Loughborough puts the question of general or specific legacy entirely on intention." Walton v. Walton, supra note 7, at 264.
17 To illustrate, in Ashburner v. Macguire, supra note 7, at 111, 29 Eng. Reprint at 64, the question of classification of a legacy of stock is dismissed with the words, "The testator says, I give my capital stock to, etc., the pronoun my has been relied on in many cases, in deciding the legacy to be specific."
adimendi might be resorted to as a secondary escape, the technicalities remained when the rule was changed, so that today the effectuation of legacies of stocks is very frequently a question of law, and of impossibly refined and contradictory law as well.18

The present confusion in many jurisdictions is well illustrated by the case of *First National Bank v. Perkins Institute for the Blind*,19 decided last May by the Supreme Judicial Court of Massachusetts. There the testatrix had bequeathed to her nephew “all of my stock in the . . . Standard Oil Company of New Jersey.” This stock was callable at a premium and was so called before the testatrix’s death, in the course of refunding operations whereby debentures issued for the purpose were sold to New York bankers who agreed to give holders of the stock preferential subscription rights. Because the debenture issue was oversubscribed the testatrix was able to exchange only part of her holdings for debentures and was forced to take the balance in cash. After her death residuary legatees opposed the transfer of the debentures to the legatee of the stock, maintaining that the stock legacy had been adeemed, in which contention they were supported by the court. The primary question of classification is not discussed in the opinion; the brief remark that “the legacy of the specific thing had been disposed of . . .”20 indicates the holding and suggests that the court thought the law so clear that explanation was unnecessary. The decision, if this be so, must be supposed to turn on phraseology, on the fact that the word “my” preceded the word “stock” in the disposing clause, for it is frequently held that such words make a legacy specific.21 Yet if the testator had mentioned the number of shares and omitted the single word “my” it is likely that most courts would have considered the legacy demonstrative.22 It is highly doubtful that this sort of reasoning appeals very strongly to the intelligent layman. He is likely to suppose that

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18 It has been said that the cases classifying legacies as specific or otherwise “are . . . somewhat contradictory, run into nice and shadowy distinctions, . . . form a complicated labyrinth . . . and there is danger that a reexamination of them would produce more confusion than light; and instead of illustrating, would obscure the question before us.” In re Foote, 30 Mass. (22 Pick.) 299, 302 (1839).
19 176 N. E. 532 (Mass. 1931).
20 Ibid.
the testatrix when making her will did not think of the danger that the stock might be called, and that in any case she was quite ignorant of what the courts would do if it were. Time and again judges themselves have affirmed their belief that will-makers are not aware of the doctrine of ademption. Nor is the rationale convincing that the use of the possessive pronoun manifests an intention at the time of the will to give the particular thing mentioned. Such an intent is as obvious as it is irrelevant; the single question of importance is: did the testatrix intend to give nothing else if the stock could not be given?  

23 "We must hold the legacy ... specific although we cannot but fear that, if the testatrix had been fully advised of the consequences of making a legacy specific, she would have changed her will." Holmes, J., in Harvard Unitarian Society v. Tufts, supra note 7, at 78, 23 N. E. at 1007. "It is probable that he had no notion that, in case of the fluctuation in the value of stocks, or from any reason, it should become politic to change these securities, the gift would thereby become extinguished." Johnson v. Conover, 54 N. J. Eq. 333, 340, 35 Atl. 291, 294 (1896). See Oliver v. Oliver, L. R. 11 Eq. 506, 513 (1871); Fidelity Title & Trust Co. v. Young, 101 Conn. 539, 369, 125 Atl. 871, 874 (1924). If there be any significant difference in this matter between the knowledge of the general legal practitioner and that of his client, it remains questionable whether the former is entitled to rely on the risky technical shorthand when he can use plain English. See the forms given in Tucker, Wills (3d ed. 1927) 252, 253.  

24 "Although the testator may, at the time of executing the will, have an article or articles of the same kind as that which he purports to give, still, unless his language is sufficient to refer to, designate and identify the very article itself as forming part of his estate, which he thereby gives, the legacy is not specific, but general. Under these circumstances the word "my" is often operative in identifying the article." 3 Pomeroy, op. cit. supra note 9, § 1180. "... if a clear intention appear from the will that the testator meant to bequeath the identical stock or annuities he was possessed of at the date of it ... such intention will constitute the bequest specific." 1 Roper, op. cit. supra note 12, at 214.  

25 It would be difficult to overemphasize this point. Opposite answers may be given to the two questions: (a) Did the testatrix intend to give this stock? (b) Did she intend to give this stock only? The frequent failure to distinguish the two is illustrated by the passage from Roper, quoted supra in note 24, taken in connection with the following, also from the same author: "... if it clearly appear from references to the stock by additional expression [such as "my"] that it alone was intended to be the subject of the disposition, the legacy will be specific ..." 1 Roper, op. cit. supra note 12, at 212. In Kenaday v. Sinnott, 179 U. S. 606, 21 Sup. Ct. 233 (1900), the legacy was "deposits of currency entered on my bank book ... amounting to $10,000 more or less." This, by the type of rule followed in the Perkins Institute case, supra note 19, would ordinarily be a specific legacy. 4 Schouler, loc. cit. supra note 10. Before his death the testator invested the greater part of these deposits in bonds. The court said, "... his intention was clear that his wife should receive the amount, and we are of the opinion that we ought not to defeat that intention by holding that the pecuniary legacy was specific, and that the subsequent change was an ademption, and so a rule of law rather than a question of intention." 179 U. S. at 621, 21 Sup. Ct. at 238. (Italics the writer's.)
It may be that the unreported facts of the Massachusetts case were such that the result harmonized with the answer to that question. Whether this be so cannot be gathered from the opinion. Yet in the absence of good reasons to the contrary, it is a fair presumption that ademption was not intended. Since this problem of intention necessarily confronts the courts by virtue of the very fact that an expression of will is being dealt with, it is desirable to bear in mind the numerous avenues of escape from the technicalities thought to have been controlling in the Perkins Institute case. Fortunately these technicalities are but the remnants of a conceptualistic mode of thinking that is fundamentally foreign to the modern outlook. For this reason and because the purpose behind the development of the demonstrative legacy has been incompatible with these rules, they are more or less flatly contradicted by a number of other principles which are likely to lead to their definite overthrow. Insistently, for example, the courts continue to repeat that the testator's wishes are paramount; that the will is to be interpreted as a whole; that constructions leading to partial intestacy are to be avoided; that there exists a "judicial bias" against specific legacies. Where these resources seem inadequate to avoid classification as specific, there remains a possibility which is of particular value in dealing with bequests of stocks and bonds, namely, that a conversion from one type of security into another is not destruction or alienation but merely a change in form.

26 See Tifft v. Porter, supra note 22, at 521.
27 One finds the following, taken from Stanley v. Potter, supra note 1 at 182, 30 Eng. Reprint at 84, slightly amusing: "As to the case of Attorney-General v. Parkyns [holding legacies general] I collect from the note I read of that case, that Lord Camden would have had great difficulty in making those legacies contributory in event of a deficiency of assets; and if so I cannot conceive how they are to be taken as general legacies for any other purpose; they must have all the consequences of general legacies, or none; they could not be specific to one purpose, and general to another. This I cannot understand."
28 Kenaday v. Sinnott, supra note 25.
29 Metcalf v. Framingham Parish, supra note 22.
30 Kenaday v. Sinnott, supra note 25.
31 Ibid.
32 This conclusion has been most frequently adopted where it could be said that the conversion was not initiated by the testator, as for example upon the recapitalization, reorganization, or consolidation of the company whose securities were originally held. Fidelity Title & Trust Co. v. Young, supra note 23 (exchange for new stock of different par value); Goode v. Reynolds, 208 Ky. 441, 271 S. W. 600 (1925) (consolidation); Johns Hopkins University v. Uhrig, 145 Md. 114, 125 Atl. 606 (1924) (stocks changed into bonds on reorganization); Pope v. Hinckley, 209 Mass. 323, 95 N. E. 798 (1911) (stocks converted into voting trust certificates on reorganization); Skipworth v. Cabell, 60 Va. (19 Grat.) 758 (1870) (state bonds
It is likely that much of this confusion, resulting in part from Lord Thurlow’s attempt to apply an arbitrary rule of ademption to all bequests of personalty regardless of the character of the subject, might have been avoided had he developed more clearly a distinction which he was on the verge of drawing in Ashburner v. Macguire.\(^3\) There he said:

“By the civil law, it was competent for a man, after he had changed the subject-matter of a specific legacy, to declare, by his conduct, that such a change was no ademption. The case is put of a gold chain, which the testator, after having bequeathed it by his will, converts into a cup; the legacy is not adeemed, because the cup might be restored to its former shape. This has not been adopted by our law . . . The gold chain may have been given as a legacy, because it had long been in the testator’s family. If it be afterwards converted into a gold cup, the reason for giving it ceased.” \(^34\)

There is a type of legacy then, whose subject may be a thing of sentimental or artistic value, or of peculiar appropriateness to the legatee: the rare painting, the library that typifies its owner, even the horse that the legatee liked best to ride, in short the chattel unique in greater or less degree. It is clear enough that with such legacies the reason for the gift may cease when the subject has vanished. But while all such chattels may be valued for pecuniary reasons as well as for their uniqueness, it is usually only the monetary element which is of importance with stocks and bonds. Undoubtedly where the stocks bequeathed confer control of a closely held private enterprise, the analogy to the distinctive chattel may be compelling.\(^35\) In the absence of this circumstance, as pointed out recently in the New York case of Matter of Freeman,\(^36\) stocks, and likewise bonds, differ in no important respect from currency as media for the distribution of estates. And ordinarily bequests which are definitely pecuniary are considered general or demonstrative.\(^37\) To regard a legacy of

\(^{23}\) Supra note 3.

\(^{24}\) Ibid. at 110, 29 Eng. Reprint at 63.


\(^{26}\) Supra note 35.

\(^{27}\) See Hart v. Brown, 145 Ga. 140, 143, 88 S. E. 670, 671 (1916); 2 Page, op. cit. supra note 7, § 1226. In Matter of Newman, 4 Dem. (N. Y.) 65, 67 (Surr. 1886), legacies of sums “in government bonds” were held general. The court said, “He simply gives general legacies of money, payable in a certain
stocks thus, as essentially pecuniary, accords well with the probability mentioned before that when one makes such a bequest he intends, of course, to give the particular securities, but does not intend that the legatee should receive nothing if those securities should be disposed of.

Such an approach imposes no arbitrary rules. Presumptions are important only where the testator's instructions are not clear in view of the changes he has made in his property and only because, in the absence of the testator, parol evidence is not to be relied upon to explain his words. If the instructions are really plain they will always control. Even where they are not, the general rule will often be modified by counter-considerations arising from the situation, analyzed in the light of the assumption that the testator intended "a sensible and equitable disposition of his property." That the particular combination of parties and properties with which the court was confronted has controlled the decision of many cases is plain enough even though the results may have been expressed in legal formulae. An instance is the recent case of In re Ireland's Estate. There a legacy of stock was held specific and adeemed as a consequence of the sale of the stock by a committee appointed when the testator became mentally incapable. The court went on to say that the wisdom of adhering to the strict rule of ademption was clear because the testator could not have intended to hold the stock for the benefit of the specific legatee, "a stranger," while spending the remainder of his estate, which would otherwise go to his children, for medical attention. It seems at least possible that the results might have been different had the children been the legatees of the stock, and the residuaries strangers. Thus in Kenaday v. Sinnott, in which a legacy to the testator's wife was held demonstrative and hence not adeemed, Chief Justice Fuller said:

"The question then really comes to this, whether an irrebuttable presumption arises that the testator, by reducing the amount of money on hand at the date of his will, intended that the amount of such reduction though remaining in his assets in another manner. The effect would have been the same if he had directed them to be paid in gold coin, in greenbacks, in bonds and mortgages, in cattle, sheep, or horses. All are nothing more than general legacies. It results that... the executor should... invest that sum, so far as it will go, in government bonds, and deliver the same to her... It is, doubtless, competent for any or all of the legatees, to whom sums are given, payable in such bonds... to take money instead at their option."

38 Potter v. McLane, 247 Mass. 387, 142 N. E. 49 (1924).
39 Johnson v. Conover, supra note 23, at 339, 35 Atl. at 293.
40 257 N. Y. 155, 177 N. E. 405 (1931).
other form, should be distributed to his next of kin rather than that his wife should receive it." 41

Such instances could be multiplied. The circumstances most usually relied upon, in addition to the character of the subject separately bequeathed, as suggested in the Frencman case, and the general state of the testator's assets, are that the legatees as against the residuaries, or vice versa, are so related to the testator by blood or other ties as to be considered the natural objects of his bounty. 42 Elements such as these are certainly more desirable guides in doubtful cases than the grammatical minutiae of the will. Their use as the criteria of analysis directs the judge's attention outward toward the world in which the litigants live. Reference to such factors in the opinion makes for a clarity not otherwise attainable. Explanations based upon them are likely to prove as convincing, even to the parties to the dispute, as are those drawn laboriously from the testator's phraseology.

LEGAL PROBLEMS OF CORPORATE EXECUTIVE BONUS PLANS

Although the idea of compensation contingent upon earnings is in itself an old one, its development in the form of predetermined plans for the remuneration of corporate officials has taken place, in this country at least, almost entirely within the last twenty years. 1 With due allowance, however, for the comparative recency of its development here and for the lack of objective tests, the experience of corporations which have adopted such plans has been eminently satisfactory. 2 The most significant

41 Supra note 25, at 617, 21 Sup. Ct. at 237.
1 See Taussig and Barker, American Corporations and their Executims (1925) 40 Q. J. Econ. 1, 20. In Europe contingent compensation plans appear to have been the accepted practice some time before their general adoption in the United States. In Germany, for example, the Director frequently received a moderate fixed salary, and a tantum of 5% of net earning after meeting all operating expenses, including interest on borrowed capital, and paying a fixed moderate dividend on capital. Ibid. 43.
2 In addition to the universally expressed approval of corporate managers, the mortality of such plans has been proportionately lower than that of the more familiar "profit-sharing" plans for the rank and file. The high mortality of the latter has been ascribed to the difficulty of perceiving the relationship between the work of a subordinate employee and
result of this form of contingent compensation is its approximation of the advantages of individual ownership and management by identifying the interests of executives and stockholders in net earnings. But under unfavorable business conditions abstract advantages carry little weight with investors threatened with diminished returns on their investment and aroused to something more than academic interest in earnings reflected neither in dividend payments nor in surplus reserves.

While the advantageous features of bonus plans have received enthusiastic judicial recognition, courts have not hesitated to review the fairness of such plans upon the complaint of dissatisfied minority shareholders, despite the familiar doctrine that "the majority must determine the policy of the corporation, with whose internal management the courts wisely refrain from interfering." This attitude may be ascribed partially to the misleading effect of the use of the word "profit-sharing" as descriptive of the device. Whether a given sum of money received by an executive be called a share in the profits or compensation measured by such share makes not the slightest practical difference to any of the parties concerned. But it is institutional in this country that business profits should belong to enterprise, i.e., invested capital, and courts have strenuously opposed any attempt to dilute that interest.

A convenient basis for invoking judicial intervention is found when there have been irregularities in the formal adoption of the plan. Where it is instituted directly by the board of directors, and the irregularity complained of is in such action, the possibility of relief is limited by the fact that ratification of the action by a majority of the shareholders, even after suit is brought, has been held to bind the minority. But where the method of adoption is such that by-laws, or statutes of the state of incorporation require affirmative action on the part of the stockholders, insuffi-

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3 Bonuses which are not the product of predetermined plans do not have this effect, and will not be considered in this discussion. See Note (1926) 40 A. L. R. 1423, 1433.
5 Godley v. Crandall & Godley Co., 212 N. Y. 121, 131, 106 N. E. 818, 821 (1914).
6 An alternative theory of profits would divide them between the wages of management and the earnings of enterprise, omitting the category of profits as such. See Taussig and Barker, op. cit. supra note 1, at 40.
ciency in substance of the notice given to them has been considered
ground for interference.8

Equitable review has ordinarily been sought on the ground of
fraud, or breach of trust, although the probability of actual
fraud in the type of plan under discussion is slight. It is more
likely to arise in the case of a business partnership transformed
into a close corporation, where disagreement has disrupted the
former amicable association, and the majority, by electing them-
selves directors and officers, have attempted to distribute profits
to themselves in the guise of compensation, and thus to squeeze
out the minority. In such cases the courts have readily granted
relief.9 A similar situation would be presented in a large corpo-
ration where the interests of the holders of a controlling block
of stock were adverse to that of the stock itself.

Objection has also been made on the ground that the votes of
participants have been material to the adoption of the plan. Since
officers and directors, with respect to the management of
a corporation, stand in a fiduciary relationship to its stockhold-
ers, such objection has been sufficient to warrant judicial investi-
gation, although if the plan is fair, the necessity of an interested
vote for adoption has been considered an “unobjectionable inci-
dent.” 10 In a case of this sort, in the absence of fraud, ratification
by disinterested stockholders should conclude the matter, since
the effect of possible bias would thereby be eliminated,11 but it
has been held that even with such ratification, the plan is review-
able as to reasonableness.12

A more important criticism which has recently made itself felt
is directed to the secrecy surrounding the existence of most
executive bonus plans. “Full, free and frank disclosure . . . .
and to have the extent and method of future compensation fully
entered upon the corporate records is generally the better

8 Scott v. P. Lorillard Co., 154 Atl. 515 (N. J. 1931). Statutory refer-
ence to bonus plans is rare. A Connecticut statute provides for their in-
stitution by the board of directors in corporations organized after passage
of the act, but requires authorization by stockholders in corporations or-
requires a resolution by the board of directors and approval by the stock-
9 Schall v. Althous, 208 App. Div. 103, 203 N. Y. Supp. 36 (1st Dep't
1924); Carr v. Kimball, 153 App. Div. 825, 139 N. Y. Supp. 253 (1st
Dep't 1913), af'd, 215 N. Y. 634, 109 N. E. 1068 (1915).
10 See Booth v. Beattie, 95 N. J. Eq. 776, 777, 118 Atl. 257 (1922). But
Bonuses for Corporate Officials (1918) 86 Cent. L. J. 208.
11 See Putnam v. Juvenile Shoe Corp., supra note 4, at 97, 269 S. W. at
598.
course. In addition to the questions of sufficiency of notice where stockholder action is required, such secrecy presents the possibility of injustice to existing and prospective investors. A financial statement showing net profits without indicating the existence of a bonus plan presents a misleading picture, and while legal responsibility for such statements is doubtful, there are certainly strong arguments of policy in favor of requiring a more accurate representation.

But on whatever grounds equity has assumed jurisdiction, the reasonableness and fairness of the particular bonus plan complained of must be determined to a large extent in the light of contemporary corporate practice. Variations in the details of such plans are innumerable, necessitated by the type of business and the financial structure of the individual corporation, but all predetermined plans include a decision as to who participates, the extent of such participation, how the bonus fund is to be determined, and what form its payment is to take. Illustrative of such variations are three bonus plans presently in litigation—those of the American Tobacco Company, Bethlehem Steel Corporation, and P. Lorillard Company.

The limits of eligibility for executive bonuses have generally been specified at the inception of the plan, comprising those positions which contribute most directly to profits and losses. But

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14 See BERLE, STUDIES IN THE LAW OF CORPORATION FINANCE (1928) c. IX; (1929) 1 CORPORATE PRACTICE REVIEW, 33 (No. 8).
15 An exhaustive analysis of a number of executive bonus plans is presented in BALDERSTON, op. cit. supra note 2. See also SHARING PROFITS WITH EMPLOYEES (1929), Policy-holders Service Bureau of the Metropolitan Life Ins. Co. for additional plans. The Industrial Conference Board, is contemplating a survey at some time in the future to investigate the effects of business depression upon such plans.
16 Rogers v. American Tobacco Co. Suit was brought in the Supreme Court of New York on March 12, 1931, but was transferred to the Federal District Court on the ground of diversity of citizenship, on April 4, 1931. The subject matter of the litigation has not yet been decided. The plan appears in a pamphlet distributed to the stockholders by the company, THE AMERICAN TOBACCO Co. STOCK SUBSCRIPTION PLAN (1931).
17 Berendt v. Bethlehem Steel Corporation, 154 Atl. 321 (N. J. 1931). A résumé of the old plan is found in the opinion. A temporary injunction was obtained in this action, restraining ratification by the stockholders on the ground of insufficient notice of the substance of the plan. Thereafter, on July 2, 1931, a substitute plan was proposed at a special stockholders' meeting and since it was approved by the dissenting minority, the suit will probably not be continued. See The Business Week, July 15, 1931, at 7 and 8.
18 Scott v. P. Lorillard Co., supra note 8. The plan is summarized in the opinion, and appears in its entirety in an appendix to the brief of defendant-appellant, p. iii. A decision by the Court of Errors and Appeals is expected early this fall.
19 See BALDERSTON, op. cit. supra note 2, 30-46.
since the tendency is to apply the plan to individuals rather than to positions, there is usually a provision that the participants be selected from the eligible group by a committee of the board of directors. In the original Bethlehem Steel plan, the board of directors were given the power to delegate this function to the chairman of the board, and the latter in fact exercised his discretion. This was one of the objections made by minority shareholders, and the substituted plan makes approval by the board requisite. The American Tobacco plan, on the other hand, specifies all participants at the outset, and allows no discretion in the matter. The Lorillard plans, both that now in operation and the proposed amendment thereto which has brought it into litigation, give any member of the eligible group the option of participating by the purchase of stock. The decision as to who is eligible to participate, or who actually participates, except in so far as it might tend to indicate an obvious lack of correlation with services rendered, is a matter solely between participants and management, and offers no ground for complaint to dissenting shareholders.

The basis for apportioning the fund among the participants is of importance in determining whether the plan is really one of compensation, or is an unwarranted distribution of profits. The two most generally adopted bases are the proportion of the individual's salary to the total salaries of all participants, and the appraisal of the individual's work by some group or person. A variation of the first is the division of participants into groups according to importance, and their subdivision on the basis of salary. It has been suggested that since the effectiveness of the bonus depends upon a percentage proportionate to salary, a more satisfactory basis would be the differential between the participant's salary and a fixed minimum, but no plan has been found which embodies this suggestion. The American Tobacco Co. plan provides for 2½% of the fund as the president's share, and a total of 7½% for the five vice-presidents. The former Bethlehem Steel plan left the matter to the discretion of the chairman of the board as it did in the choice of participants, but upon objection of minority stockholders, approval of the board was made a requisite here also. The extent to which participants in the Lorillard bonus have shared has

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20 Since neither the chairman nor the members of the committee participate, the change involves merely the question of business judgment.
21 Berendt v. Bethlehem Steel Corp., supra note 17, at 322.
22 See BALDERSTON, op. cit. supra note 2, 30-46.
23 Ibid.
24 Ibid. 93.
25 The average bonus amounts to from 15% to 100% of the individual salary.
been determined by the amount of common stock of the corporation held by each, with the limitation that in no case could the amount paid to any participant exceed a stipulated percentage of the average issued common stock. The only change in this respect contemplated by the proposed amendment is a lifting of the limitation from $3\frac{1}{2}\%$ to $7\frac{1}{2}\%$ for the president, from $2\%$ to $5\%$ for a vice-president; and from $1\%$ to $2\frac{1}{2}\%$ for the secretary, treasurer, etc. Very few plans, however, have adopted stockholding as a basis of distribution. Where it has been utilized, it has been quite generally disallowed by the courts since "compensation must be a function of employment." 27

The mode of determining the size of the bonus fund has a more obvious effect on the interests of the stockholder. It is usual to state the relation to net earnings, computed after specified deductions, and in some cases to fix either an absolute or relative limit to the amount of the fund. 28 In the American Tobacco Company plan, 10% of all the profits in excess of a fixed amount is distributed to the executives. Under the original Bethlehem Steel plan, after deduction for interest charges and dividends on preferred stock, the management fund was determined on the basis of 3.43% of annual net earnings, and on a sliding scale upwards, as earning increased, to a limit of 8%. The substituted plan retains the same percentages, but provides for a further deduction from earnings for depreciation, depletion and obsolescence. The existing Lorillard plan represents an extreme attempt to protect the stockholders' interest, for after making all customary deductions from net earnings, it requires an additional allowance of $1.50 per share on average issued common stock, and 7% on its surplus and undivided profits, before the 15% to bonus may be applied. 29 The proposed plan would reduce the bonus percentage to 5%, but apply it before allowance for common stock, surplus and undivided profits, for the pertinent reason that the present plan has not permitted any bonus payments for several years. 30

On the questions of accounting raised by these plans the courts


27 Scott v. P. Lorillard Co., supra note 8, at 516.

28 See BALDERSTON, op. cit. supra note 2, 30-46.

29 $11,369,000.00.

30 By-laws, article XII: § 2.

31 "For the past several years, this bylaw has precluded any bonus distribution and this has proven quite a handicap in view of the bonus being paid by other companies. In this situation a division of such profits for bonus purposes on a 5 to 95 basis between employees and common stockholders is suggested as neither unfair nor excessive." Letter of the President, February 14, 1931.
have had little to say, although it has been suggested that, since the funds should bear some relation to group efficiency, income from a sale of assets should not be included. The sliding scale designed to give a higher percentage to management when profits are greater has received judicial sanction. But the effects of this device have provoked most of the objections to bonuses, since a high percentage of abnormally large profits results in what appears, absolutely, to be excessive compensation. Since the element of predetermination in the plan is essential both functionally, to provide incentive, and legally, to avoid the appearance of a donation, it would seem that a plan reasonable in the light of normal expectancy of profits should not be invalidated merely because greater profits were received than had been expected. There might, however, be a conflict of interest in case of expansion through merger or consolidation, where increased net earnings would allow larger bonuses irrespective of the earnings per share.

The unique plan of one company provides for the payment of the bonus in stock and in addition measures the amount so paid by the dividends actually declared on common stock as well as by net earnings. The latter feature eliminates the temptation to management, provided by the possibility of increased earnings and a proportionately larger bonus, to reinvest profits in fixed assets without declaring dividends when the risk of loss from the deterioration of such assets would fall entirely on the stockholders. The use of declared dividends as a measure of bonus payments may perhaps provide the final link in the identification of the interests of management and stockholders.

33 See Berendt v. Bethlehem Steel Corp., supra note 17, at 321.
34 Church v. Harnit, supra note 13.
35 It has been said that a large bonus and a small dividend is prima facie evidence of misappropriation of corporate funds. See Shera v. Carbon Steel Co., 245 Fed. 589, 591 (D. W. Va. 1917). A more significant comparison is the proportion of bonuses to profit. See Dowd, op. cit. supra note 10, at 209.
38 Payment of the executive bonus is ordinarily in cash and the Bethlehem Steel Corp. and the P. Lorillard Company have adopted this form. The use of stock by the American Tobacco Co. is not exceptional, however, and is more in accord with the original theory of the bonus. Where stock has been used it has normally been purchased on the open market to avoid the difficulties caused by the preemptive rights. See Frey, Shareholders' Preemptive Rights (1929) 38 Yale L. J. 563, 580. Where conditions have
MUNICIPAL OPERATION OF PUBLIC UTILITIES

Municipal operation of utilities is occasioned sometimes by the absence of any private enterprise in the field, sometimes by a frank desire for profits to alleviate the tax burden,1 but most frequently by the failure of commission control in combination with franchise agreements to insure reasonable charges by private plants. In the latter situation the usual practice has been to acquire the private utility outright either through condemnation proceedings2 or under provisions of the original franchise agreement.3 But when it is deemed unnecessary or undesirable to eliminate the competition of private capital, the city is allowed to build and operate its own plant in the absence of specific contract provision to the contrary.4 Whether or not the private competitor remains, the controversies arising from the operation of a municipally owned utility have most frequently centered about the relationship of consumer and taxpayer. And behind the specific controversy lies the further and more general problem of the relative advantages of exclusive control by the municipality itself and complete or partial control by the state commission.

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1 (1928) 17 Nat. Mun. Rev. 447 gives an illustration of a town entirely supported by its utilities.

2 See 3 Dillon, Municipal Corporations (5th ed. 1911) § 1313, 1314.

3 In granting the utility the right to operate in the city, the franchises have included clauses contemplating a return to public ownership after a given period or at the option of the city. With regard to the interpretation of the various franchise provisions as requiring or merely permitting acquisition upon adoption of municipal ownership, see 3 Dillon, op. cit. supra note 2, § 1312.

4 In Knoxville Water Co. v. Knoxville, 200 U. S. 22, 26 Sup. Ct. 224 (1906), the city covenanted in the franchise agreement not to grant the right to operate a water works to any other corporation for thirty years. Before the expiration of this period the city and the utility disagreed as to price, and the former proposed to construct its own plant in competition. The court interpreted the clause in the franchise not to prevent such action, holding that the agreement was to be strictly construed against the grantee. A similar interpretation was given to an exclusive privilege of laying gas pipes in Hamilton Gas Light Co. v. Hamilton City, 146 U. S. 258, 13 Sup. Ct. 90 (1892). But in Walla Walla v. Walla Walla Water Co., 172 U. S. 1, 19 Sup. Ct. 77 (1898), the city having contracted not to build in competition, was enjoined from building its own plant until the contract was declared void by a court because of a breach by the water company, although the breach had actually occurred. In that case the city reserved the right to condemn the private plant.
Conflicting Interests of Taxpayer and Consumer

In view of the almost universal use of the products of a public utility, the differences between the interests of the taxpayer and the consumer are usually so slight as to make any discrimination between the two classes unimportant. Yet theoretically, and in some cases actually, the consumption of the taxpayer bears no relation to the taxes that he pays. From this disparity disputes arise.

Of primary concern to both taxpayer and consumer is the allocation of the capital charges of the utility. As a means of affording the lowest possible rate to the consumer, cities have frequently adopted the plan of paying off these charges through taxation. Concerning the extent to which this practice should be permitted, however, legislative and judicial opinion is not in accord. In Utah, for example, a statute, providing for the issuance of bonds by the city, stipulates that the interest upon the bonds and a sinking fund for their redemption may be satisfied through taxation. On the other hand a statute in Montana and the charter provisions for the city of Detroit require the retirement of indebtedness through earnings. The Maine Public Service Commission has held that the consumer must contribute to the operating expenses, depreciation charges and a margin to maintain a sinking fund for the retirement of outstanding indebtedness. A middle ground has been taken by the

5 Utah Laws, 1925, c. 58. A subsequent amendment allowed the municipalities, as an alternative, to set a sufficiently high rate to pay interest and retire indebtedness. This statute was discussed in Logan City v. Public Utility Comm., 72 Utah 536, 551, 271 Pac. 961, 967 (1923). The case involved a rate war between a municipal and private plant. Taxpayers intervened alleging that the proposed rates would not pay interest on bonds or provide for their retirement and that the city had operated at a loss for some years. The Commission found the rates unreasonably low and provided for a higher level. It was reversed in the courts and the commission was denied the power to fix the rates for a municipal utility. The court instructed the commission that if taxpayers wished to maintain their plant and operate at cost they should be allowed to do so. Re Brigham Municipal Corporation, P. U. R. 1919E 339 (Utah Pub. Util. Comm. 1919). The case held that interest and amortization of bonds should be provided through taxation.

6 The statute was discussed in Public Service Commission v. City of Helena, 52 Mont. 527, 159 Pac. 24 (1916).

7 See the discussion in Municipal Ownership in Detroit (1923) 12 Nat. Mun. Rev. 523. Because of outstanding bond issues the street railroad was forced to liquidate one half of its bonds in ten years and was encountering some difficulty in doing so.

Montana Commission which has held that interest on bonds should be paid from returns but that the bonds should be retired through taxation.\(^9\)

Where the municipally operated utility is free from bonded indebtedness, it may, of course, provide service at cost with no objection. The question arises, however, to what extent the city may fix rates above cost and utilize the profits accruing therefrom to cut down the general tax level. Some municipalities have been allowed a return equal to that enjoyed by private capital,\(^9\) but in other cases they have been limited to the actual cost of production plus depreciation charges and a small surplus to provide for possible losses.\(^11\)

A common ground of complaint on the part of the consumer has been the utilization by the municipality of the services and products of its own plants, as, for example, electricity for street lighting and water for fire protection, without defraying any part of the cost thereof. Commissions and courts have held that such free service constitutes discrimination against the consumer in that he is paying, through higher rates, for service that should be furnished through taxation, and require that the city must pay at least the actual cost of such service.\(^12\) But if the rates to the consumer are not raised above a reasonable level and capital charges or any deficit in the plant operation are met by taxation, free service to the city becomes largely a question of loose accounting methods. The taxpayer in furnishing capital or funding a deficit is paying for the services rendered the city,

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\(^12\) Re Hammond Waterworks, P. U. R. 1919A 180 (Ind. Pub. Serv. Comm. 1918); Re Village of Argyle, P. U. R. 1921E 265 (Wis. Ry. Comm. 1921). In Fretz v. City of Edmond, 66 Okl. 262, 168 Pac. 800 (1917), the city was allowed to give free service to a state hospital. The suit to enjoin the city was dismissed because the plaintiff citizen could not show damages. The court considered that discrimination could only be enjoined in dealing with a private corporation.
although the charges are not carried in that way on the municipal books.

Encouragement of industrial users by furnishing water and power at reduced or even nominal rates has also been frowned upon and price charges less than the actual cost of production enjoined even when the municipality has urged that the presence of the industry, through added taxable property and buying power, has more than made up for the loss of revenue to the utility.

Since municipally owned utilities are granted tax exemption, it is urged that in determining a rate level a sum equal to the taxes which would have been imposed had the plant been privately owned should be included as an operating expense to compensate the taxpayer for the loss of tax receipts resulting from municipal ownership. The Wisconsin Railway Commission has uniformly allowed such an item, while it has been forbidden in Indiana. So long as its rates are reasonable, however, a city desiring to carry such a charge for the benefit of its taxpayers should be allowed to do so, at least in respect to local taxes. But if the majority of taxpayers favor operation at cost, there would seem to be no reason for forcing such a charge on the plant.

Further problems are presented by the expansion of a municipal plant to allow for service outside the city limits. Some jurisdictions hold that without a legislative grant a city is not empowered to serve consumers outside its corporate limits. The majority of states, however, have granted this power either by a general law or through special charters. The permissi-

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34 Re City of Milwaukee, P. U. R. 1927B 229 (Wis. Ry. Comm. 1928); Re Village of Mukwanago, P. U. R. 1922B 109 (Wis. Ry. Comm. 1921); Re City of Hartford, P. U. R. 1919F 216 (Wis. Ry. Comm. 1919); Re Board Water Commissioners of City of Madison, P. U. R. 1918F 75 (Wis. Ry. Comm. 1918); see (1927) 16 NAT. MUN. REV. 733. It was shown that a Cleveland electric plant carrying tax costs as a special surplus, decreased costs and still made a better showing than competing private plants when the size of their respective units were considered.
36 Tax exemption is granted to a municipality as an instrument of the government. This is an advantage of public ownership that should not be denied if the taxpayer is willing to support a public plant or at least lose the tax returns from a private one.
37 Dyer v. Newport, 123 Ky. 203, 94 S. W. 25 (1906); 3 DILLON, MUNICIPAL CORPORATIONS §§ 1299, 1300.
38 By ARIZ. REV. CODE (1928) § 409, cities are authorized to own and operate utilities in and out of their corporate limits, providing that their rates cover interest on bonds and not less than 3% of principle. The corporation commission is empowered to give a certificate of public necessity and convenience in case a private utility is already serving the city, and
ble amount of this outside service is limited to the excess of available power over local needs. Under the Michigan constitution the amount that can be sold outside the city is limited to 25% of that utilized within. In Consumers Power Co. v. City of Allegan it was unofficially brought to the attention of the court that the city intended to sell, through meters belonging to outside consumers but located within the city limits, the excess power to be produced by a proposed plant capable of furnishing five times the city needs. The court, although unable to make a holding on the point, stated that such a practice would be enjoined under the constitutional limitation of the sale of excess power. But sale through the city’s distribution system to outside consumers of current bought from a private plant has been held to be perfectly permissible.

The position of the outside consumer is complicated by the various methods of financing municipal ventures, for where a heavy burden is placed on the taxpayer by plant operation, a problem of accounting is involved in placing an equitable charge on the outsider through rate adjustments. With a self-supporting plant the charges to him will more closely approximate those enjoyed by the citizen consumer and any increased cost of distribution could easily be determined and added to the rate in effect within the corporate limits. The rates must at least cover the cost of service, and a larger return may be allowed than in the case of a citizen consumer. A nice question is raised in Western New York Water Co. v. City of Buffalo where a large industrial user of water operated its plant outside the city limits but maintained its meter and pumping station on a lot within the city and attempted to take advantage of lower city rates. The court held that since the complaint was made by a taxpayer

in the absence of such a certificate no plant may be built. For a general grant in North Carolina, see N. C. PUB. LAWS 1929 c. 285, § 1 sec. 2.

20 3 DILLON, MUNICIPAL CORPORATIONS, § 1299.
21 Art. 8, § 23.
23 Holmes v. City of Fayetteville, 197 N. C. 740, 150 S. E. 624 (1929).
24 Where a city had bought a private plant operating in part outside the city, and the part outside was operating at a loss, the Arizona Commission held that the city could discontinue that part outside its limits. The commission held that a city may make up a deficit within the city through taxation but could not do so for a venture outside the city line. Ro City of Phoenix, P. U. R. 1929D 497 (Ariz. Corp. Comm. 1929). For cases contra see 3 DILLON, MUNICIPAL CORPORATIONS 2123, n. 1.
25 In Squirrel Island Village Corp. v. Boothbay Harbor, P. U. R. 1919F 154 (Me. Pub. Util. Comm. 1919) the Maine commission allowed a return of 8% when the service was given to an outside village. The same commission held that 8% was too great a return where complaint was made by a citizen consumer in Bonser v. Electric Light Commission, supra note 8.
26 242 N. Y. 202, 151 N. E. 207 (1926). This case was followed without opinion in a case of the same name, 242 N. Y. 507, 152 N. E. 404 (1926).
who could show no damage or that service was being given below cost, the city would not be enjoined from supplying the water.

It would seem, therefore, that where there is no patent discrimination in the distribution of the costs of producing services between taxpayers and consumers within and without the city limits the municipality can operate as it thinks best.

State Versus Local Control of Municipally Owned Utilities

Although in a number of jurisdictions the legislatures have expressly excepted municipally owned utilities from the regulation of state commissions, the constitutional power of the state to control such utilities has been generally sustained by the courts. Granting the power, however, the wisdom of complete control may be questioned. With policies involved in the operation and financing of publicly owned utility plants in general by no means settled, there are convincing arguments for allowing the voters to determine certain of the policies that shall govern in their own city. But there are other problems that are peculiarly within the scope of state control. Uniform and adequate systems of accounting are necessary in the construction of a reasonable rate schedule, and experience in Wisconsin, at least, has shown that the municipality is not always wise in its choice of accounting methods. State control of this aspect of operation, in at

26 In Springfield Gas & Electric Co. v. City of Springfield, 257 U. S. 66, 42 Sup. Ct. 24 (1921), the Supreme Court upheld an Illinois statute excepting municipal utilities from state control which was attacked by a private utility as denying private capital equal protection of the law. The Court emphasized the voters' control of the municipal utility in holding that the two types of plants were sufficiently dissimilar to justify different treatment by the legislature. See Overton, The Regulation of Municipally Owned Public Utilities (1922) 7 Conn. L. Q. 191; (1922) 20 Mich. L. Rev. 537.

27 City of Logansport v. Public Service Commission, supra note 10; Pabst Corporation v. City of Milwaukee, 190 Wis. 349, 208 N. W. 493 (1926); 3 Dillon, Municipal Corporations, § 1324. In Town of Holyoke v. Smith, 75 Colo. 286, 226 Pac. 158 (1924), the Colorado Utility Commission was denied the power to fix rates of a municipal utility when the commission was classed as a special commission within the meaning of the state constitutional clause excepting municipal ventures from the jurisdiction of any special commission. Compare a Utah case to the same effect: Logan City v. Public Utility Commission, supra note 5. Contra, under a similar constitutional provision: Public Service Commission v. Helena, supra note 6. With the exception of the Holyoke and Logan cases regulation has been denied only because of limits in the powers granted the commission, as interpreted by the courts. Kumm, The Legal Relation of City and State with Reference to Public Utility Regulation (1922) 6 Minn. L. Rev. 32, and 140 et seq.

28 King, The Regulation of Municipal Utilities (1921) 53-4, 307-8. In a survey of Wisconsin municipal utilities it was found that few kept
least an advisory capacity, has obvious advantages for the small town which would be unable to employ competent rate experts. Thus in New Jersey annual reports under a uniform plan of accounting are made by the municipal utilities to the state commission, though the commission has no power to control their other policies.

Where the municipal plant gives service outside its jurisdiction state control would again seem wise. In the absence of regulation or competition the outside consumer is entirely at the mercy of the municipal utility since he lacks the voting power enjoyed by the citizen consumer. This situation has been remedied in New Jersey and Colorado by allowing the state commission, without power to fix the rates of a municipal plant within a city, jurisdiction where the city serves surrounding sections.

Even where a private plant is in competition with a city-owned utility giving service outside the city limits, state control, although not so essential to the consumer, is desirable. Private utilities might attack the constitutionality of the distinctive treatment of municipal utilities operating outside the jurisdiction of the operating cities with more success than was met in the Springfield case, where the court relied to some extent upon the consumers' voting power. In fairness to private capital and to prevent wasteful competition and plant duplication, the state commission should be given power to control the extension of service beyond the city limits by requiring a certificate of public convenience and necessity similar to that required in the case of the extension of a private plant. If a private utility is

books and in many cases the stubs on the check books were the only memoranda kept. In one case the records were kept in a vest pocket account book. In a majority of towns no credit was given the plant for service rendered to the city and revenue was placed in the general fund and any expenses paid by appropriation. Such a situation would hardly exist in larger municipalities.


Springfield Gas & Electric Co. v. City of Springfield, supra note 26. Even if the constitutionality of such a distinction were sustained, which is likely, the private utilities have a better ground for pressing its repeal.

already rendering adequate service at a reasonable charge there seems to be no reason for allowing a municipal plant to enter the field.

Although the municipal plant should be thus regulated while operating outside the corporate limits, no such policy is necessary within the city. The majority of problems arising within the city are questions of municipal policy, and in view of the approximate identity of interest between the consumer and taxpayer, the franchise should be a sufficient guaranty of fair treatment for both. Access to the courts would be sufficient to provide for any glaring inequalities. In the case of a private plant operating in competition within a city the same safeguard is sufficient. Where capital is provided through taxation the tax exempt city plant, if reasonably efficient, should be able to undersell a private plant. This is particularly true when the taxes of the private utility include a share of the capital charges of its competitor and where the municipal requirements are filled by the city plant. Under these conditions competition seems difficult and if the majority of voters are willing to shoulder a greater burden to continue the operation under public ownership no requirement for the continued competition of the private plant appears. Were the state able to fix the rate level of a municipal plant on a plane upon which a private utility could operate on an equal basis, the lower rates available under public ownership would be sacrificed. Therefore so long as the rates fixed by the municipal utility do not conflict with charter provisions the state should not be allowed to interfere.

INTERPRETATION OF "AUTHORITY" IN SECTION 23 OF THE NEGOTIABLE INSTRUMENTS LAW

When a representative negotiates a negotiable instrument without actual authority from his principal, the question arises whether the negotiation is "inoperative" under Section 23 of the Negotiable Instruments Law, or whether the connotation


Supra note 7.

1 "Authority, in the law of agency, denotes an oral or written communication from the principal to the agent, expressing an actual intention that the agent shall act on the principal's behalf in one or more transactions with third persons, or causing the agent reasonably to believe that such was the principal's intention." A. L. Corbin, Comment (1925) 34 Yale L. J. 788, 793.

2 "When a signature is forged or made without the authority of the
of authority to negotiate is similar to that of authority to deliver in Section 16, under which a holder in due course is protected by a conclusive presumption of the validity of delivery.\(^3\) If the former conclusion is reached, the lack of authority becomes a "real" defense. If, on the other hand, the negotiation is not wholly inoperative, it becomes significant whether the issue is between immediate parties, that is, the principal and the transferee of the representative, or between remote parties, the principal and a subsequent holder.

Theoretically unrelated to these problems of the intrinsic validity of unauthorized negotiations, but frequently confused therewith by the courts is the question of notice of the irregularity to the holder.\(^4\) In respect of this factor, a remote holder appears to be in a more favorable position, the courts perhaps being influenced by the fact that only the immediate party is able directly to prevent the original misapplication. Thus where a corporate officer with general power to indorse paper for the corporation indorsed a check payable to the corporation and deposited it to his personal account, the depositary bank was held

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\(^3\) Section 16 reads in full: "Every contract on a negotiable instrument is incomplete and revocable until delivery of the instrument for the purpose of giving effect thereto. As between immediate parties, and as regards a remote party other than a holder in due course, the delivery, in order to be effectual, must be made either by or under the authority of the party making, drawing, accepting, or indorsing, as the case may be; and in such case the delivery may be shown to have been conditional, or for a special purpose only, and not for the purpose of transferring the property in the instrument. But when the instrument is in the hands of a holder in due course, a valid delivery thereof by all parties prior to him so as to make them liable to him is conclusively presumed. And where the instrument is no longer in the possession of a party whose signature appears thereon, a valid and intentional delivery by him is presumed until the contrary is proved." BRANNAN, THE NEGOTIABLE INSTRUMENTS LAW (4th ed. 1926) § 23. A proposed revision of this section reads as follows: "When the signature of a person is forged or made without authority it is inoperative to render him liable or to transfer or to defeat his rights under the instrument unless he is precluded from setting up the forgery or want of authority." This probably would make no change in the law. See Turner, Revision of the Negotiable Instruments Law (1928) 38 YALE L. J. 25, 40.

\(^4\) See Merrill, Bankers' Liability for Deposits of a Fiduciary to his Personal Account (1927) 40 HARV. L. REV. 1077; Thulin, Misappropriation of Funds by Fiduciaries: the Bank's Liability (1918) 6 CALIF. L. REV. 171; Scott, Participation in a Breach of Trust (1921) 34 HARV. L. REV. 454; Comment (1926) 35 YALE L. J. 854; (1926) 10 MINN. L. REV. 611.
to be on notice of a diversion of corporate funds. But that in such a case the immediate transaction and not merely the form of the indorsement constitutes the notice is indicated by the holding that a remote holder of an instrument transferred under identical circumstances is not put upon inquiry.

If the holder does not lose his rights to the instrument because he is on notice, the next consideration for the court would seem to be whether the negotiation was within the "apparent authority" of the representative. This issue would be raised, for example, where a corporate officer with no real authority to negotiate a bill or note, although officers of that type usually have this power, does negotiate an instrument for his personal use.


7 "The term 'apparent authority' means that there is in fact no authority, but that the conduct of the principal leads the third person with whom the agent deals to believe reasonably that there was authority. In such case the agent by acting beyond his authority has legal power to bind the principal." Corbin, op. cit. supra note 1, at 794. See also Restatement of the Law of Agency (Am. L. Inst. 1926) §§ 44, 47, 48.

8 "Apparent authority" will depend largely upon the type of representative, and the powers which such a representative usually exercises. A trustee, who is said to have "legal title" to the funds and control over them, can validly draw a check upon the trust fund and deposit it to his personal account, or perform similar acts which other representatives cannot. Maryland Casualty Co. v. City National Bank, 29 F. (2d) 662 (C. C. A. 6th, 1928); Newton v. Livingston County Trust Co., 231 App. Div. 355, 247 N. Y. Supp. 121 (4th Dep't 1931); New Amsterdam Casualty Co. v. First National Bank, 144 Okl. 130, 289 Pac. 749 (1930). See also 1 Mores, Banks and Banking (6th ed. 1928) § 317; Comment (1928) 25 Yale L. J. 854. The distinction between trustees and other representatives is brought out in two recent Virginia cases. Cocke's Adm'r v. Loyall, 150 Va. 336, 143 S. E. 881 (1928); W. L. Chase Co. v. Norfolk National Bank, 151 Va. 1040, 145 S. E. 725 (1928). See Comment (1930) 16 Va. L. Rev. 401. There is a presumption that the trustee will use the funds properly. Therefore, if the depositary profits in the misapplication of the funds, the presumption is overcome, and the principal may recover. Tingley v. North Middlesex Savings Bank, 266 Mass. 337, 165 N. E. 119 (1929).

When a negotiable instrument is payable to a representative as such, or when money is deposited by him in his name as fiduciary, it seems that he has "apparent authority" to transfer the instrument or money by signing as fiduciary, although he misappropriates the proceeds. Lincoln Oil Pro-
If the immediate party knows that such officers usually have this power, and does not know of the individual limitation, he should be allowed to recover. The situation would be analogous to the principal's giving secret instructions to an agent which a third party is not bound to know. But where the immediate party either did not know that the representative actually was an officer or did not know that such officers usually have this power, it seems that he could not recover upon any basis of reliance on the appearance of authority. And when he transferred the instrument to a remote party who knew nothing of the original transaction, it seems that since the negotiation had never come within the doctrine of apparent authority, the remote party could not recover upon that basis.

If the transaction is not relieved of the effect of Section 23 by the existence of "apparent authority," it remains to determine what part of the negotiation was without real or apparent "authority". In this connection, it is desirable to advert to the dual nature of a representative's power to negotiate for his principal and to divide it into the convenient categories of "signing authority" and "transacting authority." The former includes the power, either general or limited, to affix the principal's signature to a negotiable instrument; the latter includes the power, either general or limited, to transfer the instrument, signed by the principal, or by a representative with "signing authority," to a third party.

The courts seem to be reluctant to extend the "signing authority" of an agent beyond the instructions actually given. In Jennings v. Manhattan Co., for example, a representative was given

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9 Or ordinarily "apparent authority" cannot be limited by secret instructions. 1 MECHEN, AGENCY (2d ed. 1914) §§ 710, 730-735, 1000.

10 Where a party accepting a check or note endorsed by an agent and shown upon its face to be endorsed by an agent, maintains that the agent had apparent authority to make such endorsement, he must prove that the facts, giving color of authority to the agent, were known to him. If such person had no knowledge of such facts, he does not act upon them, or part with anything on the faith of any apparent authority, and, therefore, is not in a position to claim anything from such apparent authority." Jackson Paper Mfg. Co. v. Commercial National Bank, 199 Ill. 151, 159, 65 N. E. 136, 139 (1902). See Brady, Forged Checks (1926) 43 BANKING L. J. 421, 422.

“full authority” by a power of attorney to indorse the principal’s name to two drafts and to receive the money due thereon. The representative indorsed and presented one to the drawee, who paid him by a check payable to the principal. The representative then indorsed the principal’s name, indorsed it himself, and gave it to his wife, who also indorsed in blank, and deposited it to her account in the defendant bank, from which she withdrew the funds. The indorsement of the principal’s name to the check was held to be “unauthorized” and void. Similarly, when a clerk with instructions to stamp the principal’s indorsement on checks, which indorsement by its form showed that the instrument could be used only for deposit to the principal’s account, indorsed in blank and diverted the proceeds, it was held that no rights could be conveyed by such indorsement. It seems then that where a representative has a limited or special “signing authority,” any signature which is not made within those limits is “inoperative” under section 23, so that even a holder in due course cannot recover thereon.

“Signing authority,” moreover, seems to be rarely implied even from a broad range of other powers. For example, a salesman with instructions to sell goods and collect the price has no power to indorse checks so received, and a manager of a local business cannot usually bind his principal on negotiable instruments.

Where the representative has general “signing authority” but limited “transacting authority,” three comparatively recent New York cases illustrate the trend of decision. In the case of Wagner Trading Co. v. Battery Park National Bank, which is followed by the similar recent case of Weissman v. Banque de Bruxelles, a corporate officer indorsed a check payable to the corporation and deposited it to his personal account in the defendant bank. The court failed to distinguish the separate ideas of notice, “signing authority,” and “transacting authority,” but said:

“Assuming as we do that Wagner had general authority to indorse checks for the plaintiff’s corporate purposes, clearly this did not authorize him to indorse checks to his own order and

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15 Dodds v. McColgan, 125 Misc. 405, 211 N. Y. Supp. 371 (Sup. Ct. 1926); Smith v. Thompson, 233 N. W. 576 (Wis. 1930); MECHM, op. cit. supra note 10, §§ 988–1000.
16 228 N. Y. 37, 126 N. E. 347 (1920).
17 Supra note 5.
appropriate the money to his own personal use, and the nature of this transaction was such as to warn defendant that the checks were being diverted from usual business channels."  

In *Lasker v. Mutual Bank*, the corporate president and the secretary, who had general power to indorse corporate checks, indorsed one payable to the corporation in blank, then indorsed it personally, and diverted the proceeds. It later came to the defendant bank, which collected it for the third party indorser who presented it. The court held that the bank was a holder without notice and therefore entitled to the check. Similarly, when a representative has power to indorse his principal’s name to checks in blank and to deposit them only in a specified bank, his diversion of the funds does not impair the validity of the endorsement. An analysis of these cases shows that in each the officer had “signing authority” but exceeded his “transacting authority.” The immediate party, who was held to be on notice, could not recover; the party who qualified as a holder in due course did recover.

Thus the “inoperative” provision of section 23 probably refers to lack of “signing authority,” while lack of “transacting authority” seems to be governed rather by section 16, where a remote holder in due course is allowed to recover despite lack of delivery. The problems arising from these cases, therefore, might be concluded by the following inquiries: (1) Is the holder of the instrument a holder in due course? (in which the question of notice, involving his status as an immediate or remote party, would be material) (2) Was the negotiation or any part thereof within the representative’s apparent authority? (3) What part of the negotiation—the signing or the transacting—was without real or apparent “authority”?

Thus interpreted, section 23 of the N. I. L. is in harmony with the Uniform Bills of Lading Act. Under section 23 of the latter act, it is provided that if a carrier’s agent or employee,

18 Supra note 16, at 43, 126 N. E. at 349.
19 Supra note 6.
21 Compare also Merchants’ Bank & Trust Co. v. People’s Bank, 99 W. Va. 544, 130 S. E. 142 (1925), and People’s Bank v. International Finance Corporation, 30 F. (2d) 46 (C. C. A. 4th, 1929), both involving the fraudulent issuance by a bank cashier of certificates of deposit. In the former the plaintiff, unable to prove himself a holder in due course, was denied recovery. In the latter, a holder in due course recovered. In the Lasker case, supra note 6, at 380, the indorsee was found to be a holder in due course because “corporate obligations frequently bear the personal indorse-
who has actual or apparent authority to issue bills of lading, issues one without receiving any goods, the carrier is liable to a bona fide purchaser of the instrument. In other words, if the agent or employee has "signing authority" but exceeds his "transacting authority" the bona fide purchaser can recover from the carrier.

-ment of officers in order to give the instrument greater credit," so that the indorsement did not put the holder on inquiry of the abuse of authority. And when the check is drawn by the officer to his own order, and then indorsed by him, the same result seems to follow even as to an immediate party. Havana Cent. Ry. v. Knickerbocker Trust Co., 198 N. Y. 422, 92 N. E. 12 (1910); Whiting v. Hudson Trust Co., 234 N. Y. 394, 138 N. E. 33 (1923).

The first part of this section reads: "If a bill of lading has been issued by a carrier or on his behalf by an agent or employee the scope of whose actual or apparent authority includes the issuing of bills of ladings, the carrier shall be liable to:

(a) The consignee named in a non-negotiable bill, or
(b) The holder of a negotiable bill,

"Who has given value in good faith relying upon the description therein of the goods, for damages caused by the non-receipt by the carrier or a connecting carrier of all or part of the goods or their failure to correspond with the description thereof in the bill at the time of its issue." Section 22 of the Federal Bills of Lading Act corresponds with this. See Note and cases collected, 4 UNIFORM LAWS ANNOTATED, § 23.