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WRITING DOWN FIXED ASSETS AND STATED CAPITAL

FROM 1929 to the end of 1932, alone, estimated net profits of all privately-owned corporations in the United States declined by about seventy-six percent.[1] An important contributing cause of the sharpness of this decline was the fact that, despite the drop in gross earnings, corporations continued to estimate depreciation expense on the basis of the original cost of fixed assets,[2] or original cost, plus later upward revaluations. Since most fixed assets were purchased during the period of higher prices, the allowance in dollars for the capital

1. STATISTICAL ABSTRACT OF THE UNITED STATES—1933 (U. S. Bur. of Foreign and Domestic Commerce, 1933) 272. This includes industrial and mercantile companies, public utilities and Class I Railroads. During the same period, average closing prices of industrial stocks on the New York Stock Exchange dropped by some 74%, and average closing prices of twenty-five selected railroad stocks dropped by some 84%. The drop in market value of forty selected bonds was about 37%. *Supra* at 275. The write-down practices under discussion began in the latter part of 1931 and had gotten well under way in 1932. *Infra* note 59. These practices were the direct outgrowth of price level and net income changes which had occurred by the end of 1932.

2. To the effect that, in the past, this has been the normal basis for estimating depreciation expense, see dissenting opinion of Brandeis, J., in United Railways of Baltimore v. West, 280 U. S. 234, 265-269 (1930).

investment lost by expiration of the service life of the fixed asset during the current accounting period reflected the previously greater costs of the commodities and services necessary to make up the asset.[3] Therefore, while the corporate profit and loss statement currently reflected lower gross earnings, gross earnings being made up of current dollars of greater purchasing power, the deduction for depreciation losses was nevertheless unreduced because expressed in terms of past dollars of lesser purchasing power;[4] thus leaving a smaller margin of net profit.

As a result of the drop in corporate net income and the consequent curtailment of dividends, corporation managements found their retention of control threatened. Presumably, for this reason the present depression has witnessed the widespread adoption of a novel method of reducing depreciation costs and thus freeing current income for the payment of dividends.[5] This method, suggested by stock market brokers, investment trusts and finance companies, and taken up by many manufacturing and merchandising corporations,[6] consists of reducing stated capital in accordance with methods provided by state statutes. But, instead of utilizing the resultant capital surplus for dividend purposes, the practice is to cancel it in whole or in part against a reduction in the valuation of fixed assets to represent purported current price levels.[7] With the stated

3. Construction costs in 1929 averaged about 28% higher than at the end of 1932. GRAHAM, PUBLIC UTILITY VALUATION (1934) 22.

4. Measured by the drop in the general index of prices of the Federal Reserve Bank of New York, the purchasing power of the dollar increased by about 26% from the beginning of 1929 to the end of 1932. GRAHAM, op. cit. *supra* note 3 at 22. As measured by the general index of wholesale prices of the U. S. Bureau of Labor Statistics, the increase in purchasing power of the dollar seems to have amounted to 32%. Daniels, *The Valuation of Fixed Assets* (1933) 8 ACCOUNTING REV. 302, n. 2.

5. To the effect that the primary purpose of the use of this method is to free future income for the payment of dividends, see KESTER, ADVANCED ACCOUNTING (3d ed. 1933) 459; Daniels, *Principles of Asset Valuation* (1934) 9 ACCOUNTING REV. 114, 116; cf. HOAGLAND, CORPORATION FINANCE (1933) 140.

6. "Should Not Block Asset Write-Offs," N. Y. Times, February 5, 1933, II, at 16, col. 1; "Business Begins to Write Down Book Values of Fixed Assets" (May 4, 1932) BUSINESS WEEK 24; "Urge Write-Downs of Fixed Assets", N. Y. Times, January 31, 1932, II, at 9, col. 3. It was pointed out that security values would thus be increased, because the investor has relied, particularly since 1929, almost entirely on the corporate showing of earnings, irrespective of the book equities behind securities. See also Daniels, *supra* note 5, at 116.

7. For possible methods of accounting for the write-down, see KESTER, ADVANCED ACCOUNTING (3d ed. 1933) 544-546; cf. note 25, *infra*. Stated capital may be reduced in various ways, such as by a reduction of the par or stated value of the capital stock, a change from par to no-par stock of a lesser stated value, or vice versa, a redemption of certain classes of shares, a stock donation by owners. See, for example, TENN. CODE ANN. (Williams, 1934) § 3736; KESTER, *supra*, at 541-542.

For examples of companies which have accomplished write-downs of fixed assets against capital surplus transferred from stated capital, as well as other surpluses, see the statements of the American Woolen Company, Barnsdall Oil Company, G. R. Kinney and Company, Curtiss-Wright Corporation, Doehler Die Casting Company, Ever Ready Company, Radio Corporation of America, and United Fruit Company in MOODY'S, INVESTORS SERVICE since 1931. See also Cartinhour and Dewey, *Capitalization Changes as a Result of the Depression* (1932) 4 CORP. PRAC. REV. 26, 29.

value of fixed assets thus reduced, the expense of periodically accounting for the lost, or depreciated, service life of the asset is reduced by an amount which, over the period of the remaining service-life of the asset, will exactly equal the amount of the capital surplus against which was cancelled the devaluation of fixed assets. Consequently, the total credits to the profit and loss account over the remaining service life of the asset will be larger by the same amount[8] and will ordinarily be reflected in the earned surplus account as assets available for dividends.

The apparent reason for crediting the fixed asset account for the amount of the write-down and at the same time debiting capital surplus, transferred from stated capital, is that, otherwise, the necessary offsetting debit would have to be made either against earned surplus or against an already existent paid-in surplus, or else against a capital loss account indicative of a capital impairment. Were the debit made against earned surplus, no assets, not already free, would be freed in the future for dividends[9] and in most states

8. It is assumed in the illustration below that the fixed asset has a ten year service life, that depreciation is on a straight-line basis, and that the write-down is made at the end of the third year of the asset's service life.

	Old Basis of Depreciation		
Plant Cost	$5,000		
Less:			
Reserve for Depreciation	1500	(3 years at $500 per year)	
Net Book Value	$3500		$3500
	New Basis		
Revalued Plant (on basis of replacement cost new)	$3000		
Less:			
Reserve for Depreciation	900	(3 years at $300 per year)	
Net Book Value	$2100		$2100
Amount of Write-Down			$1400

One tenth of the service life of the fixed asset being lost each year, that percentage of annual depreciation will be multiplied against the new depreciation base of $3000, just as it was formerly multiplied against the old base of $5000. But, whereas one-tenth of $5000 brought a $500 annual depreciation charge, one-tenth of $3000 brings a $300 annual charge, or a savings on depreciation expense of $200 per year. Since there are seven years of service life of the fixed asset remaining, there will be a total savings on depreciation expense of seven times $200, or $1400, over the total remaining service life. It will be noted that this sum is exactly equal to the amount of the write-down of the fixed asset, as shown on the above account.

9. But some companies seem to be writing off the loss against earned surplus, where earned surplus has not already been wiped out by past deficits, the purpose being merely to replace an annual deficit with net earnings, or to improve net earnings on future profit and loss statements. Radio Corporation of America followed this procedure in 1931, although, at the same time, it transferred from stated capital to capital surplus an amount substantially equivalent to the earned surplus used in cancelling losses, thus freeing capital for future dividends or other uses and creating various unexplained reserve accounts. POOR'S, INDUSTRIAL (1934) 2404; Farr, *Give the Stockholder the Truth* (1933) 93 SCRIBNER'S 228, 231. Although Kester [ADVANCED ACCOUNTING (3d ed. 1933) 543] is of the opinion that most write-downs are being cancelled against capital surplus, even where earned surplus exists, the motive being to leave the earned surplus available for dividends, a survey of 135 companies made early in 1933 by the National Association of Cost Accountants states

the same is true as to paid-in surplus.[10] Were it made to a capital loss account, the corporation would be bound under the laws of most states to apply future net income created by the reduced depreciation charges to make up that capital impairment.[11] Furthermore, other means of making possible the same amount of dividends are unavailable. While the same amount of assets, freed for dividends by the write-down method could be freed by simply reducing depreciation charges, without writing down the book value of fixed assets and of state capital, this would invite a legal attack on the ground of fraudulent payment of dividends as a result of insufficient provision for depreciation.[12]

that, at least among the 68 companies which replied to the effect that they had accomplished write-downs of fixed assets, 28 had charged the write-down against earned surplus and only 13 against capital surplus. It was not stated, however, whether these 28 had reduced their stated capital at the same time, as in the case of the Radio Corporation of America, and either paid out dividends from the resultant capital surplus or used it to offset other expected future losses or to set up unexplained reserves, possibly to meet those losses. "Survey Confirms Write-Off Trend," N. Y. Times, February 26, 1933, II, at 15, col. 7. The problem of misrepresentation to future investors, discussed later is substantially similar in the case where the write-down is cancelled against earned surplus to the case where it is cancelled against capital surplus. Also, where the method used by the Radio Corporation of America is adopted, the resulting problems as to creditors are similar to those involved where the fixed asset losses are cancelled against capital surplus transferred from stated capital.

10. Comment (1931) 31 COL. L. REV. 844. To make the corresponding debit against paid-in surplus, however, would similarly result in an improved showing of earnings in the future. Thus, in such states as Illinois, Ohio, Louisiana and Michigan, where the recipient of dividends from paid-in surplus must be informed of the source at the time of payment, the corporation might find it to its advantage to cancel a loss in book value of fixed assets against paid-in surplus and thus make it possible in the future to declare dividends out of what may be represented to the stockholder to be earnings, instead of paying dividends directly from what must be represented to the stockholders as coming from capital.

11. See note 15, *infra*; Comment (1933) 3 BROOKLYN L. REV. 91, 99; MEAD, CORPORATION FINANCE (6th ed. 1930) 570. The rule is to some extent modified in three states by allowing payment of dividends despite a capital impairment, from net earnings for the current or preceding fiscal year, as in Minnesota, or from net earnings for the current and/or the preceding fiscal year, as in Delaware, or from net earnings of the preceding accounting period which shall not be less than six months nor more than one year in duration, as in California. CAL. CIV. CODE (Deering, Supp. 1933) § 346 (2); Del. Laws 1929, p. 392; Minn. Laws 1931, c. 300, § 21 (II). All three statutes, however, prohibit payment from current net profits where the value of the dissolution preference of any class of shares has been impaired.

New Jersey seems to be following the rule adopted in these three states, although without specific statutory provision to the same effect. Borg v. International Silver Co., 11 F. (2d) 147 (C. C. A. 2d, 1925); Goodnow v. American Writing Paper Co., 73 N. J. Eq. 692, 69 Atl. 1014 (1908).

12. See cases summarized in Briggs, *Asset Valuation in Dividend Decisions* (1934) 9 ACCOUNTING REV. 220, 231-232. The following corporation statutes specifically require a deduction for depreciation in calculating assets available for distribution as dividends: OHIO GEN. CODE ANN. (Page, Supp. 1935) § 8623-38; LA. GEN. STAT. (Dart, 1932) § 1106 (IV); Minn. Laws, 1931, c. 300, § 21 (I); Pa. Laws, 1933 p. 404; VT. PUB. LAWS (1933) § 5850.

Another possibility is that the amount of the loss in value could be credited to the fixed

Again, while the same amount of assets could be freed merely by reducing stated capital and paying dividends directly from the resultant capital surplus, as permitted by the laws of practically every state and the District of Columbia, this method would make it apparent to future investors or lenders and to present stockholders that the dividends are from capital and not from income. This is particularly true in the three states where statutes require that the source of such liquidating dividends be revealed to the recipient at the time of payment.[13] But by the expedient of writing off the purported loss in value of fixed assets against a capital surplus transferred from the stated capital, the corporation seemingly may represent and pay out in the future as earnings what otherwise either would render management liable for wrongful payment of dividends, or, even if legally paid out by reducing stated capital, would be paid out as capital and not as earnings.

This method of freeing future income for dividends raises several problems. First, is management justified in reducing stated capital to offset a purported loss from a reduction in value of fixed assets? And, as corollary to the same question, what is the proper measure of this loss, and, therefore, of the reduction in stated capital? Second, if there is a theoretical justification, does the actual practice nevertheless endanger the rights of creditors, stockholders and future lenders and investors? Third, is the existent protection to these interests sufficient to meet the possible dangers? If not, the final question is, what remedies ought to be made available?

I

If a company were capitalized with one class of shares and neither creditors nor future lenders nor investors were involved, no question would ordinarily arise as to the justification for reducing stated capital in order to offset an alleged loss in value of fixed assets, after the necessary proportion of stockholders have consented to the reduction in accordance with the state statute. No one could object to the company's act of liquidating a part of its business by making no attempt in the future to depreciate on the old basis so as to recover lost capital out of gross income. If a company were capitalized with more than one class of shares, the other circumstances remaining the same, a question might arise as to whether one class was being treated unjustly as compared with another by the particular plan proposed for transferring stated capital to capital surplus. Here again, however, no objection could normally arise as to the validity of the write-down process, per se, or as to the validity of the extent to which the write-down is made, as long as the recapitalization

asset account and debited to another asset account as a deferred charge for assets written off, the loss being periodically amortized as an expense over the remaining service-life of the fixed asset. But this would not increase future dividends, since the periodic amortization expense would exactly equal the gains in net income by reason of reduced depreciation charges.

13. CAL. CIV. CODE (Deering, Supp. 1933) § 346; ILL. STAT. ANN. (Smith-Hurd, 1935) § 157.60. Section 1106 (II) of LA. GEN. STAT. (Dart, 1932) seemingly applies to dividends paid from capital surplus transferred from stated capital, under § 1126 (II); and thus requires notice to the recipient. The point is not made very clear by the statute, however.

is in accordance with the state statute.[14] This question can only arise where creditors are concerned.

With various individual modifications, the corporation statutes of thirty-seven states and the District of Columbia attempt to protect creditors by assuring the maintenance of a minimum capital investment by the stockholders of the corporation. This is done by provisions which in effect would prohibit the payment of dividends when the stated capital of the corporation is impaired, or will be impaired by the payment.[15] While probably none of these statutes would afford creditors a remedy against the management or the stockholders without proof of actual or threatened damage because the corporation is thus rendered insolvent,[16] the statutory prohibition may nevertheless check

14. In each of these cases, however, a question might arise as to whether management is misleading stockholders and future investors and lenders to their possible injury by thus writing off losses due to bad management and not to price level change. See notes 31 and 32, *infra*. An additional problem might arise where the stated capital is reduced below the amount of the asset preference to which certain classes of stockholders may be entitled in event of dissolution. Cf. note 42, *infra*.

15. ARK. STAT. ANN. (Castle, Supp. 1931) § 1701 y; COLO. STAT. ANN. (Courtright, 1930) § 1009; CONN. GEN. STAT. (Revision of 1930) § 3386; D. C. CODE (1929) § 278; Ga. Acts, 1877, p. 35; IDAHO CODE ANN. (1932) 29-129; ILL. STAT. ANN. (Smith-Hurd, 1935) § 157.41; IND. STAT. ANN. (BURNS, 1929) § 4856.17; IOWA CODE (1931) § 8378; KY. STAT. (Carroll, 1930) § 548; LA. GEN. STAT. (Dart. 1932) § 1106 (Ia.); ME. REV. STAT. (1930) p. 874, § 37; Md. Laws 1931, c. 480, § 87; Mich. Laws 1931, p. 575-6, § 22; MONT. REV. CODE (1921) § 5939; NEV. COMP. LAWS (Hillyer, 1929) §§ 1625, 1760; N. J. COMP. STAT. (Supp., 1931) § 47-30; N. M. STAT. ANN. (Courtright, 1929) § 32-135; N. Y. CONSOL. LAWS (Cahill, 1930) c. 60, § 58; N. C. CODE ANN. (Michie, 1931) § 1179; N. D. Laws 1931, p. 197; OHIO GEN. CODE ANN. (Page, Supp. 1935) § 8623-38; OKLA. STAT. (1931) § 9763; ORE. CODE ANN. (1930) § 25-219; PA. STAT. ANN. (Purdon, 1930) tit. 15, § 631; S. C. CODE (Michie, 1932) § 1353; S. D. COMP. LAWS (1929) § 8789; TENN. CODE ANN. (Williams, 1934) § 3737; TEX. PEN. CODE ANN. (Vernon, 1927) art. 1078; UTAH REV. STAT. ANN. (1933) § 18-2-17; VT. PUB. LAWS (1933) § 5850; VA. CODE ANN. (Supp. 1932) § 3840; Wash. Laws 1933, c. 185, § 24 (IV); WIS. STAT. (1931) § 182.19 (1); WYO. REV. STAT. ANN. (1931) § 128.131. The statutes of California, Delaware and Minnesota, with the limitations pointed out in note 11, *supra*, also state this rule. Many of these statutes, however, consider capital to be the aggregate amount of par-value stock, plus that portion of the consideration paid for no-par stock which is stated on the accounts as capital. Since practically 85.4% of the capitalization of public utility and industrial companies is now composed of no-par, or par of such low nominal value as to be virtually no-par [DEWING, CORPORATION SECURITIES, (1934) 87-89], these statutes give management an almost limitless discretion in determining what amount of capital it intends to keep unimpaired. See DEWING, *supra*, at 70-73. Vermont and Virginia are examples of states which require that the full consideration received for no-par stock be regarded as part of the capital to be maintained unimpaired.

16. Of the statutes cited in note 15, *supra*, those of Arkansas, Connecticut, Montana, Nevada, New Jersey, New Mexico, New York, North Carolina, North Dakota, Oklahoma, South Dakota, Tennessee, Vermont, and Wisconsin expressly give the creditor or his representatives a remedy only in event of dissolution or insolvency. Of the rest of the thirty-seven statutes and that of the District of Columbia cited, ten, those of Colorado, District of Columbia, Georgia, Iowa, Kentucky, Maine, Maryland, Oregon, Virginia, and Wyoming, state, in substance, that the creditor may claim against the directors who wrongfully pay dividends to the extent of the claims outstanding at the time of the wrongful payment or

management by the threat of possible litigation.[17] If creditors rely on the maintenance of that minimum capital investment, supposedly guaranteed by these statutes, practical considerations of keeping the good will of creditors would demand that management offer some justification for transferring part of that minimum capital to capital surplus,[18] despite the fact that the laws of most of the states seem to permit the transfer with little or no restrictions, so far as creditors are concerned.

There may be at least two alternative justifications for transferring stated capital to capital surplus in order to absorb a purported loss in the value of fixed assets. These two may at the same time afford the standard by which the loss should be measured. The first is that the creditors' security is sufficient when the company maintains at least that capital currently necessary to replace such a fixed asset as was originally acquired by the company, and set up on the accounts at its original cost, and that, correspondingly, the depreciation expense account should only reflect the cost of currently replacing that part of the service-life of the fixed asset which expired during the current accounting period. Since the current replacement cost of most fixed assets is well below the original cost of the same assets, this theory would justify a representation of loss on the balance sheet[19] and a cancellation of that loss

contracted thereafter, and another, that of Indiana, is similar in statement to these ten. Probably, however, all of these statutes would be construed to give the creditor a remedy only in event of actual damage by reason of insolvency or dissolution. The statutes of Idaho and Washington, both based on the UNIFORM BUSINESS CORPORATION LAW, do not mention rights of creditors in event of wrongful payment of dividends. They seem to render management and shareholders liable only to the corporation. Probably, creditors would here also have a theoretical right to recover, but only in event of insolvency or dissolution. Thus it is likely that these provisions as to impairment of capital protect the creditor little more than do the statutes of Minnesota, Mississippi, Missouri, Nebraska and West Virginia which state in substance that a dividend is wrongful only when its payment would render the corporation insolvent, or if it should be made at a time when the corporation is insolvent.

17. But cases in which creditors have been able to force directors and stockholders to return dividends paid out of capital are rare. DEWING, CORPORATION SECURITIES (1934) 73.

18. HOXSEY, WRITING DOWN ASSETS AND WRITING OFF LOSSES (Address before the Mass. Soc. of Cert. Pub. Accountants, 1933) 23-24. It does seem to be a valid answer to creditors' objections to argue, as does Professor Kester, that the write-down of fixed asset values against the capital surplus transferred from stated capital does not affect the creditor because his position "is certainly no worse when the value facts are stated than when they are not stated." KESTER, ADVANCED ACCOUNTING (3d ed. 1933) 542. When the corporation writes down its stated capital investment, it is thereby bound under the statutes to retain only enough income out of its gross returns to maintain that lower capital investment unimpaired. If the write-down is excessive so that, assuming that the corporation has not a substantial surplus, that lower capital investment is insufficient to maintain the business in a solvent condition, the creditor is certainly not protected, despite the fact that the revaluation of fixed assets concurrently with stated capital may acquaint him more realistically with the actual value of the assets securing his claim.

19. For the argument in favor of this method of accounting for depreciation, see Schmidt, *The Basis of Depreciation Charges* (1930) 8 HARV. BUS. REV. 257. In a recent dividend decision, the court, while reaching a result that in effect justified a current maintenance instead of depreciation policy, nevertheless theoretically espoused the replacement cost

against capital surplus transferred from stated capital. A second possible justification is that the creditors' security is sufficient when the company maintains at least that number of current dollars worth of capital investment which will, as measured by a general index of prices, currently purchase an amount of commodities and services of any kind (not a particular fixed asset, as in the case of the replacement cost basis) equivalent to the amount which could have been purchased at the time the fixed asset was originally purchased with the number of dollars originally invested in that asset. By this theory the depreciation expense account would reflect that number of current dollars substantially equivalent in general purchasing power, although not in number of dollars, to the proportionate part of the original investment which was lost during the current accounting period by the expiration of part of the service-life of the fixed asset. Since the general purchasing power of the dollar has increased materially from the time when many of these fixed assets were originally set up on the accounts, this theory would also justify a representation of loss[20] to be cancelled by reducing stated capital. Either theory of valuation[21]

theory by defining depreciation as "represented by the number of dollars necessary to rehabilitate the property sufficiently to place it in safe condition for operation." Guaranty Trust Co. v. Grand Rapids, Grand Haven and Muskegon Ry. Co., 7 F. Supp. 511, 520 (W. D. Mich. 1931).

Distinguish between the replacement cost theory of depreciation and the suggestion made by Castenholz [A SOLUTION TO THE APPRECIATION PROBLEM (1931); *The Accountant and Changing Monetary Values* (1931) 6 ACCOUNTING REV. 282] that expected replacement costs be treated as a deferred charge to be accounted for as depreciation expense only when realized, and without allowing the appreciation or decrease in value of the fixed assets due to price level changes, to affect earned surplus available for dividends. Cf. GRAHAM AND KATZ, ACCOUNTING IN LAW PRACTICE (1932) 192-193.

20. Among recent advocates of this theory of depreciation are KESTER, ADVANCED ACCOUNTING (3d ed., 1933) 540-541; HOXSEY, op. cit. *supra* note 18; cf. Sweeney, *Capital* (1933) 8 ACCOUNTING REV. 185, 198. It is significant of the change in attitude of some accountants, probably brought about by the pressure of the depression upon corporate management, that Kester, for example, formerly decried any other system of depreciation accounting than that based upon the original cost of the fixed assets. KESTER, ACCOUNTING THEORY AND PRACTICE (2d ed. 1925) 292.

21. It has also been suggested as justification for the devaluation of fixed assets in order to reduce depreciation charges that depreciation charges should be adjusted periodically in accordance with changes in the intensity of use of the fixed assets. This theory seems similar to that advanced by the railroads in opposition to having accrued depreciation deducted from the valuation of railroad property in determining the base for rate regulation. Depreciation Charges of Telephone and Steam Railroad Companies, 177 I. C. C. 351, 392 (1931). While theoretically this method would accomplish perhaps the most equitable apportionment of fixed asset costs, since the most intense use of fixed assets would probably occur when gross returns are greatest, nevertheless, it is objected that it would fail to accomplish the purpose of writing off the cost of the fixed asset during its service life, unless gross earnings or intensity of use could be estimated in advance with any degree of accuracy, which latter is deemed improbable, or unless the length of its service life depends substantially upon the number of units of output that the fixed asset is made to produce. GRAHAM, PUBLIC UTILITY VALUATION (1934) 86-87; for further criticism see Paton, *Aspects of Asset Valuations* (1934) 9 ACCOUNTING REV. 122, 125.

might in any particular case result in substantially the same representation of capital loss, but not necessarily so.[22]

The replacement cost method of revaluation indicates to management what current sales price is necessary in order to recover at least a sufficient amount currently to maintain the unimpaired usefulness of the company's fixed assets, so that if management is able to adjust its sales prices accordingly, creditors may be assured that, despite the lower capitalization of the company accompanying the revaluation of the fixed assets, the fixed assets necessary to continued smooth functioning of the company will not be neglected. However, depreciation charges based upon the purchasing power method of revaluation, as measured by a general index of prices, may enable management most accurately to adjust sales prices to the ability of buyers, themselves sellers in another market, to make purchases. It would also tend to assure creditors that, despite the recapitalization of the company on the lower level, the new depreciation charges will recover sufficient gross income to enable management to maintain a constant approximate equivalence of ability to purchase any commodities and services necessary to the smooth functioning of the business.[23]

22. See Daniels, *The Valuation of Fixed Assets* (1933) 8 ACCOUNTING REV. 302, 305. The larger the company and the more far-flung and complex the array of its fixed assets, the more likely will it be that the sum total of the changes in replacement costs "will correspond in considerable measure to the movements in the value of money as expressed in indexes of prices in general." Paton, *Aspects of Assets Valuations* (1934) 9 ACCOUNTING REV. 122, 126; cf. GRAHAM, PUBLIC UTILITY VALUATION (U. of Chicago Studies, 1934) 21-29.

In a survey of 135 companies made in 1933 by the National Association of Cost Accountants, 50% of the replies favored writing down assets to "net sound values" (viz., present replacement cost, less depreciation over the past life of the assets); 17 replies favored present market value; 15 suggested various other values, such as those based on complete appraisals, which take into consideration not only present replacement costs and market value but also the future trend of industry. "Survey Confirms Write-Off Trend," N. Y. Times, February 26, 1933, II, at 15, col. 7.

23. Furthermore, it may be that either basis for depreciation accounting, if generally accepted, is to be preferred to the original cost basis from the standpoint of adjusting national purchasing to consuming power and therefore making for a balanced social economy. Thus, assuming that management is guided in its sales policy by the depreciation expense account as one of the expenses that sales price must cover, either basis would result in higher sales prices in a time of rising prices than in a time of falling prices. In a time of rising prices, this, plus the lower dividends to investors which would follow higher depreciation charges would tend to prevent an artificial demand for commodities and services, as in the pre-1929 years, with the attendant over-expansion of plant and equipment and insufficient reserve for cost of replacement of fixed assets or for costs of purchasing other commodities and services. It would likewise tend to prevent the resultant over-borrowing, unemployment and reduction of wages at the very time when sales prices have to be raised in order to provide the necessary replacements or other commodities and services for which insufficient provision was previously made. Furthermore, by bringing about higher prices at the time when the average worker is receiving higher wages, and vice versa in a time of falling prices, either basis for depreciation would tend to bring production and consumption into equilibrium. These arguments impressed the German economists, who experienced the German currency inflation of a decade ago, with the need for accounting in terms of changing price levels. Sweeney, *Capital* (1933) 8 ACCOUNTING REV. 185, 198; Schmidt, *Is Appreciation Profit?* (1931) 6 ACCOUNTING REV. 289; Schmidt, *The Basis of Depreciation Charges* (1930) 8 HARV. BUS. REV. 257; "International Congress of Account-

But if either of these theories of revaluation of fixed assets and concomitant readjustment of stated capital is a legitimate answer to creditors' objections to the write-down movement in time of declining prices, when it will make possible a declaration and distribution of income not otherwise possible, it is such only on the theory that it will also be applied in times of rising prices, when it will result in withholding income otherwise distributable as dividends. If fair dealing between the corporation and its creditors requires that the corporation recover from gross income by means of the deduction for depreciation expense at least that amount currently necessary to replace the proportionate part of the fixed asset's service-life which expired during the current accounting period, the recovery for depreciation will have to be increased in a period of rising costs of replacement.[24] That will necessitate a periodic revaluation of the fixed asset account, and concurrently, an increase of stated capitalization in order to assure creditors that "real" capital, as measured by replacement costs, will not be impaired.[25] But in a time of rising prices the

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ing," The Times (London) Sept. 13, 1929, at 18, col. c. One answer to these propositions has been made on the ground that depreciation accounting has substantially nothing to do with sales price, since in the long run companies will in any event collect from their customers, "not an amount equal to their individual expenses of production, but one equal to those (plus interest and normal profits) of the marginal producer." Daniels, *The Valuation of Fixed Assets* (1933) 8 ACCOUNTING REV. 302, 304-305; cf. GRAHAM, PUBLIC UTILITY VALUATION (1934) 53; MEAD, CORPORATION FINANCE (6th ed. 1930) 301-302; in general, see HOXSEY, op. cit. *supra* note 18, at 13; Nissley, *Effects of Recent Events on Financial Statements* (1933) 55 JOUR. OF ACCOUNTANCY 272, 287; "Answers Criticism of Write-Off Plan," N. Y. Times, January 29, 1933, II, at 15, col. 5.

24. Thus, in denying the validity of the purchasing-power-of-the-dollar theory of mortgage liability advanced by the defendant in Federal Land Bank of Omaha v. Wilmarth, 252 N. W. 507, 512 (Iowa 1934), the court stated: "Assuming . . . that the appellant's philosophy is correct, then, were the situation reversed, would the appellant, in what he would term prosperous times, be in court asking that he not be permitted to pay $20,000 in satisfaction of the obligation, but that he be required to pay $40,000."

25. The following is an illustration of the method which might be used in accounting for such periodic revaluations under either of the two suggested theories. Assume: Original cost of the asset machinery is $5000, its service-life estimated to be 10 years; at the end of the third year, it is revalued and the value of the asset new is determined to be $3000; at the end of the fourth year, it is revalued and its value new is determined to be $6000; and that depreciation is by the straight-line method.

Journal Entries

1.	Machinery (Cost)	$5000	
	Cash		$5000
2.	Depreciation (for three years)	1500	
	Reserve for Depreciation (Cost basis)		1500
3.	Revaluation Surplus	1400	
	Revaluation Reserve for Depreciation	600	
	Revaluation of Machinery (1st revaluation at the end of the third year)		2000
4.	Depreciation	300	
	Revaluation Reserve for Depreciation	200	
	Reserve for Depreciation—Cost basis		500
	(4th year of depreciation)		
5.	Revaluation of Machinery	3000	
	Revaluation Reserve for Depreciation		1200
	Revaluation Surplus Account		1800
	(2nd revaluation at end of 4th year to cost new, $6000; sound value, $3600).		

corporation's depreciation costs, rising with the upward revaluations of fixed assets, may ascend faster than the prices which the corporation can obtain for its products. To avert the resultant necessity to reduce dividends drastically, management will be pressed to find a new scheme for valuation. If, to avoid cutting dividends, management should maintain the decreased value fixed as its depreciation basis at the time of low prices, the result might well be the impairment of that "real" capital, with the eventual breakdown of the company as it seeks later to replace necessary working equipment for which it has made insufficient provision. Therefore, sufficient security for the creditor is likely to be provided only where the corporation segregates in the form of a surplus reserve account at least a substantial part of the earnings made available for dividends during the period of declining prices by the use of the replacement-cost method of revaluation. This surplus reserve will enable management to pay dividends during the period of rising prices, without making it necessary to skimp dangerously on depreciation charges. Similar considerations apply if, rather than the replacement cost method, the corporation adopts the general purchasing power method of revaluation of fixed assets and concomitant adjustment of capitalization.

II

The actual practice of the present write-down movement seems inconsistent with the apparently reasonable theoretical justifications offered to creditors.

In general, the reduction in book values of fixed assets and concurrent reductions in stated capital fail to approximate even fairly closely either the percentage of decrease in replacement costs from the time when most of these fixed assets were set up on the accounts, or the increase in general purchasing power of the dollar during the same period. They evidence, rather, an intention arbitrarily to write down these valuations to a point where depreciation charges will "reflect as small a part of future costs as possible," and thus to make possible greatly increased dividends in the future.[26] The probable

6. Depreciation	600	
Reserve for Depreciation—Cost basis		500
Revaluation Reserve Account		100
(depreciation for 5th year)		

26. A 1933 survey of 34 companies showed that the average write-down of tangible fixed assets was 46% of the former net book values, or anywhere from 30 to 60% in the individual cases. It was noted that the increasingly frequent practice is to write intangible fixed assets down to one dollar. Hornberger, *Accounting for No-Par Stocks During the Depression* (1933) 8 ACCOUNTING REV. 58, 59. Assuming even that all these assets were purchased or revalued upwards at peak prices of 1929, average write-down of tangible fixed assets was at least 20% in excess of the actual drop in general price level, and at least 26% in excess of the actual drop in general construction costs (on the basis of public utility construction costs) from 1929 to the end of 1932, as measured by the Federal Reserve Bank of New York Index of General Prices. See figures given by GRAHAM, PUBLIC UTILITY VALUATION (1934) 22. And certainly in the many cases where intangible fixed assets (and sometimes tangible fixed assets) were written down to one dollar, the extent of the write-down bore no relation to the price level changes. The proponents of the write-down method have defended these seemingly excessive write-downs as giving a true picture of the present values of fixed assets, and erring, if at all, in the direction of "conservative accounting."

result in many cases will be that future working capital will be insufficient either currently to maintain the company's necessary fixed assets at full working efficiency, or to purchase the necessary amount of commodities and services of other kinds. This may mean either that the company will make insufficient provision for repayment to creditors in order to gain necessary additions to working capital or that it will have to borrow further and thus render its position even more precarious.

In addition, there is little to indicate that either the replacement cost or general purchasing power methods of revaluation, now offered in justification of the write-downs, will be applied consistently in times of rising prices so that the theoretical security for creditors will be realized.[27] There is no evidence on balance sheets and profit and loss statements of companies which have made write-downs in recent years that any part of the current earnings made possible by reduced depreciation charges are being segregated in some reserve account to meet the contingency of a future period of rising prices.[28] Therefore, it is likely that if the costs of replacement or the index of the general-level-of-prices rises faster than the company's sales returns during such a future period, management will abandon adherence to either method of revaluation, in order to avoid sharply cutting into dividends, and the creditor's theoretical security will be jeopardized thereby.

Furthermore, the history of most corporations during the period of rising price levels shows the inconsistency of the present theoretical justifications

Daniels answers: "Commercial Solvents Corporation reached the pinnacle of conservatism by writing down plant and equipment from $7,329,121.56 to $1. Daniels, *Principles of Asset Valuation* (1934) 9 ACCOUNTING REV. 114, 116; and see similar examples, particularly as to patents and leaseholds, presented in Farr, *Give the Stockholder the Truth* (1933) 93 SCRIBNER'S 228. "In setting up the blanket amount by which plant assets are to be written down there is some loose discussion of obsolete plants, price levels, water, past appreciation, and overcapacity, but as a rule no effort is made to analyze the plant account carefully and to set up a clear basis for valuation." Paton, *Aspects of Asset Valuations* (1934) 9 ACCOUNTING REV. 122, 128.

27. Proponents of the write-down plan have contended that present deflated price levels have come to stay. "Should Not Block Asset Write-Offs," N. Y. Times, February 5, 1933, II, at 16, col. 1. But patently this is a mere guess, and would not seem to offer adequate answer to the objection that the write-down plan may result in insufficient protection against a sharp rise in price levels, in view of past experience and current inflationary monetary measures.

28. In reducing their stated capital as well as in cancelling off earned surplus or paid-in surplus of the past to offset purported losses in values of fixed assets, many companies have transferred large amounts to surplus accounts variously known as Reserve for Special Contingencies, General Reserve, Reserve for General Contingencies, without any additional explanation of the meaning of these segregations of assets. Farr, *Give the Stockholder the Truth* (1933) 93 SCRIBNER'S 228. These, however, are clearly not segregations of increased earnings made available by reduced depreciation charges on the basis of the new valuations of fixed assets. Thus if the company chooses to preserve in the business the amount of assets represented by these reserve accounts, these assets may in the future furnish some protection against a sharp rise in replacement costs. Nevertheless, the fact that they are so ambiguously described indicates that management does not intend in any way to limit itself to such use of these assets as a buffer fund and that they may at any time be paid out in the form of dividends.

with actual practice in the past. On the surface, the fact that most corporations revalued their fixed assets upward during the period of rising prices and depreciated on the higher basis would tend to indicate that they adhered to the replacement cost or general purchasing power theory of revaluation. Actually, however, the purpose in many cases was only to improve the appearance of the balance sheet by raising the valuation of assets, and, concomitantly, the valuation of invested capital. The fixed asset account or the revaluation-of-fixed assets account was debited for the amount of the unrealized appreciation in value; where this unrealized appreciation was not distributed immediately as dividends, it was treated as an increase of capital, and not of realized income, by making the off-setting credit to a revaluation surplus account. But at the end of each accounting period, management transferred from revaluation surplus to earned surplus account the exact amount by which earned surplus would otherwise have been reduced during that accounting period, due to the increased depreciation charges. Thus, dividends were in no way affected; and management did not in reality retain out of gross income the amount that the increased costs of replacements or rising level of general-index-of-prices indicated would be necessary to keep the company's capital unimpaired.[29] In many cases, this resulted in excessive borrowing and in a socially injurious sales price and wage policy at the time when the actual replacements had to be made.[30]

It would seem, therefore, that the methods of revaluation upon which the write-down movement is purported to be based are likely to prove inconsistent in practice, with consequent danger to creditors. Furthermore, the actual practice indicates that the present write-down movement may injure, first, stockholders, and, secondly, future lenders and investors.

Normally, the average voting stockholder has a self-interest in exercising his vote to retain an efficient and reliable management. An important means of checking on the efficiency and reliability of management must necessarily be the financial statements issued by the corporation. If losses due to bad management can be hidden from the stockholder by management's failure to present them as deductions from current gross income or from earned surplus, the stockholder's check on management is to that extent nullified. It is apparent that a very large portion of the present purported losses in value of fixed assets represent poor judgment of management in purchasing obsolete, unnecessary, or poorly constructed assets.[31] This, perhaps, is one reason why the actual write-downs of fixed assets have generally far exceeded the drop in replacement costs or in the level of the general-index-of-prices. To cancel

29. Daniels, *The Valuation of Fixed Assets* (1933) 8 ACCOUNTING REV. 302, 305-309. This would not apply, however, to the instances in which the appreciation in value of fixed assets was capitalized by means of a dividend of par-value stock to an equivalent amount. In such cases the corporation presumably was required to maintain that capital unimpaired by actually recovering its appreciated value through future depreciation charges.

30. Schmidt, *The Basis of Depreciation Charges* (1930) 8 HARV. BUS. REV. 257.

31. Hornberger, *Accounting for No-Par Stocks During the Depression* (1933) 8 ACCOUNTING REV. 58, 60; Daniels, *The Valuation of Fixed Assets* (1933) 8 ACCOUNTING REV. 302, 313-314. To the effect that the same type of abuse is increasingly evident in write-downs under the English Companies Law, see Morgan, *Company Reconstructions* (London, 1934) 140 THE ACCOUNTANT 346, 347.

losses due to bad management against a reduction in stated capital of the company, without presenting them as expenses on the profit and loss statement or at least as deductions from earned surplus available for dividends, is apt to mislead the stockholder into believing that the losses were due to causes over which the management has no control.[32]

This failure to make a true disclosure of the cause of the losses may also mislead prospective investors and lenders, just as it may mislead present stockholders; and thus result in purchases of stock or loans of money that would not otherwise be made.

Furthermore, even where the write-down is made consistently in relation to the replacement cost or general-index-of-prices standard, it would seem that the present unexplained representations of increased earnings on profit and loss statements, or explanations which infer or openly state that the earnings are due to improvements in the market for the company's commodities or services,[33] are misrepresentations with respect to future lenders or investors. For, when the corporation writes down the book values of its fixed assets, it is in effect discounting all future expected earnings from those assets to the extent that the earning power of its fixed assets tends to fluctuate with replacement costs or the general index of prices. Since those expected earnings are less than what was expected when the asset was originally purchased, or when later revalued upwards, the discounted present value amounts to a lesser sum

32. This is true even where the corporation statute, as in Illinois [ILL. STAT. ANN. (Smith-Hurd, 1934) § 157.60a] and Ohio [OHIO GEN. CODE (Page, Supp. 1935) § 8623-39], seems to require that the requisite proportion of stockholders, whose assent to the reduction of stated capital is necessary to its validity, must also consent to the particular write-offs to be made against the resultant capital surplus. In effect stockholders are forced to accept the statements of management that these write-downs represent actual price level changes, and they are in no position consciously to assent to or dissent from a write-down actually made necessary by poor management. As to the same problem under the English Companies Law, see Morgan, *supra* note 31.

Daniels, *supra* note 4, at 116 states that, if earned surplus is unavailable for purposes of off-setting such losses not due to uncontrollable trends in price levels, the losses should be set up as deferred charges and amortized over future income. Cf. HOXSEY, op. cit. *supra* note 18, at 13-16; KESTER, ADVANCED ACCOUNTING (3d ed. 1933) 542.

33. Thus, United Fruit Company wrote-down its fixed assets by over $40,000,000 in 1931, which increased its profits for 1932 by about $5,000,000 and presumably by that amount or more for each year thereafter. Yet, its report for 1934, as given to the New York Times, speaks of earning $12,049,299 in that year, and infers that the increase in earnings over 1933 and before was due to a lessening of import quota restrictions on bananas in various countries, and to similar improvements in business conditions. No mention is made of earnings due to having written down fixed assets at the end of 1931. "United Fruit Made $12,049,299 in 1934," N. Y. Times, February 5, 1933, at 36, col. 1. The fact that depreciation charges have been decreased may be hidden by recording net operating profit, with no specific deduction for depreciation, but with merely a footnote explanation to the effect that depreciation has already been deducted. See statements of the Doehler Die Casting Company and Radio Corporation of America in POOR'S, INDUSTRIAL (1934); cf. the statement of the Ever Ready Company, Ltd., also reported there.

These misleading presentations of corporate accounts substantially impair the value of comparative balance sheets and income accounts. Nissley, *Effects of Recent Events on Financial Statements* (1933) 55 JOUR. OF ACCOUNTANCY 272, 288-289.

than the discounted value of the earnings as of the time when the asset was purchased. Thus, when the company reduces stated capital concomitantly with the write-down of fixed assets, it is accepting a yet-unrealized loss in advance. If the reduction of stated capital were not now accomplished, those losses would, as realized over the life-time of the fixed assets, presumably impair stated capital approximately to the extent of the present reduction of capital made to offset the write-down of the fixed assets.[34] Under the general American rule, management would then be legally bound in the future to repair that lost capital before paying dividends.[35] By now reducing capital to the approximate extent of that future loss as discounted in advance, the corporation presumably does not intend to attempt to repair those capital losses and is permitted to proceed in the future on a lower capital investment basis without recording the losses (which exist, as calculated on the former investment basis) on its profit and loss statement, as they accrue. Thus, it will in the future have to recover less out of gross income by means of the depreciation charge in maintaining unimpaired the stated capital as reduced. This does not mean, however, that the corporation will not in the future suffer losses, at least as measured in number of dollars, if comparison be made with its capital investment before the reduction in stated capital. Therefore, no matter how much the write-down improves the showing of earnings in the future, as compared with earnings of the past few years, the extent of that improvement from a historical standpoint is the extent of a dollar loss which the corporation, by now reducing its stated capital, has chosen not to repair. Obviously, however, the lender or investor assumes that that showing of improvement in earnings is the measure of the increased value of the corporation's shares, or the decreased risk in purchasing its bonds. For these supposed actual earnings are the primary bases on which he may calculate the present discounted value of all expected future earnings of the company, and therefore the present value of the company's securities, or the risks he takes in lending it money.

It is, therefore, misleading for the corporation to give the impression on future profit and loss statements, either by absence of any explanation or by an express statement, that the improved showing of earnings is due to improved efficiency or an improved market for the company's commodities and services. Nor is it sufficient merely to note the revaluation of fixed assets and concurrent adjustment of capital on the balance sheet at the time of the write-down. Since from a historical standpoint, which is the only safe standard for gauging a company's relative success or failure, the company will be realizing a loss in the future to the extent of all future dividends made possible by the write-down, it is in those future profit and loss statements that the truth should be told to the investor. At least, notation on those statements should be made as to the portion of total earnings that would accrue were depreciation based on the original cost of the fixed assets, and the added amount accruing by reason of the revaluation.

34. Daniels, *The Valuation of Fixed Assets* (1933) 8 ACCOUNTING REV. 302, 303; Sweeney, *Income* (1933) 8 ACCOUNTING REV. 323.

35. Notes 11 and 15, *supra*.

III

Despite the possibilities of inconsistency and abuse presented by the write-down movement, little legislative attention has been given to the problem. There are five main groups of existent state statutes which may possibly afford some protection to creditors.

The first group[36] is represented by the statutory provisions of seven states to the effect that "no reduction shall be made in capital unless the assets remaining after such reduction are sufficient to pay any debts."[37] These provisions seem to be intended primarily to apply to the situation where liquidating dividends are paid directly from the capital surplus transferred from stated capital. If a company is unable to pay its debts in the future as a result of having paid dividends out of the supposed earnings derived from the present write-down of fixed assets, concurrent with reduction of stated capital, that inability will be due presumably, not to paying dividends directly out of assets represented by the capital surplus transferred from stated capital, but to having written capital investment down too far in offsetting the devaluation of fixed assets. Thus the future capital retained in the business will be insufficient to replace fixed assets or to purchase necessary commodities and services of other kinds. Therefore, if statutory provisions of this type are strictly construed, they would seem inapplicable to the cancellation of fixed asset losses against capital surplus transferred from stated capital. Liberally construed, however, they may perhaps be held to render management liable where the future inability to pay debts results from the present reduction of stated capital below an amount which, if maintained unimpaired in the future, would be reasonably sufficient, as indicated by the present level of replacement costs or general-index-of prices, to maintain the company in a solvent condition.

The second group is represented by the provisions of three statutes to the effect that the reduction of capital must not injure the rights of creditors.[38] Possibly by reason of their ambiguity, these provisions seem more applicable to the method of using the capital surplus, transferred from stated capital, to offset a devaluation of fixed assets. Nevertheless, that very ambiguity as to the particular conduct forbidden renders the protection doubtful.

A third type is illustrated by the relatively unimportant corporation law of Arizona, which provides that "a fictitious increase or decrease of stock shall

36. The ten statutes (those of Arkansas, Florida, Idaho, Louisiana, Maryland, Minnesota, New York, Ohio, Tennessee and Wyoming) which provide that the reduction in stated capital may not go below a stated sum, varying between $300 and $1000, and/or that the corporation may distribute any of its assets over liabilities plus capital stock as reduced would make possible practically unlimited reduction of stated capital and concurrent write-off of fixed asset valuations to the same extent. Hence they seem to furnish no protection to creditors against abuse of the write-down movement, and are not included in the discussion.

37. CONN. GEN. STAT. (1930) § 3420; Del. Laws 1929, p. 389; ILL. STAT. ANN. (Smith-Hurd, 1934) § 157-60; MASS. ANN. LAWS (1932) c. 156, § 45; NEV. COMP. LAWS (Hillyer, Supp. 1934) § 1624; OHIO GEN. CODE (Page, Supp. 1935) § 8623-40; R. I. Laws 1931-1932, c. 1941, § 53 (B and C).

38. ME. REV. STAT. (1930) p. 874, § 51; S. C. CODE (1932) § 7689(a); VA. CODE (Michie, Supp. 1932) § 3781.

be void."[39] This provision is similarly ambiguous. Its language may be construed to mean, however, that a reduction of stated capital and concomitant devaluation of fixed assets below any reasonable estimate of the actual drop in replacements costs of the company's fixed assets or of the general-index-of-prices level is "fictitious" and therefore illegal.

A fourth group is represented by the statutes of four western states and the District of Columbia.[40] In substance, these require that stated capital must not be reduced below the amount of the company's liabilities or any probable liabilities, the latter as measured by the estimated cost of the fixed assets which it may be the purpose of the corporation to construct. The Utah statute allows the reduction of state capital to an amount equal to one-half the amount of the company's liabilities. These provisions may offer more adequate protection to the creditor in that he may be assured that at least a substantial "capital cushion" will be maintained unimpaired following the reduction of stated capital. But the mere fact that stated capital, as reduced, is equal to the amount of the outstanding liabilities, or in the one case, to one-half those liabilities, does not assure the creditor that that capital will be sufficient to enable the company to replace its fixed assets in the future or to purchase other commodities and services necessary to maintaining the company in a solvent and fairly secure position.[41] In the final analysis, such an assurance is usually the only real protection to creditors.

All of the foregoing statutes have the common defect that they offer no special provisions for enforcement.[42] All are seemingly governed as to enforcement by the ordinary dividend provisions of the state corporation law, which usually make the directors or stockholders liable to creditors in the event of dissolution or insolvency caused by failure to comply with the statutory requirements as to reduction of capital.[43] Creditors, therefore, are probably

39. ARIZ. REV. CODE (Struckmeyer, 1928) § 589.

40. N. D. COMP. LAWS ANN. (Supp. 1925) § 4557(2); OKLA. STAT. (1931) § 9775; WYO. REV. STAT. ANN. (1931) § 28-136; UTAH REV. STAT. ANN. (1933) § 18-2-44; D. C. CODE (1929) §§ 289-295. The California statute falls in a similar category by requiring that no payment of dividends be made from the surplus resulting from reduction of stated capital, unless remaining assets "taken at their fair present value will at least equal one and one-quarter times its debts and liabilities." CAL. CIV. CODE (Supp. 1933) § 348(b). The statute of North Carolina seems to require that the remaining assets equal one and one-third the total amount of liabilities. N. C. CODE ANN. (Michie, 1931) § 1179.

41. It has also been criticized as neglecting the importance to creditors of the distinction between liquid, as opposed to frozen assets. Legis. (1934) 47 HARV. L. REV. 693, 696.

42. Three statutes provide that stated capital may not be reduced below the value of preferred stockholder's preference on dissolution, unless, as stated in the Minnesota statute, a majority of such class assent to the reduction of its preference. CAL. CIV. CODE (Deering, Supp. 1933) § 348; ILL. STAT. ANN. (Smith-Hurd, 1934) § 157.60; Minn. Laws 1933, c. 300, § 38. These statutes, while intended to protect holders of preferred stock with dissolution preference rather than creditors, also may tend to assure creditors of the maintenance of a minimum "capital cushion." This is clearly a doubtful protection, however, particularly where, as in Minnesota, that class of stockholders is expressly allowed to renounce its rights.

43. See, for example, ARK. STAT. ANN. (Castle, Supp. 1931) § 1701z; CONN. GEN. STAT. (1930) § 3386; FLA. COMP. LAWS ANN. (1927) § 6581; Minn. Laws 1931, § 38 (III); S. D. COMP. LAWS (1929) § 8777-F; UTAH REV. STAT. ANN. (1933) § 18-2-17.

left with the dubious protection of being able to invoke these statutory limitations subsequent to the actual reduction of stated capital and at the time of insolvency. Furthermore, these plaintiffs would probably have the difficult burden of proving the direct connection between the excessive write-down and the subsequent actual damage sustained by them, perhaps many years later.

This result may be modified, however, by the provisions in five statutes requiring that, shortly after the corporation files its certificate of reduction of capital with the proper state officer, it shall publish a more or less detailed notice of its plan of reduction of stated capital once a week for a period usually of three or four weeks in a newspaper of general circulation of the county in which the principal office of the corporation is located.[44] In the Delaware statute, this provision is coupled with a specific provision that, in the event that the corporation fails to comply, its directors and stockholders shall be liable to creditors to the amount of the damage suffered by them as a result.[45] By interpreting these provisions as to publication as intended to enable creditors to receive notice of the write-down and thus to protect themselves, and by construing them together with the provisions limiting the extent to which the corporation is permitted to reduce its stated capital, it is possible to interpret the limitations on the reduction of capital in these five statutes as intended to give creditors an injunctive remedy where creditors' rights are threatened by the reduction proceedings, and not merely a claim for recompense when the actual damage is suffered.

Only one statute has specifically provided for preventive, rather than merely remedial measures in protection of creditors. The Texas statute, after directing that no reduction of stated capital shall prejudice the rights of creditors, requires that the corporate management shall furnish the Secretary of State with a list of the names and addresses of all the company's creditors, and the amount due each, as well as with proof by affidavit of the financial condition of the corporation. The Secretary of State may require that the company's debts be paid or reduced as a condition precedent to allowing the reduction in stated capital.[46] This statute is the closest approach that any American state has made to the comprehensive procedure provided by the English Companies Act for the protection of creditors in event of a reduction of capital.[47] As compared with that Act, however, it is seriously defective, in that it makes no provision for affording to any objecting creditors a hearing before a tribunal competent for the purpose and with broad discretionary powers of approval, modification or rejection, either of the claims of any creditor or of the company's plan for reducing stated capital.

44. GA. CODE ANN. (Michie, 1926) § 2201; KAN. REV. STAT. ANN. (1923) §§ 17-215 to 17-217; N. J. STAT. SERVICE (1932) § 47-29; N. M. STAT. ANN. (1929) § 32-134; N. C. CODE ANN. (Michie, 1931) § 1161.

45. Del. Laws 1929, p. 389.

46. TEX. ANN. CIV. STAT. (Vernon, 1925) art. 1332.

47. 19 & 20 GEO. V, c. 23, §§ 55-60 (1929). Section 56(2) of the Companies Law seems to make the procedure provided in the act for the protection of creditors mandatory upon the court only where the reduction of capital is to be followed by payment of dividends from the resultant capital surplus, and discretionary where the purpose is to "cancel any paid-up share capital which is lost or unrepresented by available assets." (Section 55b).

In some cases, there is a possibility that creditors may find a remedy under the provisions of the trust indenture between the settlor corporation and the trustee holding the settlor's collateral securities for the benefit of bondholders. Indentures may provide that the settlor corporation will not during the lifetime of the bonds reduce stated capital below a certain percentage of its stated capital as it stood when the declaration of trust was made.[48] Or, in some cases the settlor may be a holding company and may have deposited bonds and stocks of its subsidiaries with the trustee as security for the payment to its bondholders, covenanting that it would not during the lifetime of the bonds permit its subsidiaries to reduce their capital stock below a certain percentage of their stated capital, as of the date when the holding company's declaration of trust was made.[49] Or the settlor may have covenanted that it would during the lifetime of the bonds retain in the business an amount of its future earnings, equal to that set aside periodically in a sinking fund, to provide a sinking fund reserve as a "capital cushion" over and above the amount guaranteed to be set aside year by year in a sinking fund.[50]

48. Thus, for example, the reorganization plan agreement which terminated the receivership of the Aetna Explosives Company in 1918 provided that the mortgage securing Series A and B bonds should contain a provision to the effect "that the company shall not, on or before Jan. 1, 1929, reduce its stated capital below an amount equal to 80% of the Series B bonds then outstanding; and shall not, after Jan. 1, 1929, and prior to the retirement of all the Series B bonds, so reduce such stated capital below an amount equal to 100% of the par value of the Series B bonds then outstanding." (1918) 108 COMM. AND FIN. CHRON. 2242. A similar provision is found in the trust indenture between the Duquesne Light Company and the Chase National Bank on 15 year 7½% Convertible Debenture Gold Bonds (1921) art. 4, § 3, p. 27. A search of close to 100 other trust indentures failed, however, to disclose any other similar provisions.

49. For example, see the AGREEMENT OF ASSIGNMENT AND PLEDGE BETWEEN THE GREAT WESTERN UTILITIES COMPANY AND THE DES MOINES NATIONAL BANK, TRUSTEE (1928) § 4(c), p. 50; INDENTURE OF TRUST BETWEEN THE GULF STATES STEEL COMPANY AND THE UNITED STATES MORTGAGE AND TRUST COMPANY, $6,000,000 15 year 5½% Sinking Fund Gold Debentures (1927) 18, Art. II, § 5.

50. For example, see the FIRST MORTGAGE AND COLLATERAL TRUST INDENTURE OF THE HERSHEY CHOCOLATE CORPORATION TO THE NATIONAL CITY BANK OF NEW YORK (1920) Art. 3, § 23.

Some protection may also be afforded by provisions in some indentures to the effect that the trustee shall have the right to vote upon a proposed reduction of the capital stock of companies whose securities have been given by the settlor to the trustee as collateral, or that the stock of subsidiaries in the hands of the trustee shall not be so reduced "as to render it less than a controlling interest in the hand of the trustee." For example, see FIRST AND REFUNDING MORTGAGE OF THE GREAT WESTERN POWER COMPANY OF CALIFORNIA TO THE BANKERS TRUST COMPANY (1919) 105, § 5; TRUST INDENTURE FROM THE CHILE COPPER COMPANY TO THE GUARANTY TRUST COMPANY OF NEW YORK (1917) 61, Art. 7, § 6; FIRST LIEN INDENTURE 5% 30 YEAR GOLD BONDS FROM THE GEORGIA, LIGHT, POWER AND RAILWAYS COMPANY TO THE NEW YORK TRUST COMPANY (1911) 35, § 9; FIRST MORTGAGE, 4% 50 YEAR GOLD BONDS OF THE GENESEE RIVER RAILROAD COMPANY TO THE STANDARD TRUST COMPANY OF NEW YORK (1907) 30, Art. 3.

For brief discussions of such covenants in the light of the write-down movement, see HOXSEY, op. cit. *supra* note 18, at 23-24; KESTER, ADVANCED ACCOUNTING (3d ed. 1933) 543-544. To the effect that covenants in trust deeds may furnish an important legal weapon to creditors in checking abuses of the write-down movement, see Hoyt v. E. I. Dupont de Nemours Powder Co., 88 N. J. Eq. 196, 102 Atl. 666 (1917).

The existent statutory protection to stockholders against possible use of the write-down plan by management as a means of covering up its errors or fraud seems likewise inadequate. So far as appears, only two states require that the company's stockholders assent to the particular use to be made of the capital surplus transferred from stated capital, where a cancellation of loss in fixed asset or similar values is contemplated.[32] Hence management is free to cancel almost any losses against the capital surplus account, without explanation to stockholders.[51] Furthermore, probably few stockholders are aware of the intricacies of depreciation theory, so that, even where stockholders have consented to the cancellation of an excessive write-down of fixed assets against capital surplus transferred from stated capital, not knowing that the write-down is excessive, few if any would realize or remember in the future that dividends then accruing, assuming that they are represented to the stockholders as earnings, are anything but indicative of good management. And the likelihood, as evidenced by the actual practice, is that those dividends will be unqualifiedly represented as from earnings. While at least four statutes provide that notice of the source of dividends paid directly from the capital surplus transferred from stated capital be given to the recipients at the time of payment,[52] no states have enacted the logically corollary requirement that recipients of dividends due to lowered depreciation charges under the write-down plan be apprised of the fact that the dividends are not from earnings, as that term is understood by the ordinary investor. Furthermore, a provision of the Ohio statute specifically allows management to write off "any particular loss or expense" against any paid in surplus and thereby to "make available for dividends without notice as to the source of such dividends any earned excess of assets resulting therefrom or thereafter arising"; and requires only that a disclosure of such action be made "in the next annual statement of the corporation."[53]

This lack of protection for the stockholder, which may result in his injury, may also result in misleading the future lender or investor in at least two ways. First, the company's stocks and bonds may attain undeservedly high market values by reason of a bad management being thus able, at least temporarily, to show increased earnings, instead of losses. Secondly, even where the losses are not due to the management, the fact that the true source of

51. This may be modified to some extent, however, by a recent ruling of the Stock List Committee of the New York Stock Exchange. While not taking a "categorical" stand on the subject of the write-down of fixed assets, the Stock List Committee has asked both petitioning and already listed issuing corporations to report to stockholders in full detail and for their "specific approval" the purposes and methods of capital stock reduction, together with the resultant adjustments. Information based on a communication of November 9, 1934, from J. M. B. Hoxsey, Executive Assistant of the Stock List Committee, to the YALE LAW JOURNAL.

52. CAL. CIV. CODE (Deering, Supp. 1933) § 346 (3); ILL. STAT. ANN. (Smith-Hurd, 1934) § 157.60. The statutes of Ohio, Louisiana, and Michigan have provisions as to dividends, although not expressly as to dividends resulting from reduction of stated capital, which seem to require such notice. OHIO GEN. CODE ANN. (Page, Supp. 1935) § 8623-38(d); LA. GEN. STAT. (Dart, 1932) § 1106 (II) and see § 1126 (II); Mich. Laws 1931, pp. 575-576, § 22.

53. OHIO GEN. CODE (Page, Supp. 1935) § 8623-38(e).

future improved earnings is hidden is likely to result in an artificial inflation of the values of the company's stocks and bonds, unjustified by the actual financial condition of the company.

Under the Securities Act[54] and the Securities Exchange Act,[55] the Federal Securities and Exchange Commission may, perhaps, protect future lenders and investors by requiring that the companies under its jurisdiction inform the public by means of the documents filed with the Commission, as to the basis chosen for revaluation of fixed assets and accounting for depreciation, the date of the write-down of fixed assets and stated capital, if any, and the proportion of future earnings shown, which are actually due to the company's having cancelled the present unrealized loss in fixed asset values against stated capital. These facts would be shown in each balance sheet and profit and loss statement of the company as the improved earnings accrue.[56] It is doubtful, however, that the Acts would also offer to the future lender or investor any substantial means of recovering damages from company officers who sign the statements filed with the Commission, to the extent of any injury caused the lender or investor by the seeming misrepresentation of earnings under the write-down plan. The plaintiff's burden under the Securities Exchange Act of proving the defendant's bad faith and knowledge of the false or misleading character of the information or omissions in the statements, as well as the plaintiff's reliance and the causal connection between the reliance and the damage, and the somewhat lighter, but substantially similar burden under the Securities Act,[57] will probably close this avenue of redress. Courts would be particularly loath to hold directors or other officers liable in such cases where such persons have proceeded in apparent good faith under state statutes which seem to allow cancellations of devaluations of fixed assets against capital surplus transferred from stated capital, without any notice in future corporate statements as to the source of the improved earnings derived from the write-downs.[58]

IV

The reduction of stated capital to offset a write-down of fixed assets is only one of the many methods by which corporate managements are seeking to

54. 48 STAT. 74, 15 U. S. C. A. § 77 (a) et seq. (1933), as amended by 48 STAT. 905, 15 U. S. C. A. § 77b (1934).

55. 48 STAT. 881, 15 U. S. C. A. § 78a (1934).

56. 48 STAT. 74, § 7, 15 U. S. C. A. §77g (1934); and Schedule A (25, 26); 48 STAT. 894, § 13, 15 U. S. C. A. § 78m (1934. In this connection, see "SEC Splits on Data Filed by a Utility," N. Y. Times, November 22, 1934, at 31, col. 3.

57. See Comment (1935) 44 YALE L. J. 456, 470-475.

58. While only the Ohio statute expressly allows such absence of notice (*supra* note 53) the statute of Illinois may be interpreted to reach the same end, since it expressly allows the use of capital surplus, transferred from stated capital, to offset any deficits "arising . . . from a diminution in the value of . . . assets." ILL. STAT. ANN. (Smith-Hurd, 1935) c. 32, § 157.60a. The statute fails to require any notice to recipients as to the source of dividends arising therefrom, although expressly requiring notice where dividends are paid directly from the capital surplus. Note 52, *supra*.

continue dividends in spite of heavy actual and prospective losses.[59] These methods have also been much in evidence in England and the British dominions in recent years.[60] Nevertheless, despite the extent and importance of the interests involved, no litigation involving the write-down movement appears yet to have arisen in the United States,[61] although the cases abroad are increasing in number.[62] In the case of creditors, the lack of litigation involving the write-down movement in the United States is probably due to many different reasons. Thus, the creditors may be ignorant of the dangers presented. They may in many cases lack sufficient organization and consequently depend on the initiative of the investment bankers who floated the bond issues, but whose self-interest may be more akin to that of the corporate management than to that of the bondholders. Also, they may fear to press management too hard by preventing it from paying dividends, thus encouraging it to choose the alternative of reorganization proceedings, which might put at least certain classes of creditors in an even worse position. Again, some creditors may believe that the increased showing of earnings will perhaps improve the creditor's actual security by facilitating the efforts of the company to obtain fresh capital by means of new stock issues and also by enabling the company to float new bond issues, with the proceeds of which to pay off present creditors at the time their

59. Other methods include the cancellation of past deficits, accumulated arrears in dividends on preferred stock, expected inventory, securities, exchange and other losses against capital surplus transferred from stated capital, or against paid-in surplus created by stating capital at less than the full consideration received for no-par stock. See examples in Farr, *Give the Stockholder the Truth* (1933) 93 SCRIBNER'S 228. Often dividends are paid directly from the capital surplus transferred from stated capital. The write-down movement seems to have begun late in 1931 with the cancellation of expected security losses against stated capital by investment trusts and finance companies. "Should Not Block Asset Write-Offs," N. Y. Times, Feb. 5, 1933, II, at 16, col. 1; see also HOXSEY, op. cit. *supra* note 18, at 1. Similar measures seem to have been adopted, although in lesser degree, during the 1921-1922 depression. Cartinhour and Dewey, *Capitalization Changes as a Result of the Depression* (1932) 4 CORPORATE PRACTICE REV. 26. Other purposes for reducing stated capital include the reduction of franchise tax and transfer tax charges (the latter where no-par is changed to par of low nominal value). In general, see Comment (1935) 21 VA. L. REV. 562; Hornberger, *Accounting for No-Par Stocks During the Depression* (1933) 8 ACCOUNTING REV. 58; Marple, *The Source of Capital Surplus* (1934) 9 ACCOUNTING REV. 75; Nissley, *Effects of Recent Events on Financial Statements* (1933) 55 JOUR. OF ACCOUNTANCY 272; "Trend to Cut Book Values" N. Y. Times, December 18, 1932, II, at 15, col. 3; "Urges Better Accounting," N. Y. Times, April 22, 1932, at 34, col. 4.

60. Morgan, *supra* note 31, at 346; Anonymous, *Financial Manipulation: A Project of Reform* (Canada 1933) 40 QUEEN'S QUARTERLY 264; *Reconstruction and Reduction of Capital—An Important Judgment* (1933) 2 So. AFRICAN L. T. 46; "City Notes—Important New Issues," The Times (London), May 7, 1930, at 21, col. f.

61. An earlier decision, however, touches on important aspects of the problem, so far as creditors with trust deed security are concerned. Hoyt v. E. I. Dupont de Nemours Powder Co., 88 N. J. Eq. 196, 102 Atl. 666 (1917).

62. E.g., Atkinson-Oates Motor, Ltd., 1932-1933 South African Law Reports (Orange Free State Provincial Division) 111. Several other similar cases are reported in (1933) 1 So. AFRICAN L. T. 152, 174. Morgan, loc. cit. *supra* note 1, states that "such schemes have recently been a feature of public company practice" on account of the "vast amount of money involved, violent opposition of shareholders, length, and expensive litigation."

claims mature. The present bondholder may consequently find the market value and salability of his bonds improved. Finally, in many cases the principal deterrent may be the lack of adequate legal remedies for creditors who object. In the case of stockholders, this lack of litigation may again be due to many different reasons. Many stockholders may be ignorant of the dangers, although this point is to some extent modified by the fact that at least ten state statutes require that management give the stockholders a more or less detailed summary of the proposed plan for reducing stated capital in notifying them of the meeting called for a vote on the proposed plan,[63] and that at least two of those ten statutes[32] require that a certain portion of stockholders must consent to the particular plan for making use of the capital surplus transferred from stated capital. In addition, many stockholders may desire to reap dividends or to improve the present salability of their shares, irrespective of the possibility that the equity represented by the shares may at some future time be damaged or wiped out as a result. Another reason may be derived from the fact that, in at least thirteen states,[64] only the consent of a certain proportion of voting shares is ordinarily necessary to effectuating the reduction of stated capital, so that possibly dissenting non-voting shares would therefore not be heard, and from the fact that, in at least one state, adversely affecting non-voting classes of shares may be barred from voting on the reduction of capital by reason of a provision in the company's articles or an amendment thereto.[65] Finally, a reason for lack of serious objection by stockholders may

63. ALA. CODE ANN. (Michie, 1928) § 7003; CAL. CIV. CODE (Deering, Supp. 1933) § 348; ILL. STAT. ANN. (Smith-Hurd, 1934) c. 32, § 157.59; N. D. COMP. LAWS ANN. (Supp. 1925) § 4557; OHIO GEN. CODE ANN. (Page, Supp. 1935) § 8623-39; OKLA. STAT. (1931) § 9775.

64. DEL. LAWS 1933, p. 388; GA. CODE ANN. (Michie, 1926) § 2201; IDAHO CODE ANN. (1932) § 29-148; LA. GEN. STAT. (Dart, 1932) § 1125; ME. REV. STAT. (1930) p. 874, §§ 51, 52; Minn. Laws 1933, c. 300, § 38; MONT. REV. CODE (1921) §§ 5920-5922; N. C. CODE ANN. (Michie, 1931) § 1131; R. I. Laws (1931-1932) c. 1941, § 53 (B2); TENN. CODE ANN. (Williams, 1934) § 3736; UTAH REV. STAT. ANN. (1933) § 188-2-44; VA. CODE (Michie, Supp. 1932) § 3781; Wash. Laws 1933, c. 185, § 40. The Tennessee statute would allow a reduction of stated capital merely by a resolution of the board of directors and without any requirement that assent of stockholders be secured, where the certificate of incorporation of the company or any amendment thereto authorizes such procedure. Similarly, the North Carolina statute would appear to allow a reduction by a mere resolution of the board of directors where the reduction is not accompanied by an amendment to the corporate charter.

65. W. VA. CODE (1931) 31-1-12, § 12. However, seven statutes provide in substance that no plan for the reduction of stated capital and/or distribution of resultant excess assets shall discriminate between holders of different classes of stock in violation of the equal or prior rights of holders of any single class or classes. FLA. COMP. LAWS ANN. (1927) § 6548; LA. GEN. STAT. (Dart, 1932) § 1126; MISS. CODE ANN. 1930 § 4133; NEV. COMP. LAWS (Hillyer, 1929) § 1624; N. Y. CONSOL. LAWS (Cahill, 1930) c. 60, § 38 (12); OHIO GEN. CODE (Page Supp. 1935) § 8623-39 (such a meaning may be implied from the statement that the reduction may be made in "any way not unfair, inequitable or repugnant to law"); TENN. CODE ANN. (Williams, 1934) § 3736. The statutes of Delaware, Florida, Mississippi, Nevada, New York, Tennessee and West Virginia, however, permit such discriminations where a certain proportion of the shares of the classes adversely affected have voted for the plan of reduction of stated capital.

be suggested by the fact that in only one state is it possible for a dissenting stockholder to bring suit, within a proper period following the stockholders' meeting at which the management's plan was adopted, to have the plan annulled or modified, so that the reduction in capital shall not exceed the actual impairment of capital.[66]

No matter what practical non-legal considerations exist to restrain many creditors and stockholders from litigating the validity of the write-downs, these considerations do not apply to all such interested persons; nor do they prove the social desirability of the write-downs. Adequate legal remedies must be afforded those who wish to contest the validity of the write-downs, or to secure compensation for their resulting injuries. The effect of the existence of such remedies would be not only to protect these individuals through actual litigation, but also to exercise a healthy restraining influence on the discretion of corporate management. By providing those remedies and thus checking the more patent abuses and inconsistencies of the write-down movement, state legislatures may do much to guide the movement into socially more desirable channels.

The write-down plan should be treated by the state legislatures as a form of voluntary reorganization of presumably solvent companies.[67] For it involves a recapitalization on a lower investment basis, which may present grave dangers to the security of creditors. Furthermore, it is usually accomplished by the wiping out of at least a part of the shareholder's book equities, although not necessarily his real equities. And it may often be accompanied by the modification or wiping out of the preferences of certain classes of shares and by grossly unequal treatment between various classes.[68] In fact, at least one corporation statute provides specifically that a reduction of stated capital may be treated as a voluntary reorganization, giving dissenting stockholders certain rights[69] which the same statute seemingly allows management to avoid at will

66. ME. REV. STAT. (1930) p. 874, § 53. The New York Statute provides, however, that a stockholder who dissents from the proposal to reduce stated capital and whose preferential rights would be adversely affected by the plan of reduction, may make a demand upon the corporation at least twenty days prior to the date on which the meeting of stockholders is held, to have his shares appraised by appraisers appointed by a court and to secure payment of the appraisal value in return for his shares. N. Y. CONSOL. LAWS (Cahill, Supp. 1934) c. 60, §§ 21, 38.

67. One of the arguments, or threats which accompanied the propaganda in favor of the write-down movement was that, if such write-downs were not voluntarily allowed to be accomplished, the same results could be achieved by means of receivership, reorganization or merger. "Urges Better Accounting," N. Y. Times, April 22, 1932, at 34, col. 4; HOXSEY, op. cit. *supra* note 18, at 22; see Daniels, *supra* note 4, at 302, 309.

To the effect that such reductions of stated capital and accompanying write-offs are in effect voluntary reorganizations or liquidations of part of the corporate business, see Seeley v. New York Nat. Exchange Bank of New York, 8 Daly 400, 402 (N. Y. 1878), aff'd, 78 N. Y. 608 (1879); Strong v. Brooklyn Cross-Town Rr. Co., 93 N. Y. 426 (1883); see cases cited in Greenough and Ayer, *Funds Available for Corporate Dividends in Washington* (1934) 9 WASH. L. REV. 63, 72 n. 35.

68. See Morgan, *supra* 31 at 346.

69. OHIO GEN. CODE ANN. (Page, Supp. 1935) § 8623-72. The dissenting stockholder is given a right to file a written demand upon the corporation within twenty days of the stockholder's meeting at which the reduction of stated capital was approved, for cash pay-

by simply calling the procedure a reduction of stated capital, and following the ordinary statutory procedure provided for the latter purpose.[70]

If on considerations of political expedience and convenience it is impractical for the states to provide expertly qualified administrative tribunals to supervise the often complex adjustments of these voluntary reorganizations, the problem should be handled by state courts of general jurisdiction with broad, discretionary powers.[71]

One possible statutory procedure for handling these voluntary reorganizations might be to require first that the corporate management pass a resolution setting forth in complete detail a statement of the company's financial condition, together with the extent, method, and reasons for the proposed reduction of capital, the nature of the losses proposed to be cancelled by that means, the amount of the future dividends, if any, expected to be produced thereby, or the amount of any proposed liquidating dividend to be paid directly from capital surplus transferred from stated capital.[72] Every stockholder should then be mailed a notice of the special stockholders' meeting to vote on the proposed plan, the notice to contain the directors' resolution in full[73] and to be mailed at least a month in advance of the meeting[74] in order to give the

ment of the fair value of his shares as of the day before the vote was taken. The New York statute, however, has the same provision in its procedure for reduction of stated capital. Note 66, *supra*.

70. The section of the statute devoted to the procedure for accomplishing a reduction of stated capital concludes: "Any reduction . . . and any adjustment or change so authorized shall be presumed to be fair and equitable to all shareholders." OHIO GEN. CODE ANN. (Page, Supp. 1935) § 8623-39.

71. This is the method used under the English Companies Law, which requires that, before the reduction of share capital may be effected, the special resolution of the corporation and its stockholders for the reduction of share capital must be confirmed by the court on petition of the company; and the order of the court, together with the minutes of reduction taken by the court, must be filed with the Registrar of Companies. 19 & 20 GEO. V, c. 23, §§ 55, 58 (1929). The only American statute which requires confirmation by a court is that of Maine; but it requires confirmation only where, within thirty days after the stockholders' meeting which resulted in a favorable vote on the proposed reduction of stated capital, a dissenting stockholder brings a suit in equity for revision of the proceedings on the ground that the reduction exceeds the "actual impairment of capital." The court may in such case annul or modify such reduction proceedings. The action of the court, or in case no bill in equity is filed, the action of the corporation in accordance with the statutory procedure, shall be conclusive on all parties, whether stockholders or creditors. ME. REV. STAT. (1930) p. 874, § 53.

72. While no existent state statute goes to this extent in requiring detailed information as to the reduction of stated capital in the resolution, at least one statute goes a substantial distance in this direction. OHIO GEN. CODE (Page, Supp. 1935) § 8623-39.

73. The following statutes, for example, are similar in that they require the purpose and amount of the proposed reduction of stated capital to be set forth in the notice: N. D. COMP. LAWS ANN. (Supp. 1926) § 4557; OKLA. STAT. (1931) § 9775. So far as appears, however, no statute requires that the notice to stockholders contain the complete information here proposed to be required.

74. At least two statutes require thirty-days notice. ARIZ. REV. CODE (Struckmeyer, 1928) § 589; ALA. CODE ANN. (Michie, 1928) § 7003. The Kentucky statute provides for 20 days notice. KY. STAT. (Carroll, 1930) § 553. Delaware requires only ten days notice Del. Laws 1933, pp. 388-391. Practically all the remaining statutes have no time requirement whatever.

stockholder adequate opportunity to consider the proposal. Directors should be made civilly liable to stockholders for false or misleading statements or omissions in the resolution as printed in the notice, to the extent of the damage the stockholder may suffer as a result.[75] The proxy accompanying the notice should contain equal space both for an affirmative and a negative answer, to avoid malpractices in this respect that have appeared in England and, perhaps, also in the United States.[76] The affirmative vote of at least a majority, preferably two-thirds in amount of each class of shares, should be required.[77] Fol-

75. As a result of abuse of the write-down movement in England, suggestion has been made that the Companies law be amended to make directors liable in such cases, just as they are liable for misleading or untrue statements in prospectuses. Morgan, *supra* note 31, at 346, 347.

76. Morgan, *supra* note 31. Parliament is now being pressed to amend the English Companies Law to this effect.

77. The provisions of the statutes vary considerably in this respect. Delaware requires the written consent of all voting shares, or a resolution of the board of directors plus the favorable vote of a majority of voting shares at a special meeting of stockholders called for the purpose. Del. Laws 1933, p. 388, § 28 (a) (b). With varying limitations, eight statutes require the assent of a majority of voting shares. GA. CODE ANN. (Michie, 1926) § 2201; ILL. STAT. ANN. (Smith-Hurd, 1934) § 157.59; ME. REV. STAT. (1930) p. 874, § 51 (where however, the reduction is for the purpose of wiping out an impairment of capital, as in the case of write-down of fixed assets, a favorable vote of two-thirds of all outstanding voting stock is required); Minn. Laws 1933, c. 300, § 38 (I); NEV. COMP. LAWS (Hillyer, 1929) §§ 1606, 1624 (plus favorable vote of the majority of shares of any class or classes whose preference would thereby be decreased); TENN. CODE ANN. (Williams, 1934) § 3736; UTAH REV. STAT. ANN. (1933) §§ 18-2-44 to 18-2-45 (unless the articles of incorporation otherwise provide). Nine statutes require the affirmative vote of a majority of outstanding shares, whether voting or non-voting. ARIZ. REV. CODE (Struckmeyer, 1928) § 589; ALA. CODE ANN. (Michie, 1928) § 7003; CAL. CIV. CODE (Deering, Supp. 1933) § 348; IND. STAT. ANN. (Burns, 1926) § 4834; MASS. LAWS ANN. (1933) c. 156, § 41 (if two or more classes of stock have been issued, the favorable vote of a majority of each class outstanding and entitled to vote is required, including in any event, where par value stock is changed to no-par, a majority of the outstanding stock of each class adversely affected); NEB. COMP. STAT. (1929) § 24-103; N. H. Laws 1931, c. 69; ORE. CODE ANN. (1930) § 25-223; PA. STAT. ANN. (Purdon, 1930) tit. 15, § 281-5. Twelve statutes require a two-thirds affirmative vote of all shares. COLO. STAT. ANN. (Courtright, 1930) § 1016; CONN. GEN. STAT. (1930) § 3420; D. C. CODE (1929) tit. 5, §§ 289-295; KAN. REV. STAT. ANN. (1923) §§ 17-215 to 17-217; KY. STAT. (Carroll, 1930) § 553; MICH. COMP. LAWS (1929) § 10010; N. D. COMP. LAWS ANN. (Supp. 1925) § 4557; OKLA. STAT. (1931) § 9775; S. C. CODE (1932) § 7689(a); TEX. CIV. STAT. ANN. (Vernon, 1927) art. 1332; VT. PUB. LAWS (1933) § 5795 (but if the stock be divided into several classes, the favorable vote of two-thirds of each outstanding class entitled to vote is necessary); WIS. STAT. (1931) § 180.07; WYO. REV. STAT. ANN. (1931) §§ 28-137 to 28-139. Six statutes require an affirmative vote of two-thirds of all voting shares. IDAHO CODE ANN. (1932) § 29-148; LA. GEN. STAT. (Dart, 1932) § 1125; Mont. Laws 1931, §§ 5918-5923; N. Y. CONSOL. LAWS (Cahill, 1930) c. 60, § 37, 3a, 3b (if the purpose of the reduction is merely to reduce or increase the number of no-par or par shares, or in case all of the company's capital stock is divided into par value shares, only a favorable vote of a majority of voting shares is required; but if the preferences of any class or classes of shares will thereby be changed, there must also be a favorable vote of two-thirds of the shares of such class); VA. CODE (Michie, Supp. 1932) § 3781; Wash. Laws 1933, c. 185, § 40. Rhode Island requires the affirmative vote of a majority of the shares of each voting class. R. I. Laws 1931-32, c. 1941, § 53, cl. B (2).

lowing the affirmative vote, management should be required to petition the proper court for confirmation of the proposed plan,[78] submitting to the court the resolution properly signed by the company's executive officers, a copy of one of the notices to the stockholders, separate lists of the names and addresses of assenting and dissenting stockholders,[79] and the certified proxies or ballots upon which stockholders cast their vote,[80] together with lists of the names and addresses of any other stockholders and of all creditors and the nature and amount of the claims of each.[81] Suitable newspaper publication of the proceedings should then be required, giving the proposed plan in detail,[82] together with the court before which the proceeding is pending and the statutory length of time for its pendency, perhaps three months, subject to extension by the court. At the same time, a notice similar to that sent to stockholders should

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The Mississippi statute requires the affirmative vote of a majority of voting shares, or, if any class would be adversely affected by the reduction of stated capital, the affirmative vote of a majority of the shares of such class or classes voting as a class, plus a majority of the shares of every other class as a class. MISS. CODE ANN. (1930) § 4133. Two statutes require the affirmative vote of two-thirds of each class outstanding. OHIO GEN. CODE (Page. Supp. 1935) § 8623-39; W. VA. CODE (1931) 31-1-12. North Carolina requires two-thirds of each class of voting shares. N. C. CODE ANN. (Michie, 1931) § 1161. Florida requires four-fifths of all shares. FLA. COMP. LAWS ANN. (Supp. 1934) § 6017 (1).

The English Companies Law requires the affirmative vote of a three-fourths majority of those shares voted; but this does not necessarily mean three-fourths of all shares. Complaint has been made that the Companies Law is antiquated in this respect, since the stockholder polls upon such "vitally important resolutions represent only a ridiculously small proportion of the total shares," thus enabling a compact group to effectuate reductions of share capital which are grossly unfair to certain classes of stockholders. Morgan, loc. cit. *supra* note 31.

78. Six state statutes require confirmation of the plan of reduction of stated capital by the Secretary of State, or the corporation commissioner, or state charter board; but none, with the exception of the Maine statute under certain circumstances (*supra* note 71) require confirmation by a court. ILL. STAT. ANN. (Smith-Hurd, 1935) § 157-59; IND. STAT. ANN. (Burns, 1926) § 54834; KAN. REV. STAT. ANN. (1923) §§ 17-215 to 17-217; LA. GEN. STAT. (Dart, 1932) § 1125; MASS. ANN. LAWS (1933) c. 156, § 45; TEX. ANN. CIV. STAT. (Vernon, 1927) art. 1332. Nearly all the remaining statutes, however, require only that a certificate or resolution of reduction of stated capital, stating the fact of compliance with the statutory procedure and, often, the nature and amount of the reduction, and signed and acknowledged by the chief executive, officers of the corporation be filed with the Secretary of State, or similar officer. Under some statutes, an additional copy must be filed in the office of the county recorder or registrar of deeds for the county in which the principal office of the corporation is located.

79. The Connecticut statute provides similarly as to assenting stockholders, the purpose being to hold such assenting stockholders liable to creditors if the corporation becomes insolvent as a result of the subsequent distribution of capital. CONN. GEN. STAT. (1930) § 3240.

80. For a similar provision, see R. I. Laws 1931-1932, c. 1941 § 53, cl. B. (2).

81. Cf. note 46, *supra*.

82. Cf. notes 44, and 45, *supra*. The English Companies Law provides similarly that the court may order that the Company publish the reasons and causes of the reduction "as the court may think expedient with a view to giving information to the public." 19 & 20 GEO. V, c. 23, § 57 (2b) (1929).

be sent to each creditor,[83] informing him of the statutory period during which he might be permitted to object either personally before the court, or before an impartial master appointed by it, or, where necessary, by correspondence with the court or master, as the case might be. Notice of the pendency of the proceedings and the similar right to object should also be sent to stockholders who dissented.[84] If no objection is registered with the court or master during the statutory period for the pendency of the proceedings, the plan of reduction of stated capital should be automatically confirmed. The corporate management, however, should still remain liable for any false or misleading statements or omissions in the resolution and notices that may later be shown to have resulted in damage to stockholders or creditors.[85] If, however, objection is made, the court or its master acting for it should have full discretion to dismiss the objections, or to compel the corporation to pay the objecting stockholder the market value of his shares as of the day previous to the stockholders' meeting,[86] or the creditor the full or modified amount of his claims, or to make some suitable substitute provision.[87] This should be a condition precedent to confirming the reduction. If the court or master, following an objection brought by a dissenting stockholder or creditor, and upon its own

83. The English Companies Law contains similar provision. See note 45, *supra*. Section 60 also makes it a misdemeanor for any director willfully to conceal the name of, or misrepresent the amount or nature of the claim of any creditor entitled to object. And Section 59 provides that if, following the confirmation of the plan of reduction by the court, the corporation is unable to satisfy the claim of any creditor who was entitled to object to the reduction of share capital, but was in ignorance of the proceedings and not on the list of creditors furnished to the court by the company's directors, those holding stock at the time of the reduction may be liable to contribute for the payment of the claim an amount not exceeding the extent to which such stockholders would have been liable on calls or unpaid contributions, if the company had commenced to be wound up on the day before the said date.

84. While the English Companies Law does not contain a similar provision, it does provide that the holders of "not less in the aggregate than 15% of the issued shares" of a particular class of stock may apply to the court to have the variation of their rights by means of the reduction of share capital cancelled. 19 & 20 GEO. V, c. 23, § 61 (1929). One reason for suggesting a more liberal provision in American statutes than that present in the English Companies Act, is the difficulty of welding a compact group of dissenting stockholders out of the widely distributed group of shareholders in the usual American corporation.

85. Cf. note 76, *supra*.

86. For similar provisions in state statutes, see note 66, *supra*.

87. This is substantially the provision as to creditors under the English Companies Law. See note 47, *supra;* cf. CANADA STATS. (1934) §§ 49-58, p. 335. In addition to such a general provision as to dissenting stockholders and creditors, the statute might suggest specific means of securing creditors against abuse of the write-down, such as by requiring the corporation, before paying any subsequent dividends, to set aside from the freed capital surplus or from the resultant improved future earnings a sufficient sum in the form of a trusteed sinking fund to repay creditors at the time their claims mature. As to preferred stockholders, such suggested specific methods might include (1) paying such stockholders the market value of their shares as of the day before the meeting of stockholders took place, or (2) the par value of their shares, before any dividends resulting from the write-down may be paid to common stockholders.

investigation determines that the facts stated or omitted in the resolution and notices of the management were false or misleading, or that the plan as proposed will jeopardize the present or future solvency of the company, it may refuse to confirm the plan in any form, or may offer to the petitioners a modified plan. If the latter alternative is adopted, the original procedure might be followed as to the resolution by the board of directors and the securing of the requisite assent of stockholders; but, once the plan is adopted by stockholders owning the requisite number of shares, the court should this time forthwith confirm it. If the confirmed plan provides for a cancellation of fixed asset or other losses against capital surplus transferred from stated capital, every future profit and loss statement of the company, on which are shown earnings due to the present write-downs, should clearly distinguish between those earnings accruing by reason of such write-downs and those accruing from other sources. Similarly, every future balance sheet over the same period should point out the original cost of the revalued assets, the date of each revaluation and the amount and the basis thereof, and the portion of earned or other surplus arising by reason thereof, and that portion of earned or other surplus otherwise created.[88] Likewise, all future recipients of dividends accruing by reason of the write-downs and reduction in stated capital should be notified of the source at the time of payment.[89] Finally, it might be required as in England that, subsequent to the reduction in stated capital, the company add to its name the words "and reduced."[90]

CREDIT TRANSACTIONS AND LEGAL CATEGORIES

REPORTED cases are replete with many forms of stating the distinction between suretyship or guaranty,[1] and indemnity[2] contracts in the instances where

88. The English Companies Law requires companies to reveal in their balance sheets "how the values of fixed assets have been arrived at." 19 & 20 GEO. V, c. 23, § 124 (1929). Compare the similar provisions under the Securities and Securities Exchange Acts, *supra* note 56.

89. It has been suggested that "the disclosure to stockholders might take the following form: (1) notice on the balance sheet beside the plant item concerning the date and fact of the appraisal, (2) statement on the income sheet of the amount of net income based on cost, (3) earmarking of surplus representing that part passed thereto in excess of income based on cost valuation of assets, (4) charging cash dividends first to earned surplus based on cost, (5) notification to stockholders of the source of any cash dividends based on the earmarked surplus." Daniels, *supra* note 4, at 309.

90. The English Companies Law contains a similar provision. 19 & 20 GEO. V, c. 23, § 57 (2a) (1929).

1. The terms suretyship and guaranty are used synonymously in this discussion without any attempt to refer to the distinctions supposed to exist between them. For an exhaustive analytical discussion and criticism of the differences supposed to exist, see Radin, *Guaranty and Suretyship* (1929) 17 CALIF. L. REV. 605, and (1930) 18 CALIF. L. REV. 21.

2. Indemnity is a term used in a variety of senses. See Arnold, *Indemnity Contracts and the Statute of Frauds* (1925) 9 MINN. L. REV. 401, 413; Treanor, *Rationale of Corporate and Non-Corporate Suretyship Decisions* (1927) 3 IND. L. J. 105, 213-215. Thus it is used to mean an original, independent contract to save the indemnitee against contingent

the distinction is invoked. For example, it is often said that a contract of suretyship is one to answer for the debt, default or miscarriage of another, whereas a contract of indemnity is one wherein the promisor agrees to save the promisee harmless from a loss.[3] Or, it may be said that the surety's promise is secondary and collateral to another promise, while the indemnitor's promise is original and independent of any other contract.[4] And a promise of suretyship is sometimes said to be a promise to do an affirmative act, while a promise of indemnity is merely to repair a loss, the liability of the indemnitor occurring only after the promisee has sustained actual loss.[5] Still another definition says that a promise of suretyship is one to protect the promisee against loss from the default of a third person, while a promise of indemnity is one to protect the promisee from liability to a third person.[6] Thus, as a matter of definition, suretyship may be distinguished from indemnity by the fact that a contract of the former type envisages a legal relationship concerning three parties, whereas a contract of indemnity concerns a legal relationship between only two parties.[7] That is, typically, suretyship is said to exist where two persons are liable on the same debt, one as principal, one contingently liable if the principal defaults, and the normal expectation is that the debt will be paid by the principal, or that he will reimburse the surety in the event of payment by the surety.[8] On the other hand, a contract of

loss of a specified character. Hall v. Equitable Surety Co., 126 Ark. 535, 191 S. W. 32 (1917). And it is used to mean a right to recover for injuries, Proctor v. Dillon, 235 Mass. 538, 546, 129 N. E. 265, 269 (1920), or as the implied right of reimbursement owed to one who has discharged the debt of another, U. S. Fidelity & Guaranty Co. v. Centropolis Bank, 17 F. (2d) 913, 916 (C. C. A. 8th, 1927). Indemnity insurance has a meaning which distinguishes it from life insurance. Wayland v. Western Life Indemnity Co., 166 Mo. App. 221, 235, 148 S. W. 626, 630 (1912). Indemnity is also used to mean "the stipulated desideratum to be paid to the assured in case he has suffered a loss through the perils or contingencies specified." Physicians' Defense Co. v. Cooper, 199 Fed. 576, 579 (C. C. A. 9th, 1912).

3. Howell v. Commissioner of Internal Revenue, 69 F. (2d) 447 (C. C. A. 8th, 1934); see Eckhart v. Heier, 37 S. D. 383, 384, 158 N. W. 403, 404, (1916).

4. Wolthausen v. Trimpert, 93 Conn. 260, 105 Atl. 687 (1919); Oppenheim v. National Surety Co., 105 Okla. 223, 231 Pac. 1076 (1925); 28 C. J. 892.

5. Mahana v. Alexander, 88 Cal. App. 111, 263 Pac. 260 (1927); see Westville Land Co. v. Handle, 112 N. J. L. 447, 452, 171 Atl. 520, 524 (1934); Eckhart v. Heier, 37 S. D. 382, 384, 158 N. W. 403 (1916). And see Comment (1932) 11 TENN. L. REV. 61, 63.

6. Somers v. U. S. Fidelity and Guaranty Co., 191 Cal. 542, 217 Pac. 746 (1923); McManus v. Tralles, 253 S. W. 406 (Mo. App. 1923); Oppenheim v. National Surety Co., 105 Okla. 223, 231 Pac. 1076 (1925).

7. Treanor, *supra* note 2, at 217-218; Merrill, *Nebraska Suretyship* (1930) 8 NEB. L. B. 267, 270; STEARNS, LAW OF SURETYSHIP (4th ed. 1934) §5.

8. ARANT, SURETYSHIP (1931) § 5; STEARNS, LAW OF SURETYSHIP (3d ed. 1922) § 5. A suretyship relation is recognized whether or not there is a privity between the principal and the security party. Hecker v. Mahler, 64 Ohio St. 398, 60 N. E. 555 (1901); Mathews v. Aikin, 1 N. Y. 595 (1848); Wright v. Garlinghouse, 27 Barb. 474 (N. Y. 1858); General Ry. Signal Co. v. Title Guaranty and Surety Co., 203 N. Y. 407, 96 N. E. 734 (1911). Nor is it necessary that a surety party enter into the agreement at the time that the contract between the principal and his creditor is made. McKibben v. Fourth National Bank, 32 Ga. App. 222, 122 S. E. 891 (1924); Leslie v. Compton, 103 Kan. 92, 172 Pac. 1015 (1918); Hartley v. Sandford, 66 N. J. L. 627, 50 Atl. 454 (1901).

indemnity is said to exist where, upon the occurrence of an agreed contingency, one person alone becomes liable to the obligee.

But, inasmuch as the function of both suretyship and indemnity is the same,[9] namely to provide security against loss, there is a wide field in which the distinctions as made are hopelessly confused. Assume, for example, that *B* wishes to shift the risk of a contingent loss, and that such loss involves the non-fulfillment of an obligation which *C* owes to *B*. If *B* secures himself by procuring *A* to be "surety" for *C*, or if he secures himself with a promise of "indemnity" insuring himself against loss suffered in case *C* defaults,[10] the risk assumed by the security party in either case is the same in that it is dependent on the same contingency. The condition precedent to the security party's liability is the default of a personal obligation, and hence three parties are in fact involved. Yet in a large number of cases in which exactly these factors are present, the situation is legally regarded wholly from the viewpoint of the relation of security and secured, and the contract is called one of indemnity.[11] Thus, in a given set of facts, one court will construe the situation as a suretyship transaction, while another court, or the same court at a different time will find there has been an indemnity relationship established. In other words, the legal relationship may be, and often is, different from the factual relationship.[12]

One of the most fruitful sources for instances in which a distinction between suretyship and indemnity is invoked, is cases wherein the statute of frauds is interposed as a bar to the enforcement of an oral promise to answer for the debt, default or miscarriage of another.[13] It is well established that a contract of "indemnity" does not come within the statute, whereas a contract of suretyship does.[14] But the cases are irreconcilable as to when a given situation is indemnity and when it is suretyship.[15] The chief criterion by

9. Mahana v. Alexander, 88 Cal. App. 111, 116, 263 Pac. 260, 263 (1927); ANANT. SURETYSHIP (1931) 27. See also Treanor, *supra* note 2, at 199.

10. Generally it is held that the label used by the parties is not governing nor does it indicate their intent. Cheesman v. Wiggins, 122 Ind. 352, 23 N. E. 945 (1889); Dolgoff v. Schnitzer, 209 App. Div. 511, 205 N. Y. Supp. 11 (1st Dep't, 1924); Nugent v. Wolfe, 111 Pa. 471, 4 Atl. 15 (1886). See Corbin, *Contracts of Indemnity and the Statute of Frauds* (1928) 41 HARV. L. REV. 689, 694.

11. See notes 19, 24, 37, 42, *infra*.

12. "Certainly the cases justify us in saying that one contract called an indemnity may in reality be a guaranty and another designated as guaranty may in truth be an indemnity contract." Arnold, *supra* note 2, at 414.

13. See Wolthausen v. Trimpert, 93 Conn. 260, 264, 105 Atl. 687, 688 (1919).

14. Thomas v. Cook, 8 Barn & Cr. 728 (K. B. 1928), is regarded as the precedent for this rule that a contract of indemnity is not within the statute. The statement has been repeated in countless cases. See Jones v. Bacon, 145 N. Y. 446, 40 N. E. 216 (1895).

15. But some courts, recognizing that indemnity may be and often is used synonymously with suretyship, say that a promise of indemnity is within the statute if it is a promise to answer for the debt of another. See Cheesman v. Wiggins, 122 Ind. 352, 23 N. E. 945 (1889); Garner v. Hudgins, 46 Mo. 399, 401 (1870). See also 1 WILLISTON, CONTRACTS (1920) § 482: "The greatest confusion exists in regard to the question whether promises to indemnify are within the statute. . . . A promise to indemnify a creditor against loss if he sells goods to another, or advances money to him, is certainly a promise to answer for the debt or default of another, and of course within the statute; yet the use of the

which a distinction is made is whether or not a contract is "independent," and if it is found to be so, the contract is said to be one of indemnity, and enforceable even though oral.[16] Theoretically, perhaps, an independent contract is never one to answer for the debt of another,[17] but actually the test has been greatly extended so that a contract which factually appears to be one to answer for the debt of another is often legally termed independent and hence one of indemnity.[18] The cases dealing with identical situations reach opposing results on the basis of reasoning confused by a conflict of legal and factual criteria. Thus, for example, if *A* promises *B* to indemnify him if *B* will become surety for *C*'s promise to *D*, some courts hold that *A*'s promise is "original and independent" of *C*'s implied promise to *B* to reimburse *B*, and therefore hold *A*'s promise is one of indemnity, which is enforcible though oral in form.[19] Other cases, indistinguishable in fact, have been decided precisely contrariwise.[20] It has been pointed out that the confusion in these cases arises partly out of the fact that *B*, the promisee, occupies a dual status.[21] On the one hand he is, or may become, a debtor to *D*. And it is well established that a promise to a debtor to pay his debt is not within the statute

word indemnify in such a transaction is entirely proper. It is therefore a primary question whether the promisor agrees, not merely to indemnify, but to indemnify for the debt, default or miscarriage of another." And yet this recognition of confusion in terminology does not serve to clear up the real confusion in the cases nor to identify the factual with the legal relationship. See Nugent v. Wolfe, 111 Pa. 471, 480, 4 Atl. 15, 17 (1886); Macey v. Childress, 2 Tenn. Ch. 438 (1875). And see Steinmetz, *Contracts of Guaranty and Indemnity and Credit Insurance* (1910) 44 AM. L. REV. 736, 746 et seq.

16. Hall v. Equitable Surety Co., 126 Ark. 535, 540, 191 S. W. 32, 34 (1917); S. Landow and Co. v. Gurian, 93 Conn. 576, 107 Atl. 517 (1919); Anderson v. Spence, 72 Ind. 315, 321 (1880); Wilson v. Smith, 73 Iowa 429, 35 N. W. 506 (1887); cf. Curtis and Gartside Co. v. Aetna Life Ins. Co., 58 Okla. 470, 474, 160 Pac. 465, 466 (1916).

17. Some courts have asserted, as would seem to be correct, that a promise cannot be independent if the principal debtor's obligation continues to exist, but only if the new promisor is solely liable. Spear v. Farmers' and Mechanics Bank, 156 Ill. 555, 41 N. E. 164 (1895); McManus v. Tralles, 253 S. W. 406, 409 (Mo. App. 1923); Easter v. White, 12 Ohio St. 219, 226 (1861); Nugent v. Wolfe, 111 Pa. 471, 481, 4 Atl. 15, 17 (1886); Mankin v. Jones, 63 W. Va. 373, 376, 60 S. E. 248, 249 (1908).

18. The decision as to whether or not a contract is within the statute has thus very frequently been based on the test as to whether or not the contract is independent rather than on whether or not it is a contract to answer for the debt of another. See, for example, first paragraph of opinions in Spear v. Farmers' and Mechanics' Bank, 156 Ill. 555, 41 N. E. 164 (1895) and Nelson v. Boynton, 44 Mass. 396 (1841). And see criticism of this tendency, in opinion of Grover, J., in Brown v. Weber, 38 N. Y. 187 (1868).

19. Resseter v. Waterman, 151 Ill. 169, 37 N. E. 875 (1894); Stoltenberg v. Johnson, 163 Ill. App. 422 (1911); Dyer v. Staggs, 217 Ky. 683, 290 S. W. 494 (1927); Hawes v. Murphy, 191 Mass. 469, 78 N. E. 109 (1906); Minick v. Huff, 41 Neb. 516 (1894); Jones v. Bacon, 145 N. Y. 446, 40 N. E. 216 (1895); Ferrell v. Maxwell, 28 Ohio St. 383 (1876).

20. Posten v. Clem, 201 Ala. 529, 78 So. 883 (1918); Spear v. Farmers' and Mechanics' Bank, 156 Ill. 555, 41 N. E. 164 (1895); Craft v. Lott, 87 Miss. 590, 40 So. 426 (1905); Hartley v. Sandford, 66 N. J. L. 627, 50 Atl. 454 (1901); Easter v. White, 12 Ohio St. 219 (1861); Bayard v. Pennsylvania Knitting Mills, 290 Pa. 79, 137 Atl. 910 (1927); Wolverton v. Davis, 85 Va. 64 (1888).

21. See Corbin, *supra* note 10, at 699.

of frauds, for no suretyship relation is established by such a promise.[22] The promise of *A*, in this aspect, is a promise to assume the debtor's debt by substituting himself as debtor, not if *B* the debtor does not pay, but absolutely. But in another aspect of the case, *B* is a creditor of *C*. By becoming surety for *C*, *B* has a right of reimbursement against *C*, the principal obligor, and *A*'s promise thus becomes also a promise to *B* as creditor to pay the debt of another person, *C*, if *C* does not pay. Since this is true, it is apparent that this situation cannot really be classified in a vacuum as one either of suretyship or of indemnity, but depends entirely upon the point of view with which the relationship is regarded.[23]

Many similar instances can be given in which the results of cases are clearly inconsistent. Thus, an oral promise by *A* to indemnify *B* who becomes bail bondsman for *C* has been held by some courts a promise of indemnity,[24] and by others a suretyship agreement,[25] and hence unenforcible or enforcible as the case may be. The decision again seems to depend on whether the promise of *A* is regarded as concerning only *A* and *B*, or whether it is considered as envisaging a relationship of *A*, *B*, and *C* on account of *C*'s duty to pay the "indemnity."

The test of whether a contract is independent or collateral has been further extended in some cases by adopting the test that if the promisor received a "new consideration" for his promise,[26] or had a "leading purpose" in making the promise,[27] despite the fact that his promise is made to the creditor and

22. Cincinnati Traction Co. v. Cole, 258 Fed. 169 (C. C. A. 6th, 1919); Garroway v. Jennings, 189 Cal. 97, 207 Pac. 554 (1922); Aldrich v. Ames, 75 Mass. 76 (1857) (the promise in this case could also have been construed as one made to the creditor for the debt of the principal); Ware v. Allen, 64 Miss. 545, 1 So. 738 (1886).

23. Much of the written material dealing with the distinction between suretyship and indemnity has approached the problem with a view to rationalizing the conflicting decisions. Since it has been utterly impossible to harmonize the decisions, despite valiant attempts, the conclusion of most of the articles written on the subject has been that certain decisions are right and others are wrong. Such a conclusion is based on grounds either of some policy which the author argues should be adopted, or on some supposedly logical grounds. See Arnold, *supra* note 2; Burdick, *Suretyship and The Statute of Frauds* (1920) 20 COL. L. REV. 153; Corbin, *supra* note 10.

24. McCormick v. Boylan, 83 Conn. 686, 78 Atl. 335 (1910); Anderson v. Spence, 72 Ind. 315 (1880); Keesling v. Frazier, 119 Ind. 185, 21 N. E. 552 (1889); Gonzales v. Garcia, 179 S. W. 932 (Tex. Civ. App. 1915).

25. May v. Williams, 61 Miss. 125 (1883); Nugent v. Wolfe, 111 Pa. 471, 4 Atl. 15 (1886). But it is usually held that in criminal bail cases the result must in any case be different because on grounds of public policy the surety has no right of reimbursement from the principal. See Corbin, *supra* note 10, at 698; Arnold, *supra* note 2, at 409-410.

26. Willox v. Townsend, 245 Mich. 632, 223 N. W. 226 (1929); Mallory v. Gillett, 21 N. Y. 412 (1860); White v. Rintoul, 108 N. Y. 222 (1888); Schwoerer & Sons Inc. v. Stone, 130 App. Div. 796, 115 N. Y. Supp. 440 (1st Dep't, 1909); Day v. Morgan, 134 Wis. 595, 200 N. W. 382 (1924). See also HANNA, CASES ON SECURITY, (1932) 352n; Comment (1917) 2 CORN. L. Q. 209. Cf. Birchell v. Neaster, 36 Ohio St. 331, 337 (1881).

27. Davis v. Patrick, 141 U. S. 479 (1891); Smith v. Delaney, 64 Conn. 264, 29 Atl. 496 (1894); Patton v. Mills, 21 Kan. 163 (1878); Nelson v. Boynton, 44 Mass. 396 (1841); Gaines v. Durham, 124 S. C. 435, 117 S. E. 732 (1922); Housley v. Strawn Merch. Co. 253 S. W. 673 (Tex. 1923). See also, Arnold, *The Main Purpose Rule and the Statute of Frauds* (1924) 10 CORN. L. Q. 28.

is to pay the debt of another, it is not within the statute of frauds. When these factors are discovered, the courts have held the contract independent,[28] and such contracts have thus been assimilated with contracts of "indemnity."[29]

Ignoring, however, the vagueness of the tests as to whether or not a contract is "independent," and its subordinate tests of whether the promisor received a "new consideration" or had a "leading object,"[30] it is apparent that in many of the cases where the promisor's promise is called independent, and his promise held enforcible, a tripartite relationship exists, factually speaking. This is because the nature of the condition precedent to the third party's liability is the default of another person, the principal debtor, and this liability is discharged if the principal pays.[31] It appears, therefore, that there is no real distinction in these cases, in the sense that the courts talk of the distinction, which can ever be used as a means of understanding the cases. The explanation for these cases, and hence the explanation of what the distinction is between suretyship and indemnity, is based on a recognition of the reason why the distinction is made, rather than on how it is made. The real identifying earmarks of the cases placed in the "indemnity" category may often be

28. The holdings in these cases assert that although the security party's payment to the creditor is actually the payment of the debt of another, such a circumstance is merely coincidental, because the security party undertook the obligation to pay as his own obligation. Since he received an independent consideration or had a leading object, he is independently bound to pay the debt and the actual payment of the debt of another is merely incidental. Reed v. Holcomb, 31 Conn. 360 (1863); Nelson v. Boynton, 44 Mass. 396 (1841); Mankin v. Jones, 63 W. Va. 373, 379, 60 S. E. 248, 250 (1908).

29. Many of the cases do not actually label the transaction which is rationalized in this way as one of indemnity, but merely hold that the contract is not governed by the statute of frauds. But other cases have held that the contracts in such cases are contracts of indemnity. McCormick v. Boylan, 83 Conn. 686, 78 Atl. 335 (1910); Mills v. Brown, 11 Iowa 314 (1860); Tighe v. Morrison, 116 N. Y. 263, 22 N. E. 164 (1889); Ferrell v. Maxwell, 28 Ohio St. 383 (1876). Cf. Wolthausen v. Trimpert, 93 Conn. 260, 105 Atl. 687 (1919) (not a statute of frauds case, but same holding).

30. The test of whether or not a promise in a given instance is independent is obviously very elusive. Cf. Bartolotta v. Calvo, 112 Conn. 385, 152 Atl. 306 (1930). The promise of a third person to pay the debt of another must always, of course, be supported by a consideration. And if the promise is made after the original transaction between the debtor and creditor, such promise must be supported by some new and independent consideration in any event. See McCord v. Hines Lumber Co., 124 Wis. 509, 512, 102 N. W. 334, 335 (1905). See Carey, *Guaranties and The Statute of Frauds in Wisconsin* (1923) 2 WIS. L. REV. 193, 194; Note (1916) 2 CORN. L. Q. 209, 210. Thus it is obvious that the "new consideration" and "leading object" rules do not mean exactly what they say and differentiations must be made between promises which will be enforced and those which will not, though in both instances there is actually a "new consideration" or a "leading object." See 1 BRANDT, SURETYSHIP (3d ed. 1905) § 80; Carey, *supra*, at 216.

31. In other words, in most of these cases there is no pretense but that the principal obligor is still bound by his own promise so that his default is the condition precedent to the third party's duty to pay the creditor. Furthermore there is no doubt but that in most of these cases the security party would be granted a right of reimbursement against the principal obligor after the former had paid the creditor. For this reason the doctrines of "new consideration" and "leading object" were criticized by Grover, J. in Brown v. Weber, 38 N. Y. 187 (1868).

found in the fact that the evidence showing the existence of the alleged oral contract is so clear that justice requires its enforcement.[32] Thus, where the promisor had an object of his own to serve, or received some consideration for his promise which obviously accrued to his benefit, in the view which many courts take of the purpose of the statute of frauds,[33] it would be outrageous to allow the promisor to escape the duty which he clearly assumed. The indemnity label, thus, has merely been attached to designate conveniently a category of cases wherein an oral promise to answer for the debt of another has been enforced despite the statute of frauds.

Other cases in which the distinction between suretyship and indemnity often arises, are those dealing with contracts of corporate or compensated surety companies, whose business is the supplying of surety bonds. Typical instances of the contracts to which such companies are parties are those guarantying the fidelity and honesty of an employee,[34] guarantying that collection of a judgment can be made if execution of the judgment is stayed pending an appeal,[35] and numerous other forms of promises.[36] An analysis of the rela-

32. It has been frequently suggested that when there is a "leading purpose" or a "new consideration" moving beneficially to the promisor, the oral promise is not easily falsified and hence the evil at which the statute of frauds is aimed does not need to be considered so strongly. See HANNA, CASES ON SECURITY, (1932) 352n.; BROWNE, STATUTE OF FRAUDS (5th ed. 1895) § 212; Corbin, *supra* note 10, at 700. It is obvious that these so-called doctrines are thus merely means of evading the statute. The same result of evasion can often be reached by leaving to the jury as a question of fact whether or not "sole credit" was given by the creditor to the third party promisor. In other words if "sole credit" is given the promisor, he only is liable, the principal debtor being merely a third party beneficiary of the agreement. Hammond Coal Co. v. Lewis, 248 Mass. 499, 143 N. E. 309 (1924); Chase v. Day, 17 Johns 114 (N. Y. 1819); James v. Carson, 94 Wis. 632, 69 N. W. 1004 (1897). But if the principal's debt is already subsisting, sole credit cannot be given the promisor unless there is a novation. The doctrines of "new consideration" and "leading purpose" supplement the means of evading the statute by allowing enforcement of promises in cases where actually the principal debtor is still obligated.

33. The manner in which all parts of the statute of frauds has been riddled by exceptions is well known. The exceptions are made on the assumption, partly at least, that the statute was not intended as a rigid substantive rule of law which would penalize those who actually had valid contractual claims as well as those whose claims were fictitious, but was rather intended as a rule of evidence to exclude the possibility of recovery by a claimant on perjured testimony. Hence it has appealed to many courts that when the promisor's interest in the transaction is clearly revealed, there is no risk of enforcing a trumped up promise. See Davis v. Patrick, 141 U. S. 479, 487 (1891); Reed v. Holcomb, 31 Conn. 360 (1863).

34. American Surety Co. v. Pauly, 170 U. S. 133 (1898); New Amsterdam Casualty Co. v. Central National Fire Ins. Co., 4 F. (2d) 203 (C. C. A. 8th, 1925); General Ry. Signal Co. v. Title Guaranty and Surety Co., 203 N. Y. 407, 96 N. E. 734 (1911).

35. American Surety Co. v. Koen, 49 Tex. Civ. App. 98, 107 S. W. 938 (1903); Reed v. Horton, 132 Wash. 82, 231 Pac. 450 (1924).

36. See, for example, American Bonding Co. v. Pueblo Investment Co., 150 Fed. 17 (C. C. A. 8th, 1906) (guaranty of the performance of covenants by a lessee); United States Fidelity and Guaranty Co. v. Centropolis Bank, 17 F. (2d) 913 (C. C. A. 8th, 1927) (guaranty of county deposits in bank); State ex. rel. Karcher v. Roth, 330 Mo. 105, 49 S. W. (2d) 109 (1932) (guaranty that sheriff would not abuse his power). And see Lunt, *Fidelity Insurance and Suretyship* (1932) 161 ANNALS 105, for description of various types of guaranty bonds available from such corporate sureties.

tionship contemplated by these contracts convincingly shows that three parties are factually involved and that all the earmarks of suretyship are present. Yet many cases have held such contracts are not contracts of suretyship, but are contracts of "indemnity." Here, again, the determination of the courts has been explained on the ground that the third party's promise is supported by an "independent consideration," called a premium, which factor has been used in the assimilation of the contracts with insurance or "indemnity" contracts.[37] This position is the more readily acceptable in the courts because such companies, like insurance companies, engage in the business for profit, calculate their risks on an actuarial basis, and charge premiums accordingly.[38]

But, in these cases also, the "indemnity" label has apparently been attached because the courts have desired to escape certain legal consequences which supposedly would follow from calling the contracts suretyship contracts. Chief among these consequences is the strict rule of interpretation in favor of the surety long applied to such contracts.[39] This rule grew out of the fact that sureties were usually accommodation parties whose release from their gratuitous promises was deemed justified on the slightest pretext.[40] The undesirability of these principles as applied to compensated sureties[41] led courts to classify

37. American Surety Co. v. Pauly, 170 U. S. 133 (1898); Carstairs v. American Bonding and Trust Co., 116 Fed. 449, 453 (C. C. A. 3d, 1902); National Surety Co. v. McCormick, 268 Fed. 185 (C. C. A. 7th, 1920); Rule v. Anderson, 160 Mo. App. 347, 142 S. W. 358 (1911); Whitestown v. Title Guaranty and Surety Co., 72 Misc. 498, 131 N. Y. Supp. 390 (Sup. Ct. 1911); Shakman v. U. S. Credit System Co., 92 Wis. 366, 66 N. W. 528 (1896); United American Fire Ins. Co. v. American Bonding Co., 146 Wis. 573, 131 N. W. 994 (1911). And see FROST, GUARANTY, INSURANCE (1909) 18; Steinmetz, *supra* note 15, arguing that contracts of credit insurance are like indemnity insurance.

38. Supreme Council, C. K. A. v. Fidelity and Casualty Co., 63 Fed. 48, 58 (C. C. A 6th, 1894); Tebbets v. Mercantile Credit Guarantee Co., 73 Fed. 95, 97 (C. C. A. 2d, 1896); Lakeside Land Co. v. Empire State Surety Co., 105 Minn. 213, 117 N. W. 431 (1908); Young v. American Bonding Co., 228 Pa. 373, 77 Atl. 623 (1910).

39. The uncompensated or accommodation surety has always been regarded as a "favorite of the law." Crane v. Buckley, 203 U. S. 441 (1906); Jewel Tea Co. v. Shepard, 172 Iowa 480, 154 N. W. 755 (1915); Lange Co. v. Freeman, 13 S. W. (2d) 1092 (Mo. App. 1929). Hence the contracts of such sureties were always construed, when terms were doubtful, in favor of the surety. Anderson v. Bellenger, 87 Ala. 334, 6 So. 82 (1889); Gard v. Stevens, 12 Mich. 292 (1864); Rogers v. Warner, 8 Johns 92 (N. Y. 1811); Whitney and Schuyler v. Groot, 24 Wend. 82 (N. Y. 1840); Page v. Krekey, 137 N. Y. 307, 314, 33 N. E. 311, 313 (1893).

40. Sureties were released from their gratuitous obligations, for example, if the creditor extended time of payment to the principal. Cambria Bank v. Lanier, 135 Iowa 280, 112 N. W. 774 (1907), or if there was an alteration of the contract, Stillman v. Wickham, 106 Iowa 597, 76 N. W. 1008 (1898); Woodruff v. Schultz, 155 Mich. 11, 118 N. W. 579 (1908).

41. "The deep solicitude of the law for the welfare of voluntary parties who bound themselves from purely disinterested motives never comprehended the protection of primary enterprises organized for the express purpose of engaging in the business of suretyship for profit. To allow such companies to collect and retain premiums for their services, graded according to the nature and extent of the risk, and then to repudiate their obligations on slight pretexts that have no relation to the risk, would be most unjust and immoral, and would be a perversion of the wise and just rules designed for the protection of voluntary sureties." Rule v. Anderson, 160 Mo. App. 347, 358, 142 S. W. 358, 362 (1911)

contracts of the latter in the category of "indemnity," and to construe the contracts according to principles applied to insurance contracts. And in other cases than those dealing with corporate surety companies, similar technique is often employed in an effort to escape some technical requirement. When the rules usually applied to sureties as to what defenses are available, for example, become embarrassing in particular cases, courts have frequently escaped the rigors of the rules by switching categories and calling the contracts indemnity contracts.[42] In none of these cases can any discernable difference be observed between the relationships to which the terms suretyship and indemnity may be alternately applied. The explanation of the distinction rests rather upon the reason for which it is invoked.[43]

It might be suggested that instead of extending the "indemnity" category by the use of tenuous bases of distinction, in order to allow the enforcement of certain oral contracts to answer for the debts of another, it would have been feasible for courts to make a frank exception to the statute of frauds rule, for example, by holding contracts enforcible where proof was convincing and the promisor's interest in the contract established. Similarly, it might be pointed out that it would be possible for courts to apply different principles of construction to contracts of compensated sureties than to contracts of accommodation sureties, without invoking a metaphysical distinction between contracts of suretyship and contracts of indemnity.[44] Thus the decisions rendered would be more easily understandable if the true basis for them were apparent, while the law established would perhaps be more predictable than it is. The result reached in particular cases where these distinctions are used has usually been satisfactory, but there has been established a body of case law setting up an illusory distinction, which in turn is capable of creating vast confusion, and may produce undesirable results seemingly based on precedent.

Illustrative of the confusion which can be created, the source of which is directly traceable to this illusory distinction, is a recent case, *Howell v. Commissioner of Internal Revenue*,[45] involving a wholly different question for decision, but in which the elusive distinctions between suretyship and indemnity are invoked. The plaintiff and other stockholders of a bank contracted to "indemnify" the bank to a certain amount against loss which might be sustained by reason of the non-payment of certain notes held by the bank. The loss was sustained, the indemnity paid, and though the notes were retained by the bank, the plaintiff claimed that in effect he was the equitable assignee of the notes to the extent of the payment of his share of the "indemnity," and therefore that he had a claim for reimbursement against the makers of the

42. See Hall v. Equitable Surety Co., 126 Ark. 535, 191 S. W. 32 (1917) (compensated surety company case where court held defendant had no right to be released from his obligation even though he gave notice to the plaintiff to proceed against the debtor, because defendant was held to be an indemnitor); Wolthausen v. Trimpert, 93 Conn. 269, 105 Atl. 687 (1919) (same holding though defendant was not a corporate surety company).

43. See Treanor, *supra* note 2, at 220. The author explains this entire phenomenon as the result of "an idea so prevalent a few decades ago that every situation had to be brought within a formal legal category wherein doctrinal rules of supposed general validity automatically produced the proper result."

44. See Treanor, *supra* note 2, at 220.

45. 69 F. (2d) 447 (C. C. A. 8th, 1934).

notes. He claimed that this debt, being uncollectable, entitled him to make a deduction on his income tax statement as a "debt ascertained to be worthless and charged off." The court, in considering the problem, discussed the differences between contracts of suretyship and contracts of indemnity. It found that the plaintiff had entered into the agreement "for his own purposes," that he had "no intention of paying the debt of the principal debtors," and hence held that the contract was not one to pay the debt of another, but was an "independent contract," and was therefore one of indemnity. The court then concluded that because the contract was one of indemnity, the plaintiff had no right of reimbursement from the makers of the notes such as to give him a right to consider them his debtors, and to make their debts to him deductable on his income tax statement.

The categorical technique as here employed leads to a result which disregards the usual application of some theory granting reimbursement to the third party in such cases. It is well settled that in a suretyship transaction, when the security party is compelled to discharge the obligation upon the default of the principal, the payment by the third party does not discharge the obligation itself. By the operation of the fiction of an implied promise of reimbursement on the part of the principal to the security party, or by subrogating the security party to the rights of the creditor, the obligation of the principal is maintained in favor of the security party.[46] There are some technical differences between the rights under an implied promise, and rights by subrogation or equitable assignment.[47] Thus, an implied promise depends on the fact that there was

46. Mellette Farmers' Elevator Co. v. H. Poehler Co., 18 F. (2d) 430 (D. Minn. 1927); Mathews v. Aiken, 1 N. Y. 595 (1848); See STEARNS, SURETYSHIP 503; SHELDON, SUBROGATION (2d ed. 1893) 136.

47. Historically the remedy on an implied promise of reimbursement was available as a remedy in a legal action. Hall v. Smith, 5 How. 96 (U. S. 1847); Katz v. Moessinger, 110 Ill. 372 (1884); Konitzky v. Meyer, 49 N. Y. 571 (1872); Carter v. Jones, 40 N. C. 196 (1848). Subrogation, on the other hand, was historically wholly equitable in nature. Young v. Vough, 23 N. J. Eq. 325, 328, 329 (1873). But the right of subrogation is now almost universally cognizable in a court of law where the subrogee is treated as the assignee of the claim against the principal, or because in code states there is no difference between a legal and an equitable right. See Offer v. Superior Court, 194 Cal. 114, 228 Pac. 11 (1924); Boyd v. McDonough, 39 How. Pr. 389 (N. Y. 1870).

It is also true that an implied promise of reimbursement is raised to one who has paid only a part of the debt of the principal, because the assumption is that the debt was paid at the principal's request. Mellette v. Farmers' Elevator Co. v. H. Poehler Co., 18 F. (2d) 430 (D. Minn. 1927); Vermeule v. York Cliffs Improvement Co., 105 Me. 350, 74 Atl. 800 (1909); STEARNS, SURETYSHIP § 279. But the general rule is that subrogation is available only to one who has paid the whole obligation of the principal so that equity can substitute the payor to the rights of the creditor without prejudicing the creditor or the principal. United States v. National Surety Co., 254 U. S. 73 (1920); United States Fidelity and Guaranty Co. v. Union Bank and Trust Co., 228 Fed. 448 (C. C. A. 6th, 1915); Maryland Casualty Co. v. Fouts, 11 F. (2d) 71 (C. C. A. 4th, 1926); National Surety Co. v. Salt Lake County, 5 F. (2d) 34 (C. C. A. 8th, 1925). But this requirement that the whole debt of the principal must be paid before subrogation will be granted has given way to more liberal holdings. Thus an insurer whose liability is limited to a specified sum and who has paid that sum is subrogated pro tanto though the loss suffered by the insured is greater than the security afforded by the policy. Offer v. Superior Court,

privity between the debtor and third party,[48] but even if there was no privity between them, the security party may be subrogated[49] or treated as the assignee of the creditor's rights against the debtor.[50] Whatever theory is used, the principle actuating the grant of the right is based on the idea of preventing the unjust enrichment either of the creditor or of the debtor.[51] The creditor, though he is legitimately entitled to the double security for which he bargained, is not entitled to collect from both obligors on one claim. And the principal debtor is not entitled to escape the consequences of his default simply because his creditor has been satisfied.

The court in the *Howell* case found that the contract was one of "indemnity" and concluded that the plaintiff had no right of reimbursement. While an implied promise of reimbursement, perhaps, could not be raised in this case because of lack of privity between the plaintiff and the principal debtors, this technical limitation is actually of little consequence because the courts can apply the principle of subrogation or equitable assignment so as to allow reimbursement to the third party.[52] And actually the grant of such reimbursement in one form or another is made in every type of situation where the burden of loss should be borne by another than the one who has borne it.[53]

194 Cal. 114, 228 Pac. 11 (1924); Martin v. Lehigh Valley Rr., 90 N. J. L. 258, 100 Atl. 345 (1917); Powell and Powell v. Wake Water Co., 171 N. C. 290, 88 S. E. 426 (1916). Nor can the insured defeat the right of the insurer by a compromise settlement and release of a tort feasor. Camden Fire Ins. Ass'n v. Prezioso, 93 N. J. Eq. 318, 116 Atl. 694 (1922); Powell and Powell v. Wake Water Co., 171 N. C. 290, 88 S. E. 426 (1916). Furthermore courts can grant reimbursement to one who has paid only part of the debt by treating him as the assignee of so much of the claim as he has paid. Carter v. Jones, 40 N. C. 196 (1848).

48. Leslie v. Compton, 103 Kan. 92, 172 Pac. 1015 (1918); 1 BRANDT, SURETYSHIP AND GUARANTY § 231.

49. Subrogation does not depend on privity of contract nor is it limited in its application to sureties and quasi-sureties. SHELDON, SUBROGATION, 342. Offer v. Superior Court, 194 Cal. 114, 228 Pac. 11 (1924); Mathews v. Aiken, 1 N. Y. 595 (1848); General Ry. Signal Co. v. Title Guaranty and Surety Co., 203 N. Y. 407, 412, 96 N. E. 734, 736 (1911); Hecker v. Mahler, 64 Ohio St. 398, 60 N. E. 555 (1901).

50. Offer v. Superior Court, 194 Cal. 114, 228 Pac. 11 (1924); Ocean Accident and Guarantee Corp. v. Hooker Electrochemical Co., 240 N. Y. 37, 47, 147 N. E. 351, 353 (1925).

51. See Royce v. Bank of Commerce, 21 Okla. 484, 96 Pac. 640 (1908); Cope v. Johnson, 123 Okla. 43, 46, 251 Pac. 985, 987 (1926). It may be suggested that the promise of a security party can be construed, in accordance with the function he really serves, to mean a promise to assume the risk of loss, not necessarily to bear that loss absolutely Thus the security party will be obliged to bear the loss if it occurs by reason of an irresponsible contingency, or if the person causing the loss is unable to pay. But if a person is responsible for the loss and is able to compensate for it, public policy would seem to dictate that such a tort feasor or defaulter should not be allowed to escape the consequences of his act because of the fortuitous circumstance that the loss was insured against.

52. Compare Royce v. Bank of Commerce, 21 Okla. 484, 96 Pac. 640 (1908) and Cope v. Johnson, 123 Okla. 43, 251 Pac. 985 (1926). Both of these cases involved fact situations similar to those in the *Howell* case, and in both of them the right of subrogation was allowed. See also Love v. Dampeer, 159 Miss. 430, 132 So. 439 (1931).

53. Offer v. Superior Court, 194 Cal. 114, 228 Pac. 11 (1924); Richardson v. American Surety Co., 97 Okla. 264, 223 Pac. 389 (1924); U. S. Fidelity and Guaranty Co. v. Bram-

It is now well recognized, for example, that insurers who have paid a loss which has arisen, not because of irresponsible forces, but because of the fault or wrong of responsible human agency, are entitled to reimbursement from such tort feasor, or to exoneration from liability if the tort feasor makes good the loss.[54] Thus, fire insurers who have paid the insured a loss from fire caused by the tort of another have a right of recovery against the tort feasor.[55] A marine insurer is granted a right to recover against the owner of a vessel whose fault caused the loss which the insurer was bound to pay.[56] The same principle likewise is commonly applied to a junior lien-holder or purchaser of land who pays a prior lien in order to protect his interests,[57] and in numerous other common types of situation.[58] There are some limitations on the right, to be sure,[59] but in general, some form of reimbursement is allowed not only to one who is bound by his own contract to pay the debt of another,[60] but to one who has any interest to protect,[61] to one who feels morally obligated to pay the

well, 108 Ore. 261, 217 Pac. 332 (1923); McCormick v. Irwin, 35 Pa. 111 (1860); Murray v. O'Brien, 56 Wash. 361, 105 Pac. 840 (1909); McNeil v. Miller, 29 W. Va. 480, 2 S. E. 335 (1887).

54. Liverpool and Great Western Steam Co. v. Phenix Ins. Co., 129 U. S. 397 (1889) (insurer of goods in transit subrogated to insured's right against carrier); United States v. U. S. Fidelity and Guaranty Co., 247 Fed. 16 (C. C. A. 6th, 1918) (insurer of mail subrogated to rights of United States to recover on bond of thieving employee of Post Office); Aetna Ins. Co. v. Hann, 196 Ala. 234, 72 So. 48 (1916) (insurer entitled to reimbursement from third party whose negligence in constructing a wall caused injury to property of insured); Ocean Accident Corp. v. Hooker Electrochemical Co., 240 N. Y. 37, 147 N. E. 351 (1925) (insurer subrogated to insured's rights against manufacturer of defective goods sold to customers); Coop Furniture Co. v. Southern Surety Co., 264 S. W. 201 (Tex. Civ. App. 1924) (insurer subrogated to insured's rights against party who negligently broke insured's plate glass window).

55. Allen-Wright Furniture Co. v. Hines, 34 Idaho 90, 200 Pac. 889 (1921); Russell v. Chicago, Milwaukee and St. Paul Rr., 195 Iowa 993, 191 N. W. 806 (1923); Hartford Fire Ins. Co. v. Payne, 199 Iowa 1008, 203 N. W. 4 (1925).

56. Globe and Rutgers Fire Ins. Co. v. Hines, 273 Fed. 774 (C. C. A. 2d, 1921); See SHELDON, SUBROGATION 342.

57. Cook v. Kelly, 200 Ala. 133, 75 So. 953 (1917); Murray v. O'Brien, 56 Wash. 361, 105 Pac. 840 (1909); McNeil v. Miller, 29 W. Va. 480, 2 S. E. 335 (1887).

58. See note 54, *supra.*

59. It is a much quoted rule that reimbursement by subrogation will not be invoked in favor of a mere volunteer. Aetna Life Ins. Co. v. Middleport, 124 U. S. 534 (1888); Hiers v. Exum, 158 Ga. 19, 32, 122 S. E. 784, 790 (1924); Shinn v. Budd, 14 N. J. Eq. 234, 237 (1862); Koehler v. Hughes, 148 N. Y. 507, 42 N. E. 1051 (1896); Bobier v. Horn, 95 Okla. 8, 11, 222 Pac. 238, 241 (1923); U. S. Fidelity and Guaranty Co. v. Bramwell, 108 Ore. 261, 277, 217 Pac. 332, 338 (1923). Several reasons are assigned for this rule. See SHELDON, SUBROGATION 362; Comment (1925) 39 HARV. L. REV. 381. In any case, however, the rule against volunteers has been limited in application and the grant of a right of subrogation has steadily expanded. See Holloway, *Subrogation* (1926) 99 CENT. L. J. 275, 295; Comment (1925) 39 HARV. L. REV. 381; Note (1931) 8 N. Y. U. L. Q. REV. 337.

60. E.g., insurers and sureties. See note 54, *supra. Contra:* Spire v. Spire, 104 Kan. 501, 180 Pac. 209 (1919).

61. E.g., junior lienholders. See note 57, *supra.* The right is granted on this basis to stockholders who have paid corporate debts to protect their interests in corporate property. Redington v. Cornwell, 90 Cal. 49, 27 Pac. 40 (1891); Bush v. Wadsworth, 60 Mich. 255,

debt,[62] or to one who mistakenly thinks himself bound to pay.[63]

The application of the equitable right of reimbursement to such a variety of cases indicates that the courts have recognized that when one person, for a reason of equitable appeal, has paid the debt of another, he creates, in effect, a suretyship relation.[64] In such cases it is the factual relationship of the various parties which is of significance, not the formal or artificial criteria attending the classification of contracts under the terms "indemnity" or "suretyship." In other words, as a frequent thing in cases where a right of reimbursement has been the question at issue, courts, instead of attaching weight to factors which make the contract seem "independent," have focused attention on factors which show the factual tripartite relationship existing under the contract. Hence, there usually arises no need for talking in terms of "indemnity," and if the case is not strictly one of suretyship, the result reached is the same as if it were.

It may be that the loose conceptions permitted by the indemnity terminology could be considered devices whose utility would be destroyed by an attempt to find a more rigorous set of criteria for distinguishing between indemnity and suretyship. But, on the other hand, the lack of predictability when such criteria are used is very evident. And the impossibility of determining the real basis for decisions in cases which invoke this concept can scarcely be considered desirable. Furthermore, the illusion that there is a real distinction may and apparently does lead some courts to adapt to one situation tests which have been used in other situations, apparently conceiving that the result which follows, however undesirable, is forced upon them by precedent. Thus in the *Howell* case one is left either with the impression that, if any good reason existed for not granting the plaintiff the right to make a deduction on his income tax statement, that reason was concealed by the opinion of the court, or else that the court felt compelled to reach an undesirable result because it was subject

27 N. W. 532 (1886). The cases of Royce v. Bank of Commerce, and Cope v. Johnson, *supra* note 51, can be put into this class of cases. So also, it would seem, could the *Howell* case be classified if decided differently.

62. Dalton v. Dalton, 172 Ky. 585, 189 S. W. 902 (1916) (wife paid mortgage on husband's land). See SHELDON, SUBROGATION 368.

63. Simmons v. Goodrich, 68 Ga. 750 (1882) (surety could have avoided paying because creditor had varied the risk undertaken by the surety); Shaw v. Loud, 12 Mass. 446 (1815) (surety could have defended on grounds of statute of limitations); Fireman's Fund Ins. Co. v. Rowland Lumber Co., 186 N. C. 269, 119 S. E. 362 (1923) (insurer had a good defense so that it would not have had to pay the insured); See also Taylor v Roniger, 147 Mich. 99, 110 N. W. 503 (1907); Gooch v. Botts, 110 Mo. 419 (1892). *Contra:* Scandinavian Mutual Ins. Co. v. Chicago, Burlington and Quincy Rr. Co., 104 Neb. 258, 177 N. W. 178 (1920).

64. See Treanor, *supra* note 2, at 218: "But suppose the loss occurs to the insured because of the wrongful act of a third person under such circumstances that the insured has a claim against him for the loss. . . As between the wrongdoer and the insurer, the loss should fall upon the former, so we have the essential elements of a suretyship relation and the law so treats it." See Hall and Long v. The Railroad Companies, 13 Wall 367, 370 (U. S. 1871); Ocean Accident and Guaranty Corp. v. Hooker Electrochemical Co., 240 N. Y. 37, 52, 147 N. E. 351, 355 (1925); SHELDON, SUBROGATION 342; HARRIS, LAW OF SUBROGATION (1889) § 651.

to the illusion that some real distinction exists between suretyship and indemnity in such a case, and that reimbursement could only be granted to a surety. The real question presented in the *Howell* case was whether or not the income tax act either expressly or impliedly permits a deduction for a loss of the character sustained by the plaintiff. It is certainly arguable that his ability to pay a tax has been decreased by reason of the "indemnity" which he has paid. It is true that the plaintiff claims this deduction on the theory that he is in the position of a creditor holding worthless claims. The determination of his status as creditor is hence preliminary to the decision of his right to make a deduction. But the latter issue is capable of adjudication without invoking the illusory distinction between suretyship and indemnity. The principles governing the application of the doctrines of subrogation or equitable assignment or reimbursement are not in the least dependent upon any categorical labeling, but may themselves indicate the true nature of the relationship.[65]

Thus the court's explanation of its result on the grounds that the contract is independent, and hence one of indemnity, is no explanation at all in the light of the many cases where some form of reimbursement has been granted in favor of one whose promise was equally independent.[66] Whatever the form of the transaction, the tripartite relationship exists, so that the tenuous distinction drawn makes an irrelevant explanation.[67]

The conclusion of the attempt to discuss the difference between suretyship and indemnity has resolved itself in part into an explanation of what appears to have been the purpose behind the use of such terminology in some cases whereby similar factual situations were classified into different legal categories. In other words, the distinction between suretyship and indemnity in cases of this nature is of significance only when some question is presented for litigation, and the court feels that the decision of that question will be aided by a resort to the distinction, in order to attain the result desired. Hence, it is conceivable that an oral contract to answer for the debt of another person would be treated as, and called, a contract of indemnity for the purpose of enforcing the promisor's duty despite the statute of frauds. And yet the same contract might be treated as one of suretyship for purposes of granting a right of reimbursement to the third party promisor against the principal debtor.[68]

65. "Whoever is liable to pay the debt of another, whether for value, as in the case of a broker who receives a commission for incurring liability, or gratuitously, as between himself and the person originally or primarily liable, is a surety." Imperial Bank v. London and St. Katherine Docks Co., 5 Ch. D. 195, 200 (1877). "A surety is any person, who, being liable to pay a debt, is entitled, if it is enforced against him, to be indemnified by some other person who ought himself to have paid it before the surety was compelled to do so." Wendlandt v. Sohre, 37 Minn. 162, 163, 33 N. W. 700, 701 (1887).

66. See notes 53-56, *supra*.

67. See notes 53-57, *supra*.

68. See Maryland Casualty Co. v. Hjorth, 187 Wis. 270, 273-4, 202 N. W. 665, 666 (1925): "While it is universally held that the contract of an indemnity company guaranteeing to an employer the fidelity of employees is a contract of insurance, such holdings have generally been in cases involving the rights of the insured against the indemnity company and have related to a construction of the contract of insurance. . . ; it would seem that where an employee makes application to an indemnity company to guarantee his fidelity to his employer, the relation of principal and surety . . . is created just as much as though

Whether a contract is one of suretyship or indemnity can thus be answered, sometimes, only by referring to the circumstances which give rise to the need for the use of that distinction, and there certainly cannot be any basis for predicting, at the time a contract is made, into what category it may fall.

In part, however, the difference supposed to exist is no doubt viewed by courts as a rule of law which must somehow be discovered, understood and applied. Inasmuch as the categorical technique has been used to decide cases involving various types of issues, each category is viewed as providing a whole series of results which necessarily follow when a given situation is classified therein. Thus, a case which has decided that an oral promise by a third person is enforceable because it is a promise of indemnity, may be used as a precedent for a case which decides that the third party promisor is bound by his promise despite the failure of the promisee to give him notice of the default of the principal, each case on the ground that the contract is one of indemnity rather than one of suretyship.

That the reasoning in the cases which invoke these distinctions is rarely understandable is a natural enough result. A case which has consciously utilized the categories to attain the desired result is a confusing precedent when a sincere attempt is being made by a different court to discover the universal test for other cases of the same nature, and produces a far more confusing result in the case being decided. Furthermore, some courts have apparently been unable to ignore the factual relationship in favor of the legal relationship on which other courts have based their decisions,[69] so that a prior case is either overruled or an attempt made to distinguish it by some further refinement. The line of cases, even within one jurisdiction, thus presents a doubtful array of material on which to base either a prediction or a decision. The remedy, if any, would seem to lie in ignoring entirely the supposed categories and actually deciding cases on the particular factual issues presented. But, in the absence of such a remedy, it must be recognized that definitions of suretyship or indemnity are cast in terms of result rather than in terms that will lead to results.

EFFECT OF SECTION 7 (a) OF NIRA ON THE VALIDITY OF A CLOSED UNION-SHOP CONTRACT

PRIOR to the enactment of Section 7(a) of the NIRA, a closed union-shop[1]

the application had been made to a private individual and such private individual had executed a bond to the employer." Thus the courts consistently allow reimbursement to a corporate surety company. Mellette Farmers' Elevator Co. v. H. Poehler Co., 18 F. (2d) 430 (D. Minn. 1927); Colonial Trust Co. v. Fidelity Co., 144 Md. 117, 123 Atl. 187 (1923); National Surety Co. v. Berggren, 126 Minn. 188, 148 N. W. 55 (1914); Gilbertson v. Northern Trust Co., 53 N. D. 502, 207 N. W. 42 (1925).

69. See the opinion in Macey v. Childress, 2 Tenn. Ch. 438 (1875).

1. Commonly called the "closed shop." Strictly speaking it should be divided into two classes according to whether the doors of membership in the union are open or shut. BEMAN, SELECTED ARTICLES ON THE CLOSED SHOP (2d ed. 1922) 201-207.

agreement as such was valid.[2] In return for the employer's promise to hire only union members, the union would give consideration in the form of a promise to supply labor, to call off a strike or not to call one during the term of the contract, to refrain from boycotting, to accept a specified wage scale, or would permit the employer to use the union label. If an employer discharged union workers and engaged nonunion men to fill their places, in some states, notably New York, he could be enjoined.[3] But a majority of courts would refuse to grant such specific performance of the agreement.[4] In some cases equitable remedies sought by unions were refused on the ground that actions at law would have been adequate and that specific performance of a contract would not be granted unless there was a mutuality of remedy as well as of obligation.[5] Thus it was argued that because the employer could not have enforced the union promise to supply labor, personal services being involved, the union could not enjoin violation of the contract. Yet even in jurisdictions where these objections carried, the closed union-shop device was considered of great aid to labor in its attempts both to regiment labor and

2. Hoban v. Dempsey, 217 Mass. 166, 104 N. E. 717 (1914); Jacobs v. Cohen, 183 N Y. 207, 76 N. E. 5 (1905). See Hitchman Coal & Coke Co. v. Mitchell, 245 U. S. 229, 250-251, 270 (1917). Generally, while a strike for improved conditions or to benefit union members has been deemed lawful, and the resultant "closed shop," valid, a strike to injure nonmembers has been held unlawful, and the "closed shop" thereby achieved, invalid. Nat. Protective Association v. Cumming, 170 N. Y. 315, 63 N. E. 369 (1902). The New York courts generally found proper motives and means, Exchange Bakery & Restaurant Inc. v. Rifkin, 245 N. Y. 260, 157 N. E. 130 (1927), but it was otherwise in Massachusetts where strikes to secure closed union-shops were held illegal. FRANKFURTER AND GREENE, THE LABOR INJUNCTION (1930) 28-31. See also Purvis v. Local No. 500, 214 Pa. 348, 63 Atl. 585 (1906). In other instances existing agreements have been held illegal as being in restraint of trade or monopolistic. Connors v. Connolly, 86 Conn. 641, 86 Atl. 600 (1913); Polk v. Cleveland Railway Company, 20 Ohio App. 317, 151 N. E. 808 (1925). But it has been indicated that only a person who has been deprived of the right to work may attack the contract as monopolistic. Des Moines City Railway Co. v. Amalgamated Association, 204 Iowa 1195, 213 N. W. 264 (1927).

3. Schlesinger v. Quinto, 201 App. Div. 487, 194 N. Y. Supp. 401 (1st Dep't, 1922), noted in (1922) 22 COL. L. REV. 380; Goldman v. Cohen, 222 App. Div. 631, 227 N. Y Supp. 311 (1928); Ribner v. Racso Butter & Egg Co., 135 Misc. 616, 238 N. Y. Supp. 132 (Sup. Ct. 1929), noted in (1930) 30 COL. L. REV. 410.

4. See Mason, *Organized Labor as Party Plaintiff In Injunction Cases* (1930) 30 COL. L. REV. 466; Sayre, *Labor and the Courts* (1930) 39 YALE L. J. 682, 690; Witte, *Labor's* Resort to Injunctions (1930) 39 YALE L. J. 374.

5. Schwartz v. Cigar Makers International Union, 219 Mich. 589, 189 N. W. 55 (1922) See Schwartz v. Wayne Circuit Judge, 217 Mich. 384, 186 N. W. 522 (1922). *Contra:* Schlesinger v. Quinto, 201 App. Div. 487, 194 N. Y. Supp. 401 (1st Dep't, 1922). Cf. Lundoff-Bicknell Co. v. Smith, 24 Ohio App. 294, 156 N. E. 243 (1927) (employer could not enjoin breach of the union's agreement not to strike). But cf. A. R. Barnes & Co. v. Berry, 156 Fed. 72 (C. C. S. D. Ohio, 1907) (employer could enjoin union leaders from inciting a strike); Gilchrist Company v. Metal Polishers, 113 Atl. 320 (N. J. Ch. 1919) semble; Meltzer v. Kaminer, 131 Misc. Rep. 813, 227 N. Y. Supp. 459 (Sup. Ct. 1927) semble. With respect to the requirement of mutuality, see Schlesinger v. Quinto, *supra*; POMEROY, SPECIFIC PERFORMANCE (3d ed. 1926) §§ 162-165; Stone, *The Mutuality Rule in New York* (1916) 16 COL. L. REV. 443; Cook, *The Present Status of the "Lack of Mutuality" Rule* (1927) 36 YALE L. J. 897.

to secure effective collective bargaining. The agreement, if not an enforceable contract,[6] at least would create moral obligations reenforced by the fear of strike and boycott,[7] and would allow the employees to be represented in collective bargaining by more experienced union officials.

Sections 7(a) of NIRA[8] purported to acknowledge these principles and to strengthen the arm of organized labor by recognizing the propriety of collective bargaining and of membership in a union.[9] But the wording of the Section is open to interpretation invalidating the union shop contract. The Section declares that employees shall have the right to bargain collectively through representatives of their own free choosing, and that no employee and no one seeking employment shall be required as a condition of employment to join any company union or to refrain from joining, or organizing, or assisting a labor organization of his own choosing. Despite the ostensible purpose of the Section, the language of this clause, although obviously directed against the "yellow-dog" contract,[10] can be construed to have outlawed likewise the union shop contract. For when an employer agrees to employ only members of the *X* union he binds himself in effect to require as a condition of employment that his employees refrain from joining the *Y* or any other union or from renouncing the *X* union. If his employees should shift to the *Y* union, expulsion from the *X* union ordinarily would follow.[11] In New York the *X* union could compel the employer to discharge them.[12] Even if he refused, he would be

6. With respect to the nature of collectve labor agreements and the theories of enforcement, see Christenson, *Legally Enforceable Interests In American Labor Union Working Agreements* (1933) 9 IND. L. J. 69; Fuchs, *Collective Labor Agreements In American Law* (1925) 10 ST. LOUIS L. REV. 1; Rice, *Collective Labor Agreements In American Law* (1931) 44 HARV. L. REV. 572; Comment (1931) 31 COL. L. REV. 1156; Comment (1933) 11 N. Y. U. L. Q. REV. 262; Comment (1932) 41 YALE L. J. 1221. For a philosophical analysis, see Duguit, *Collective Acts As Distinguished From Contracts* (1918) 27 YALE L. J. 753.

7. Where the purpose was to promote the interests of the union men, the union in some states could call a strike to compel the discharge of non-members. Kemp v. Division No. 241, 255 Ill. 213, 99 N. E. 389 (1912); Roddy v. United Mine Workers of America, 41 Okla. 621, 139 Pac. 126 (1914). But cf. Berry v. Donovan, 188 Mass. 353, 74 N. E. 603 (1905); Lucke v. Clothing Cutters & Trimmers Assembly, 77 Md. 396, 26 Atl. 505 (1893); Brennan v. United Hatters of North America, 73 N. J. L. 729, 65 Atl. 165 (1906).

8. 48 STAT. 198, 15 U. S. C. A. 707(a) (1933).

9. The most recent and complete treatment of the legal problems raised by the Section appears in a note (1935) 48 HARV. L. REV. 630-659. See also DAUGHERTY, LABOR UNDER THE NRA (1933); STEIN, LABOR AND THE NEW DEAL (1934); McNatt, *Organized Labor and the Recovery Act* (1934) 32 MICH. L. REV. 780, 800-810; Comment (1934) 34 COL. L. REV. 1529; Comment (1933) 47 HARV. L. REV. 85, 117-125. Comment (1933) 19 ST. LOUIS L. REV. 32, 40-42; Comment (1934) 43 YALE L. J. 625.

10. The principal legal difference between this clause of the NIRA and Section 3 of the Norris-La Guardia Anti-Injunction Act, 47 STAT. 70, 29 U. S. C. A. §§ 101, 103 (1932), is that the former prohibits the use of "yellow-dog" contracts whereas the latter went only to the remedy in the federal courts. McNatt, *supra* note 9, at 806.

11. But to the effect that expulsion from the union does not automatically terminate the employment so as to make the expelled member liable to the union in damages, for having stayed on in employment, see Shinsky v. Tracey, 226 Mass. 21, 24, 114 N. E. 957, 958 (1917).

12. Ribner v. Racso Butter & Egg Co., 135 Misc. 616, 238 N. Y. Supp. 132 (Sup. Ct. 1929).

bound to deny them the right to bargain through different representatives, since ordinarily the union-shop contract would provide that representatives of the *X* union were to be the exclusive bargaining agents. Such reasoning when referred to the contrary declarations of the Section has induced pronouncements to the effect that union-shop agreements are no longer valid.[13] But that this interpretation may readily be avoided,[14] and that the closed shop contract may yet be specifically enforced was demonstrated in a recent New York case.[15]

The plaintiff Doll and Toy Maker's Union had secured an agreement with the defendant doll manufacturing corporation whereby the latter would employ only members of the union, except that if the union were unable to furnish the desired number of men, the corporation could employ nonunion workers who had obtained working cards from the union. Subsequent to this agreement the defendant discharged some union workers and proceeded to transfer to its plant in Massachusetts work which would have been done by the dismissed men. Alleging that this move was made for the sole purpose of avoiding the obligation to hire union labor, plaintiff sought to compel performance of the agreement by enjoining permanently this and other alleged violations of the contract. The defendant contended that the agreement was invalid under Section 7(a) and therefore could not be enforced. The court, declaring the Section to be constitutional and thus applicable,[16] held that the agreement was

13. Drake Bakeries, Inc. v. Bowles, 31 Ohio N. P. (N.S.) 425 (1934). A strike for a closed shop has been held to be in violation of the clause. Elkind & Sons, Inc. v. Retail Clerks International Protective Association, 114 N. J. Eq. 586, 169 Atl. 494, 496 (1933). For expressions of similar effect see (Sept. 26, 1933) U. S. L. WEEK and language used by the National Labor Board in In the Matter of General Cigar Company, NLB Case No. 163 (Feb. 6, 1934); In the Matter of Finck Cigar Company, N. L. B. Case No. 228 (May 12, 1934). But the National Labor Relations Board has avoided express commitment as to whether closed union shops with bona fide unions are legal. In the Matter of Tamagua Underwear Company, NLRB, Case No. 27 (Aug. 6, 1934); In re Hildinger-Bishop Company, NLRB, Case No. 86 (Oct. 25, 1934); See Comment (1935) 48 HARV. L. REV. 630 657. Cf. In re Bennett Shoe Company, NLRB, Case No. 159 (Dec. 10, 1934) (discharged workers having ratified the closed union shop agreement, were estopped to deny its validity). See also (1933) 47 HARV. L. REV. 85, 122, ff. 263, 264.

14. The argument has been advanced that the wording of the Section is avoided by saying that in realty it is the union rather than the management which compels membership as a condition of employment. See the address of Milton Handler, then General Counsel to the National Labor Board, (May, 15, 1934) U. S. L. WEEK 4, 6.

15. Farulla v. Ralph A. Freundlich, Inc., 153 Misc. 738, 277 N. Y. Supp. 47 (Sup. Ct. 1934). A temporary injunction had been granted previously. Farulla v. Ralph A. Freundlich, Inc., 152 Misc. 761, 274 N. Y. Supp. 70 (Sup. Ct. 1934). But see note 40, *infra*. Cf. Sherman v. Abeles, 265 N. Y. 383, 193 N. E. 241 (1934); (1935) 20 CORN. L. Q. 240. The New York Court of Appeals recently held that peaceful picketing for a closed union-shop was legal. Wise Shoe Company, Inc. v. Retail Shoe Salesmen's Union, N. Y. Times, Feb. 28, 1934, at 1, col. 7.

16. Prior to the NIRA attempts to outlaw the "yellow dog" contract were held unconstitutional. Adair v. United States, 208 U. S. 161 (1908); Coppage v. Kansas, 236 U. S. 1 (1915). It is said that these cases would need to be overruled if the principal result is reached. Comment (1933) 11 N. Y. U. L. Q. REV. 237, 245. But the New York Court of Appeals has not been willing to follow the Supreme Court decisions, notably the *Hitchman* case. Stillwell Theatre v. Kaplan, 259 N. Y. 405, 410, 182 N. E. 63, 65 (1932). Nevertheless, a lower court has recently held that despite the Section, an employer may dis-

nevertheless binding. "Closed shops" had not been outlawed by NIRA because, it was said, Congress never had that intention. The parties were given a week to settle their differences as to whether or not the contract had been violated by the defendant.

Despite the verbal difficulty inherent in the broad language of the Section, the principal conclusion is sound as respects the validity of the union-shop contract. In view of the widespread existence of closed union-shops, and of their importance to organized labor, it is probable that if Congress had intended their outlawry, the intention would have been phrased in no uncertain terms. That Congress did not so intend is borne out further by the legislative history of the Act.[17] Section 7(a) as originally drafted forbade the employer to require membership "in any organization" as a condition of employment, whereas, at the instance of the American Federation of Labor, the wording was changed to forbid the employer to require membership in a "company union."[18] Moreover, since the union shop device is a means of securing effective bargaining, which itself may be but a means to the avowed ends of industrial coöperation and of better living conditions for the worker, and since the purpose of Section 7(a) was to promote the same ends,[19] the device and Section rather than being inconsistent, are functionally harmonious. Consequently, the statutory wording should be given favorable construction by the courts. This can be done by restricting application of the clause, prohibiting the employer's interference with free choice of union membership, to the "yellow-dog" type of situation which it was designed to meet. Such a limitation would have the effect that although an employee could not be discharged for membership in the union of his choosing,[20] he could be dismissed for nonmembership in the union having the shop agreement.[21] Nevertheless, with reference to the validity of a union-

charge an employee for any reason, or for no reason. H. B. Rosenthal-Ettlinger Co. v. Schlossberg, 149 Misc. 210, 266 N. Y. Supp. 762 (Sup. Ct. 1933). See also In re Opinion of the Justices, 275 Mass. 580, 176 N. E. 649 (1931); In re Opinion of the Justices, 165 Atl. 640 (N. H. 1933), indicating that the *Adair* and *Coppage* cases are still to be followed. Section 7(a) has been held unconstitutional by a Federal District Court as applied to companies not engaged in interstate commerce. United States v. Weirton Steel Co., N. Y. Times, Feb. 28, 1935, at 1, col. 8. The case is being appealed. If Section 7(a) or the NIRA is held unconstitutional or otherwise inapplicable (e.g. to uncoded industries) the validity of closed union-shops agreements remains as before.

17. See Witte, *The Background of the Labor Provisions of the NIRA* (1934) 1 U. OF CHI. L. REV. 572, 579.

18. *Hearings before the Committee on Ways and Means on H. R. 5664,* 73d Cong., 1st Sess. (1933) 118.

19. 48 STAT. 198, 15 U. S. C. A. § 701 (1933).

20. See Comment (1935) 48 HARV. L. REV. 630, 656. An employer violates Section 7(a) if upon the termination of a union-shop contract he discharges union men without cause. In re Boston Upholstery Companies, NLRB, Case No. 209 (Dec. 22, 1934); cf. Fryns v. Fair Lawn Fur Dressing Co., 114 N. J. Eq. 462, 168 Atl. 862 (1933). But cf. Sherman v. Abeles, 265 N. Y. 383, 193 N. E. 241 (1934).

21. But cf. Norris-LaGuardia Act. 47 STAT. 70, 29 U. S. C. A. § 102 (1932). ". . . though he (the individual unorganized worker) should be free to decline to associate with his fellows . . ." White House Statement, N. Y. Times, March 26, 1934, at 1, col. 6: "Reduced to plain language, Section 7(a) of NIRA means . . . (c) Discrimination against employees because of their labor affiliations or for any other unfair or unjust reason is barred."

shop contract, the collective bargaining provisions, which give the employees the right to bargain collectively through representatives of their own free choosing, as interpreted in the *Houde* and other decisions of the labor boards, may not be ignored.[22] If a majority of the workers in a given plant should desire to be represented in the bargaining by men other than the union representatives contemplated in the union shop agreement, the question would arise as to which prevailed, the closed union-shop contract or the will of the majority workers.[23] The collective bargaining provision as interpreted under the majority rule would require that the contract should not be enforced under Section 7(a) where the majority does not continue to wish to be represented by the contracting union.[24] If the majority rule is upheld by the courts,[25] this would have the effect of writing into a union-shop agreement the condition subsequent that the contract is valid unless and until renounced by a majority of the employees in the contracting company.[26] If the condition occurred, the union would have no action against the employer, unless in violation of the Section the employer had coerced his employees to abandon their union affiliations.[27] Whether the new majority group should be allowed to conclude its own closed shop and compel the discharge of the minority is, however, subject to some doubt.[28] If the new

22. In the Matter of the Denver Tramway Corporation, NLRB, Case No. 149 (March 1, 1934); In the Matter of Houde Engineering Corporation, NLRB, Case No. 12 (Aug. 30, 1934), noted (1934) 34 COL. L. REV. 1362; followed in In the Matter of Guide Lamp Corporation, NLRB, Case No. 42 (Sept. 4, 1934). The judicial power of the NLRB is discussed in Smethurst, *Effect of Administrative Interpretation on the Powers of The National Labor Relations Board* (1935) 3 GEO. WASH. L. REV. 141. Comment (1934) 43 YALE L. J. 599.

23. See e.g., Progressive Miners of America v. Peabody Coal Company, 7 F. Supp. 340 (E. D. Ill. 1934), noted in (1934) 29 ILL. L. REV. 396; Stanley v. Peabody Coal Company, 5 F. Supp. 612 (S. D. Ill. 1933).

24. In the Matter of Hildinger Bishop Company, NLRB, Case No. 86 (Oct. 25, 1934). Compare United Electrical Coal Companies v. Rice (E. D. Ill. Dec. 21, 1934), (Jan. 15, 1935) U. S. L. WEEK 11.

25. The constitutionality of the majority rule as established in the labor board decisions has been sharply attacked on the ground that the rights of minority individuals are infringed. Sargent, *Majority Rule in Collective Bargaining Under Section* 7(a) (1934) 29 ILL. L. REV. 275. For an impartial discussion, see (1935) 48 HARV. L. REV. 630, 632-640.

26. Compare Section 8(3) of the newly proposed Wagner National Labor Relations Bill. N. Y. Times, Feb. 22, 1935, at 14, col. 2. In case of doubt as to the majority, upon petition, an election conducted under NIRA auspices would be determinative. If undue pressure was brought in the election, the group having a majority prior to the vote would continue to represent the workers in bargaining. In re Danbury & Bethel Fur Company, N L R B, Case No. 116 (Nov. 22, 1934).

27. Comment (1935) 48 HARV. L. REV. 630, 644-48.

28. It is possible that even in New York, where a rival union may go comparatively far in efforts to displace a competitor (Nann v. Raimist, 255 N. Y. 307, 174 N. E. 690 (1931) such an agreement could be held invalid on the ground of unlawful purpose. See Sayre, *Inducing Breach of Contract* (1923) 36 HARV. L. REV. 663; cf. Goyette v. C. V. Watson Company, 245 Mass. 577, 140 N. E. 285 (1923). But the situation would not be likely to arise, if the minority comprised a large group, since the employer would not then submit to a closed shop demand. Or if the doors to the new union were open, the minority could switch to it.

group became a company union, it is probable that a closed shop agreement would be invalid, for the Section in prohibiting the requirement of membership in "any company union" forbids such an arrangement.[29]

Aside from these problems in connection with the effect of NIRA on the validity of closed union-shop contracts, the principal case raises the further question of how such a contract may be enforced if the employer seeks to move his business to a different location. Ordinarily there is no provision in the contract expressly binding the employer to maintain the same business site. Consequently, the union may not enjoin a change of location unless the change was made in bad faith for the sole purpose of discharging union men and of replacing them with nonunion workers in violation of the contract.[30] But such bad faith seldom will be found. Usually the employer will have a plausible argument to show lower production costs, by virtue of the change, making possible a saving to the consumer. But, in the computation, he may not rely on a lower, nonunion wage scale, for even though the change was in good faith he is obliged, before hiring any nonunion men to do the transferred business, to employ members of the contracting union who appear for work at the new location. In reality, however, there would be a wage saving, if the new location were in nonunion territory at a distance too far for commuting, since the discharged or other union workers could not afford to seek new and nearer homes. Yet even assuming that the contract expressly forbade a change of location and that it clearly appeared that the move was a subterfuge designed to rid the employer of his union obligations, it is conceivable that in the absence of the applicability of Section 7(a), a majority of state courts would refuse to enjoin, or to give damages equal to the lost wages. The promise might be treated as other promises in collective labor agreements which, if held valid in the first place, are not specifically enforceable on one or more of a number of technical grounds.[31] But a different result is reached under 7(a) before the National Labor Relations Board,[32] and should be attainable in the Federal courts and in those state courts which uphold the constitutionality of state recovery acts.[33]

29. In the Matter of Tamaqua Underwear Company, NLRB, Case No. 27 (Aug. 6, 1934).

30. Goldman v. Cohen, 222 App. Div. 631, 227 N. Y. Supp. 311 (1st Dep't, 1928); and see cases cited note 32, *infra*. A similar situation is presented where the union seeks to enjoin dissolution or reincorporation by the employer. See (1934) 34 COL. L. REV. 376. But cf. note 40, *infra*.

31. See articles cited note 6, *supra*. Thus an agreement, to be enforceable, must be for a definite duration. In the Matter of National Aniline & Chemical Company, NLRB, Case No. 33, (Oct. 3, 1934). In many jurisdictions even prior to the NIRA there was a tendency in the same direction. Comment (1931) 19 CALIF. L. REV. 183; (1931) 15 MINN. L. REV. 251.

32. In the Matter of Consolidated Film Industries, NLB, Case No. 257 (June 30, 1934); In the Matter of George Royle and Company, NLB, Case No. 265 (June 30, 1934); In the Matter of Maujer Parlor Frame Company, NLRB, Case No. 21 (Aug. 18, 1934); In the Matter of the Fischer Press and Fischer Press Inc., NLRB, Case No. 70 (Sept. 22, 1934); In re Globe Gabbe Corporation: In re Shuster Gaio Corporation, NLRB, Case No. 206 (Dec. 22, 1934).

33. As to validity of state Recovery acts see Comment (1935) 29 ILL. L. REV. 777; Comment (1935) 33 MICH. L. REV. 597. The legislative sanction accorded collective bargaining by the Recovery acts should serve to strengthen the collective labor agreements and

For regardless of the existence of a contract, the Section in making it illegal for an employer to discharge on the basis of union membership or to deprive workers of their rights to collective bargaining, would prohibit a transfer of business for the sole purpose of avoiding labor obligations.[34] Some courts, however, might refuse to entertain such a suit on the ground that under Section 3(c) of the NIRA a private party is not entitled to sue.[35]

The doubts as to constitutionality and enforceability, and the desirability of reaching a determination before damage is done, should inspire the use of the declaratory judgment in such cases.[36] When the supposed breach of a union-shop agreement is doubtful and injury is threatened, the parties concerned, to avoid resort to the expensive and socially undesirable combat by pickets and policemen, should be able to secure a speedy declaration of their rights[37] in the manner prevailing in foreign countries.[38] Thus, if an employer had legitimate reasons for wishing to move his business, but desired to avoid the risk of violating the contract or the Section and probably to avert union threats of strike or boycott, he should be entitled to a declaration before going ahead. And in the principal situation, if the union had sought a judgment prior to the consummation of the defendant's transfer to Massachusetts, the result might have been less costly and more favorable. It is likely that in such a suit a court would be more readily disposed to find the deciding element of bad faith

dictate effective enforcement by specific performance. FUCHS, SOME LEGAL ASPECTS OF THE ENFORCEMENT OF COLLECTIVE LABOR AGREEMENTS (1934) 9-10 (Graduate thesis in the Yale School of Law library).

34. Where there is a contract the union might have to elect whether to rely on the alleged breach of it or the violation of Section 7(a). "A mere breach of contract is not in itself a violation of Section 7(a)." In the Matter of Chicago Defender, Inc., N L R B. Case No. 126 (Oct. 20, 1934).

35. Purvis v. Bazemore, 5 F. Supp. 230 (S. D. Fla. 1933), noted in (1934) 43 YALE L. J. 480; Progressive Miners of America v. Peabody Coal Company, 7 F. Supp. 340 (E. D Ill. 1934), noted in (1934) 29 ILL. L. REV. 396.

36. The Federal Declaratory Judgments Act, Judicial Code, § 2740, 48 STAT. 955, 28 U. S. C. A. § 400 (1934), affords the remedy in cases of "actual controversy." Such a controversy would exist in the principal type of situation, since the employer is under a duty by virtue both of the agreement and of Section 7(a). Cf. Nashville, Chattanooga & St. Louis Railway Company v. Wallace, 288 U. S. 249 (1933), BORCHARD, DECLARATORY JUDGMENTS (1934) part II, c. IV, and pp. 594-595.

37. But labor's resort to the declaratory judgment so far has been unsuccessful. A union suit for a declaration of its rights under 7(a) was refused in Hary v. United Electric Coal Company, 8 F. Supp. 655 (E. D. Ill. 1934), on the ground chiefly that the private party could not have brought suit for an affirmative relief. See note 35, *supra*. In Scarsdale Supply Company v. Pearce, 153 Misc. Div. 296, 274 N. Y. Supp. 77 (Sup. Ct. 1934), a suit, brought by the company for a declaration as to the legality of a proposed union-shop agreement, was refused on the ground that the question was moot since there was no jural relation. Such reasoning could not apply if the contract were signed. And it has been held that to avoid hardship the effect of a statute on the legality of a contract may be declared before the contract goes into effect. Warren v. Commerce Union Bank, 152 Tenn. 67, 274 S. W. 539 (1925).

38. BORCHARD, *supra* note 36, cases cited at 401-402. Fuchs, *Collective Labor Agreements In German Law* (1929) 15 ST. LOUIS L. REV. 1, 24-26.

on the employer's part[39] than in the usual case where the employer already has undergone the expense of moving.[40]

JUDICIAL RESTORATION OF THE GENERAL PROPERTY TAX BASE

DESPITE the fact that it does not reach those intangibles which have become a great and ever-increasing part of the national wealth,[1] and despite the fact that various forms of excise have been resorted to,[2] the general property tax upon real estate or upon real estate and tangible personalty remains the backbone of American local taxation. Not only in rural areas but even in cities, it produces more than sixty-five percent of the revenue.[3] The recent unhappy efforts of such cities as New York to enlarge revenues by other means, including income and inheritance taxes, have been only the most striking example of the unsuitability of more modern tax devices to the needs of taxing juris-

39. Under the decisions both of courts, *supra* note 30, and of the labor boards, *supra* note 32, although the contracting employer is obliged to hire union men if they appear at the new location, the change is not enjoined unless made in bad faith.

40. Indeed, the fact that the employer had already so removed and started operation in the new location led the Federal District Court in Massachusetts to nullify the effect of the decision in the instant case. The closed union-shop contract was voided under Subsection M of Section 77B of the Federal Bankruptcy Act on the ground that compliance with the labor contract, which here resulted in closing the factory to which the employer had removed, imperiled the financial stability of the corporation. N. Y. Sun, March 20, 1935, at 1, col. 4.

1. From an economic point of view this is the greatest weakness of the general property tax, due not only to inherent dishonesty of taxpayer and assessor but also to the fact that the property tax, although workable when applied to tangible objects of fairly stable value in a fairly stable economy, is mechanically unfitted to intangible objects of rapidly fluctuating value and of easy concealment. The result has been that the burden has increasingly fallen on real property, which has not proportionately shared in the increase of general wealth. See SELIGMAN, ESSAYS ON TAXATION (9th ed. 1921) 62; GREEN, THEORY AND PRACTICE OF MODERN TAXATION (1933) c. 22. For a discussion of the difficulty of reaching intangibles by the general property tax see Compton, *Ohio at the Crossroads* (1931) 9 TAX MAG. 13. This has compelled many states either to substitute an income tax for the older form of taxation or to add an income tax. Municipalities and other local units still rely principally on the property tax, often restricted to real property and sometimes aided by state funds. See Leffler, *Ebb Tide in Taxation* (1933) 22 NAT. MUN. REV. 541 (statistics on proportion of tax burden borne by general property tax). See also Comment (1934) 43 YALE L. J. 924, 928.

2. To the effect that these have been only partially successful, see Comment (1934) 43 YALE L. J. 924, 942-944.

3. In 1931, 310 cities, whose population comprised 38.6% of the total population of the United States, obtained approximately 66.2% of all their revenues from general property taxes. U. S. BUREAU OF CENSUS, FINANCIAL STATISTICS OF CITIES HAVING OVER 30,000 POPULATION (1931). See generally Leffler, *supra* note 1.

dictions developed under the simpler functioning of the property tax.[4] Sweeping reorganizations of local governmental structures and local tax systems have not been forthcoming. But the necessary expenses of local government are becoming increasingly greater, and concomitantly the necessity is growing more urgent for better utilization of the existent property tax.[5] The abuses of this tax, which have been abundantly recognized in the past without the simultaneous recognition that their abolition would go far towards restoring the measure of efficiency needful to provide for the costs of modern local government,[6] now demand correction.

Two of the most prevalent sources of abuse, and likewise two of the most essential factors in the efficiency of the general property tax, are the valuation of the individual units to be taxed, and the granting or withholding of exemptions sought by potentially taxable units.[7] The sum of these units is the tax-base, the multiplicand to which the general tax rate is applied to produce the total of the levy. When this is eaten away by mismanagement, special privilege, or corruption, the physical power of the taxing jurisdiction to raise money is gravely impaired, the governmental credit suffers, and if it is sought to remedy the inadequacy of the tax base by raising the rate, there is danger of early reaching the point of diminishing returns. Furthermore, the honest taxpayer who is not the recipient of special privilege suffers not only as a member of the community but also in his individual capacity, since his own share of the community tax burden will be proportionately higher. Moreover, local governmental units, especially since the depression, often resort to consistent over-valuation in order to evade the intended effect of laws limiting the tax-rate or the debt in-

4. See N. Y. Times, Nov. 11, 1934, § 1, at 1, col. 8; Nov. 15, 1934, at 1, col. 1; Nov. 17, 1934, at 1, col. 8; Nov. 21, 1934, at 1, col. 8; Dec. 6, 1934, at 1, col. 1; Dec. 9, 1934, § 1, at 1, col. 3; Dec. 10, 1934, at 1, col. 1; Dec. 18, 1934, at 1, col. 8; Dec. 29, 1934, at 1, cols. 6, 7.

5. See N. Y. Times, Feb. 17, 1935, at 9, col. 1 (report by A. M. Hillhouse, Research Director of the Municipal Finance Officers' Association).

6. Compton, *Romance and Reality* (1931) 9 TAX MAG. 432; Connolly, *Municipal Taxation and Finance* (1933) 11 TAX MAG. 367, 402; Hughes, *The Status of the General Property Tax in Illinois* (1932) 10 TAX MAG. 333, 334; Todd, *Taxation of Personal Property* (1931) 9 TAX MAG. 212; Todd, *The Taxation of Real Estate* (1934) 12 TAX MAG. 533; see N. Y. Herald-Tribune, Feb. 24, 1935, § 10, at 1, col. 8. Generally, however, there has been a failure to realize that the special financial problems growing out of the depression, and the previous boom are quite distinct from the question of whether under normal conditions the general property tax can adequately provide for the working needs of modern local government. That these needs will remain heavy, even when the load of debt accumulated by long decades of governmental extravagance has been liquidated, is self-evident from a consideration of the vastly increased scope of governmental services. For a convenient summary of the growth of the tax burden see GREEN, op. cit. *supra* note 1, at 225 et seq. Relief also is a heavy burden upon local and state governments and is expected to continue so for an indefinite period. See N. Y. Times, Dec. 1, 1934, at 1, col. 8; Dec. 8, 1934, at 11, col. 1; Dec. 13, 1934, at 3, col. 1; Dec. 15, 1934, at 1, col. 8; Feb. 25, 1935, at 1, col. 2.

7. NATIONAL TAX ASSOCIATION, PROCEEDINGS OF THE THIRTEENTH CONFERENCE (1920) 243; Cross, *General Tax Exemption* (1933) 11 TAX MAG. 338; Haensel, *State and Local Tax Problems* (1934) 12 TAX MAG. 651; see Todd, *Exemption and Tax Delinquency* (1934) 12 TAX MAG. 159.

curring power, thus imposing a weight of concealed illegality upon the taxpayer. There are many problems and abuses in other parts of general property tax administration, including very grave defects in tax collection. But even should every other difficulty be satisfactorily overcome, the property tax will remain both unfair and inadequate unless the problems of valuation and exemption are solved.

These problems lie within the province of the courts, and need not wait upon improbable legislative reform for solution. Valuation is not a purely ministerial task of carrying out a legislative or constitutional mandate, but involves a high degree of administrative discretion.[8] It is, even more, a quasi-judicial function, from which, although it may be necessary first to exhaust a complicated system of administrative remedies, there is always an ultimate appeal to the courts.[9] Exemption is entirely a legal problem, viz., the judicial interpretation and application to particular instances of statutes usually general in nature. The actions of the courts in this field of tax law necessarily bear a vital relation to the effectiveness of the general property tax. It will be profitable, therefore, to investigate what legal principles have guided the judiciary, whether any failures to make good use of the judicial power have been due to the established legal principles or to a misuse of them, and finally to consider what the courts could do to remedy the situation and to make their ultimate control of the tax base effective in the interests of fairness and adequate revenue return.

Valution. The principles of valuation are simple. The first principle, and the most widely ignored, is that property must be taken at "fair cash value," "true value," "actual cash value," or the equivalent term.[10] In theory, if this be done, the second principle, that of uniformity, will be attained. In practice, however, the courts were met, at least before the depression, with a condition of general underassessment which only the catastrophic decline in realty values ended.[11] Partly, this was the result of continuous pressure by individual taxpayers, each of whom hoped that his underassessment would be a little greater than his neighbor's underassessment. Partly also, in states where local assessment has been

8. Miller & Lux Inc. v. Richardson, 182 Cal. 115, 118, 187 Pac. 411, 416 (1920); German-American Lumber Co. v. Barbee, 59 Fla. 493, 495, 52 So. 292, 294 (1910). To the same effect, but without explicit statement of the reason are: Coulter v. Louisville & Nashville Rr. Co., 196 U. S. 599 (1905); Mercantile Nat. Bank of New York v. Mayor & Council of New York, 172 N. Y. 35, 37, 64 N. E. 756, 760 (1902); Shattuck v. Smith, 6 N. D. 56, 69 N. W. 557 (1896); Morgan's L. T. R. and S. Co. v. Board of Reviewers, 41 La. Ann. 1156, 3 So. 507 (1887).

9. Balfour v. City of Portland, 28 Fed. 738 (C. C. D. Ore. 1896); Boody v. Watson, 64 N. H. 162, 165, 9 Atl. 794, 798 (1887); Van Deventer v. Long Island City, 139 N. Y. 133, 134, 34 N. E. 774, 775 (1893); Northern Pacific Rr. Co. v. Pierce, 55 Wash. 103, 109, 104 Pac. 178, 179 (1909); Vancouver Waterworks Co. v. Clarke County, 55 Wash. 112, 104 Pac. 180, 181 (1909); Weyerhauser Timber Co. v. Pierce County, 97 Wash. 534, 537, 167 Pac. 35, 38 (1917).

10. COOLEY, TAXATION (3d ed. 1924) § 1146; Ballerino v. Mason, 83 Cal. 447, 23 Pac. 530 (1890); Willis v. Crowder, 134 Ind. 515, 34 N. E. 315 (1893); Tremont & Suffolk Mills v. City of Lowell, 163 Mass. 283, 39 N. E. 1028 (1895); People ex rel. Empire Mortgage Co. v. Cantor, 197 App. Div. 437, 189 N. Y. Supp. 646 (1st Dep't. 1921).

11. Compton, *Romance and Reality* (1931) 9 TAX MAG. 432; Hughes, *The Status of the General Property Tax in Illinois* (1932) 10 TAX MAG. 333, 334; Todd, *The Taxation of Personal Property* (1931) 9 TAX MAG. 212.

the basis for the taxation of larger governmental units, assessors were moved by local loyalty to hope that their unit might be more under-assessed than other units, thus escaping its just burden of taxation. State or county Boards of Equalization have sometimes sought to overcome this practice, but perhaps because their appointment or continuance in office was often influenced by the same political considerations as that of the assessors, only a small amount of good was accomplished.[11] Occasionally statutes have recognized the tendency and authorized the use of 40% or 50% or some other percentage of "true value" for tax purposes. When such allowance has proven too low for adequate taxation, with the result that legislatures were compelled to raise the authorized percentage, the courts have held that the taxpayer has no vested right and need not even be heard in the matter.[12] In the absence of statute authorizing such consistent undervaluation, courts have had to face it as an open and notorious illegality. Accordingly, when a Board of Equalization has attempted to raise tax assessments by a fixed percentage, the courts have wavered apparently as influenced either by sympathy for the individual taxpayer whose assessment has been "arbitrarily" raised,[13] or by desire to assist in the administrative task of securing larger levies.[14]

But the principle of full valuation has been most troublesome where it has come into conflict with the equally pervasive principle of equality and uniformity. This latter principle has not been as openly ignored as the former, for it is usually a provision of the state constitution, and has been read into the Fourteenth Amendment to the federal Constitution.[15] On the other hand, it is so much more indefinite, so much undercut by judicial refusal to pry closely into the discretionary elements of valuation that it has proven of little practical value. Uniformity has been held to mean not only the application of the same tax rate, but also the application of the same basis for valuation.[16] Nevertheless, uniformity and equality have been held not to debar the making of reasonable classifications as to kinds of property, which may not only be taxed at different rates, but even assessed by different and not always equivalent systems.[17]

12. People ex rel. Correll v. Cairo U. & C. Rr. Co., 247 Ill. 327, 93 N. E. 402 (1910); People ex rel. Campe v. Board of Review of Cook County, 290 Ill. 467, 125 N. E. 274 (1919); People ex rel. Browne v. Chicago & Eastern Illinois Rr. Co., 300 Ill. 467, 133 N. E. 212 (1921).

13. Rancho Santa Margarita v. San Diego County, 126 Cal. App. 186, 14 P. (2d) 588 (1932); Kittle v. Shervin, 11 Neb. 65, 7 N. W. 861 (1881); cf. Wallace v. Bullen, 6 Okla. 757, 54 Pac. 974 (1898).

14. First Nat. Bank of Greeley v. Patterson, 65 Colo. 166, 176 Pac. 498 (1918).

15. Raymond v. Chicago Traction Co., 207 U. S. 20 (1907); Sioux City Bridge Co. v. Dakota County, Nebraska, 260 U. S. 441 (1923). Cf. Sunday Lake Iron Co. v. Township of Wakefield, 247 U. S. 350 (1918); *Contra*: Bell's Gap Rr. Co. v. Pennsylvania, 134 U. S. 232 (1890); Adams Express Co. v. Ohio, 175 U. S. 194 (1897).

16. People v. Weaver, 100 U. S. 539 (1879); Cummings v. National Bank, 101 U. S. 153 (1879); Raymond v. Chicago Union Traction Co., 207 U. S. 20 (1907).

17. State Rr. Tax Cases, 92 U. S. 575 (1875); Bell's Gap Rr. Co. v. Pennsylvania, 134 U. S. 232 (1890); Adams Express Co. v. Ohio, 165 U. S. 194 (1897); Michigan Central Rr. v. Powers, 201 U. S. 245 (1906); Amoskeag Savings Bank v. Purdy, 231 U. S. 373 (1913); Southern Rr. Co. v. Watts, 260 U. S. 519 (1923); cf. Boyer v. Boyer, 113 U. S. 689 (1884).

Such a limitation, while it may in some circumstances be necessary, effects a large breach in the protection of uniformity.

Where the courts have encountered single instances of gross inequality, however, they have generally been inclined to remedy them. Not only provable fraud[18] but even nonprovable or "constructive" fraud is a recognized ground for relief. But just what is unfair discrimination or what state of unallignment constitutes constructive fraud, is very uncertain.[19] For example, in Florida,[20] where local government is said to be below the average, the courts are more alert to see and check constructive fraud than in Massachusetts, where local government is supposed to adhere to higher traditions.[21] More difficult for the courts has been the problem of how to treat the requirement of uniformity when the facts did not warrant the appellation of constructive fraud, and the problem was merely that the complaining taxpayer was less under-assessed than others. Some jurisdictions, particularly in earlier decisions, held that a taxpayer who is not assessed above the fair value of his property has nothing of which to complain,[22] at times disposing of the rule of uniformity by empty invective against

18. Kansas City Southern Rr. Co. v. May, 2 F. (2d) 680 (C. C. A. 8th, 1924); Walsh v. King, 74 Mich. 350, 41 N. W. 1080 (1889); Solomon v. Township of Oscoda, 77 Mich. 365, 43 N. W. 990 (1889); Auditor General v. Prescott, 94 Mich. 190, 53 N. W. 1058 (1892); Auditor General v. Jughitt, 132 Mich. 311, 93 N. W. 621 (1903); cf. Chicago, Burlington & Quincy Rr. Co. v. Babcock, 204 U. S. 585 (1907); Roberts v. American Nat. Bank of Pensacola, 94 Fla. 427, 115 So. 261 (1927).

19. Southern Pacific Land Co. v. San Diego County, 183 Cal. 543, 191 Pac. 931 (1920); Birch v. Orange County, 88 Cal. App. 82, 262 Pac. 788 (1927); Rancho Santa Margarita v. San Diego County, 126 Cal. App. 186, 14 P. (2d) 588 (1932); First Nat. Bank of Urbana v. Holmes, 246 Ill. 862, 92 N. E. 893 (1910); Calumet & Chicago Canal & Dock Co. v. O'Connell, 265 Ill. 106, 106 N. E. 452 (1914); People's Gaslight & Coke Co. v. Stuckart, 286 Ill. 164, 121 N. E. 629 (1918); People ex rel. McCallister v. Keokuk & Hamilton Bridge Co., 287 Ill. 246, 122 N. E. 467 (1919); People ex rel. Little v. St. Louis Electric Bridge, 290 Ill. 307, 125 N. E. 280 (1919); City of Covington v. Shinkle, 25 Ky. L. Rep. 66, 74 S. W. 652 (1903); Auditor General v. Jenkinson, 90 Mich. 523, 51 N. W. 643 (1892); Andrews v. King County, 1 Wash. 46, 23 Pac. 409 (1890); Henderson v. Pierce County, 37 Wash. 201, 79 Pac. 617 (1905); Dickson v. Kittitas County, 42 Wash. 429, 84 Pac. 855 (1906); Case v. San Juan County, 59 Wash. 222, 109 Pac. 809 (1910); Spokane & Eastern Trust Co. v. Spokane County, 70 Wash. 48, 126 Pac. 54 (1912); cf. Los Angeles Gas & Electric Co. v. Los Angeles County, 162 Cal. 164, 121 Pac. 384 (1912); Dunham v. City of Chicago, 35 Ill. 357 (1870).

20. Graham v. City of West Tampa, 71 Fla. 605, 71 So. 956 (1916); Camp Phosphate Co. v. Allen, 77 Fla. 541, 81 So. 503 (1919); cf. City of Tampa v. Palmer, 89 Fla. 514, 105 So. 115 (1925).

21. Inhabitants of Chicopee v. County Commissioners of Hampden, 82 Mass. 38 (1860).

22. Albuquerque Bank v. Perea, 147 U. S. 87 (1893); Keokuk & Hamilton Bridge Co. v. People ex rel. Bertschi, 161 Ill. 574, 44 N. E. 206 (1896); People ex rel. Kemper v. Lots in City of Ashley, 122 Ill. 297, 13 N. E. 556 (1887); City of Lowell v. Commissioners of Middlesex County, 152 Mass. 372, 25 N. E. 469 (1890); Newport Mining Co. v. City of Ironwood, 185 Mich. 668, 152 N. W. 1088 (1915); State v. Cudahy Packing Co., 103 Minn. 419, 115 N. W. 645 (1908); Lehigh Valley Rr. Co. of N. J. v. State Board of Taxes & Appeals, 174 Atl. 359 (Md. 1934); People ex rel. Nathan Warren v. Edward Carter, 109 N. Y. 576, 17 N. E. 222 (1888); cf. Fletcher Paper Co. v. City of Alpena, 160 Mich. 462, 125 N. W. 405 (1910); Amoskeag Manufacturing Co. v. City of Manchester, 70 N. H. 200, 46 Atl. 470 (1900).

the practices of assessors.[23] Some courts granted the taxpayer relief apologetically, stating that although what ought to be done was to raise all assessments of the jurisdiction, since this was impractical, individual relief would be granted.[24] And the majority rule was to disregard entirely any public question in the individual case, and to state baldly that since an illegality must be suffered it should rather be breach of the rule of true value than breach of the principle of uniformity, so that a taxpayer whose assessment was out of line might without further consideration have it lowered to the prevailing proportion.[25] A recent case in New York has developed the converse of this situation, applying to it the same logic but with inverted result.[26] Here the declining true value of real estate had apparently fallen far below the assessed value. The taxpayer complained that his property was assessed at far above the full cash value, which was the legal basis. He was met with the argument that his property was no more over-valued than any other property in the same taxing district. Thus, it was asserted, no injustice was done him, while substantial injustice would be done to other tax payers if his assessment alone were lowered. This reasoning, coupled, no doubt, with knowledge of the taxing jurisdiction's urgent need, appealed to the court, and once more uniformity triumphed over fair cash value.

Almost all of these decisions have shown a marked and natural disinclination towards avoidable interference with the scope of administrative functions requiring a large measure of discretion. But where the courts have felt themselves compelled to intervene, they have not shown any broad understanding of the problem. No real attempt has been made to visualize the sum at issue in a particular case as a typical part of the general levy or as a permanent unit of the tax base. Little regard seems to have been given the fact that the manner or adequacy of the assessment is a matter of public importance with wide-spreading, long term implications. Such an attitude, of course, is not the fault of the legal principles, fair value and uniformity, since lack of vision can vitiate any rules broad enough for general guidance. But these two principles, although commendable aspirations for all taxing systems, have never acquired through

23. Louisville Rr. Co. v. Commonwealth, 20 Ky. L. Rep. 1509, 49 S. W. 486, 488 (1899).

24. Sioux City Bridge Co. v. Dakota County, Nebraska, 260 U. S. 441, 446 (1923); Mayor & Aldermen of Jersey City v. Central Rr. Co. of N. J., 212 Fed. 76, 81 (C. C. A. 3d, 1914); cf. Peninsular Power Co. v. Wisconsin Tax Commission, 195 Wisc. 231, 218 N. W. 371 (1928).

25. Pelton v. National Bank, 101 U. S. 143 (1879); Greene v. Louisville & Interurban Rr. Co., 244 U. S. 499 (1917); Taylor v. Louisville & Nashville Rr. Co., 88 Fed. 350 (C. C. A. 6th 1898); Mobile & Ohio Rr. Co. v. Schnepper, 31 F. (2d) 587 (E. D. Ill. 1929); Randell v. City of Bridgeport, 63 Conn. 321, 28 Atl. 523 (1893); Camp Phosphate Co. v. Allen, 77 Fla. 341, 81 So. 503 (1919); Washington County v. First Nat. Bank of Weiser, 35 Idaho 438, 206 Pac. 1054 (1922); People ex rel. Miller v. Chicago, B. & Q. Rr. Co., 300 Ill. 399, 133 N. E. 325 (1921); Eminence Distilling Co. v. Henry County, 178 Ky. 811, 200 S. W. 347 (1918); Knox v. Southern Paper Co., 143 Miss. 870, 108 So. 288 (1926); In re Harleigh Realty Co., 299 Pa. 385, 149 Atl. 653 (1930); State ex rel. Oregon Rr. & Navigation Co. v. Clausen, 63 Wash. 535, 116 Pac. 7 (1911); Savage v. Pierce County, 68 Wash. 623, 123 Pac. 1088 (1912); Pacific Tel. & Teleg. Co. v. Wooster, 34 P. (2d) 451 (Wash. 1934).

26. People ex rel. Rickey v. Hunt, 241 App. Div. 261, 271 N. Y. Supp. 842 (3d Dep't, 1934).

judicial interpretation the real utility which able jurists have given to equally vague ideals in contracts or agency. Therefore in assessment-law courts must build up a new structure, not so much by reversing existing decisions as by filling in a vacuum. This would involve adding to the present legal recognition that assessments should be fair and uniform, methodological principles for the achievement of that result. The courts could test the validity of the assessors' results by applying certain quasi-scientific formulae for valuation, worked out by practical real estate men and now in use in the administrations of some progressive cities.[27] Or if these rules seemed inapplicable to less homogeneous types of property, a capitalization of the average income produced over a five or ten year period might be used as a yardstick.[28] Under this system residences inhabited by the owners should be given a fair rental value as is done in computing the British income tax.[29] Realty held for development might be measured by capitalizing average current profit on plots sold. Other practical tests of this kind could be devised to meet other situations, and even if their accuracy were rough, they would save the courts from the helplessness exhibited in most present and past decisions. Further, the adoption of such standards for review would compel assessors and Boards of Equalization at least to rationalize their results by similar methods, so that, for example, an assessor could no longer openly guess at the value of a great railroad bridge aided only by casual conversation with neighboring shop keepers.[30]

If courts were to begin interpreting the problem of valuation in this way, not only would the methodology of assessment improve and new techniques constantly develop, but also some of the changed mental attitude might gradually penetrate the legislative milieu thus aiding reform in ways beyond the power of the courts. For example, much of the incompetence characteristic of local assessors in the poorer or smaller taxing units might be abolished if the process of assessment were taken over by the state, and adequately salaried state assessors with high civil service qualifications appointed.[31] By the imposition of a heavy tax on increments in property value, the proceeds of which were strictly earmarked for debt retirement, taxing units could be saved from the worst effects of a diminished yield when property values undergo the inevitable slumps which follow on boom periods.[32] These refinements, however, are of secondary importance compared with the immediate necessity of placing valuation upon a reasonable judicial basis.

Exemption. Nevertheless, even if the process of valuation were improved to

27. For description of some of these methods see Donahue, *Methods of Relief from Inequalities in Property Assessment Applied in Greenwich, Connecticut* (1931) 9 TAX MAG 362; Todd, *Taxation of Real Estate* (1934) 12 TAX MAG. 533.

28. See recommendations to this effect in Haensel, *supra* note 7.

29. INCOME TAX ACT, 8 & 9 GEO. V, c. 40, Schedule A (1918).

30. Keokuk & Hamilton Bridge Co. v. People, 161 Ill. 574, 575, 44 N. E. 206, 208 (1896).

31. The efficacy of this or any other reform which merely shifts the personnel upon whom heavy and constant temptation or political pressure must rest is gravely to be doubted, but it might be of some avail. And that such a system would hardly prove worse in operation than the prevalent practice of local assessment see REPORT OF THE OHIO TAX COMMISSION (1930); Compton, *Romance and Reality* (1931) 9 TAX MAG. 432; Hughes, *Status of the General Property Tax in Illinois* (1932) 10 TAX MAG. 333, 334.

32. See generally Haensel, *supra* note 7.

its utmost, not enough would have been accomplished unless abuses in the granting of exemptions were also remedied. Tax exemption has a more direct and perhaps a proportionately greater effect on the size of the tax base than has mere under-valuation. An examination of the scope of tax exemption reveals that it has constantly broadened, more in some states than in others, but appreciably in all.[33] The reasons for this condition are twofold: first, there is the traditional moral and humanitarian attitude which in taxation takes the form of disliking to burden any property owner actively engaged in socially good works; secondly, tax exemptions afford organized groups of many kinds a colorable opportunity for lobbying.[34] The constant working of these causes and the natural tendency of exempt organizations to grow wealthier, often increasing thereby the percentage of exempt property within the jurisdiction first granting the exemption, have all combined to form a grave problem.[35] Exemptions once granted are seldom withdrawn. Indeed, the Supreme Court decided early that exemptions granted by a contract which did not reserve any privilege of rescission were irrevocable under the constitutional protection of the obligation of contracts,[36] and if the exemptions, as is more frequently the case, are statutory, legislative inertia or continued pressure usually holds the statutes on the books.

Exemption, by contrast to the complex process of valuation, is merely the application and interpretation of more or less explicit statutory or constitutional

33. The value of real property and improvements exempt from taxation in the United States is about 12% of the value of all such property. In thirty-one states exempt property is six to fourteen percent of the taxable real estate. Most nontaxable property is in the District of Columbia and in the Rocky Mountain district. Where data are available, two to fifteen percent of personal property is exempt. A forty year study shows the total of exempt property increasing faster than the value of taxable property. Stimson, *Tax Exemption in Illinois* (1932) 10 TAX MAG. 453. See also Stimson, *Exemption of Property from Taxation* (1934) 18 MINN. L. REV. 411; Todd, *Tax Exemption and Tax Delinquency* (1934) 12 TAX MAG. 159. The amount of tax exemption in New York State increased from $1,327,914,982 in 1904 to $6,696,761,639, in 1933, a jump of 404.3 percent. The percentage of exemption to the total property, however, increased from 18.8% in 1904 to 23.8% in 1933. Crider, *New York's Exemption Problem* (1934) 12 TAX MAG. 603, note on 604. The following official reports stress the growing menace of tax exemption: REPORT OF THE OHIO TAX COMMISSION (1930); REPORT OF THE VERMONT TAX COMMISSION (1930); REPORT OF THE RHODE ISLAND TAX COMMISSION (1931). See also Cross, *supra* note 7.

34. Exemplifying this pressure is the experience of Wisconsin. Here the courts for a long time refused to exempt the powerful, incorporated benevolent and fraternal orders such as the B. P. O. E. Under political pressure the legislature passed a statute specially exempting such orders, but specifically refusing it to the less-powerful though otherwise similar college fraternities. See Chamberlain, *Tax Exemption of Greek Letter Fraternities* (1930) 4 U. OF CIN. L. REV. 186; Grooms, *Exemption of College Fraternity Property* (1926) 14 KY. L. J. 338.

35. See notes 6, 7, 11, 34, *supra*.

36. New Jersey v. Wilson, 7 Cranch 164 (U. S. 1812). Exemptions granted by statute, however, are considered mere privileges and may be revoked at any time. Rector of Christ Church v. County of Philadelphia, 24 How. 300, 302 (U. S. 1860); Grand Lodge v. New Orleans, 166 U. S. 143 (1897); Seton Hall College v. South Orange, 242 U. S. 100 (1916) State ex rel. Foote v. Bartholomew, 108 Conn. 246, 142 Atl. 800 (1928); Shiner v. Jacobs, 62 Iowa 392, 17 N. W. 613 (1883); *Contra*: Atwater v. Woodbridge, 6 Conn. 223 (1826).

provisions.[37] This would not seem, necessarily, to be a task incapable of precise delineation, but actually the law of tax exemption has remained more fluid, its limits more vague, and the application of its guiding principles less predictable than any other aspect of general property tax law. The theory advanced for most types of exemption is that the exempt institution serves some worthy public purpose, religious, charitable, educational, or governmental; or that it furthers the public welfare in some special way as is the case with temporary grants to foster manufacturing, encourage a railroad and so forth.[38] The difficulty, however, both with the statutes and the theory, is that the purpose and use of property is not always clear in itself and has been rendered less so by judicial laxity in borderline cases.

Thus, in determining what kinds of property fall under a religious exemption, it would be impossible to deny the claims of churches and the ground whereon they stand, or likewise the claims of those parts of camp-meeting grounds used exclusively for devotional exercises.[39] Once outside the church or burial plot, however, uncertainty begins, and it is here that many courts have immolated the tax base to the humanitarian principle. Generally a church is and ought to be exempt on land necessary to give it light and air,[40] but a California court has gone so far as to grant exemption on a valuable plot used for parking purposes by those attending church in a congested area.[41] Parish houses adjoining a church and used sometimes for religious, sometimes for secular purposes, have on occasion been held exempt,[42] although, except when parsonages are exempted by name, the courts generally have been consistent in holding them taxable on the ground that their primary purpose is not religious.[43] Many Roman Cath-

37. Statutory language varies infinitely from state to state and even from decade to decade. Sometimes exemption is merely by statute, sometimes it is a constitutional provision, and at other times there is merely a constitutional grant to the legislature of the power to make certain types of exemption, in pursuance of certain public policies, as for example, to encourage manufacturing, irrigation etc., or there is a prohibition against making certain kinds of exemption thought to be corrupt or undemocratic.

38. COOLEY, TAXATION (3d ed. 1924) § 653.

39. First Unitarian Society of Hartford v. Town of Hartford, 66 Conn. 363, 34 Atl. 88 (1895); Inhabitants of Fox Croft v. Pisquataqua Valley Camp-Meeting Association, 86 Me. 78, 29 Atl. 950 (1893); cf. Davis v. Cincinnati Camp Meeting Association, 57 Ohio St. 257, 49 N. E. 401. *Contra*: People ex rel. Breymeyer v. Watseka Camp Meeting Association, 160 Ill. 576, 43 N. E. 716 (1896) (but only on wording of statute requiring ownership in congregation). See generally Comment (1927) 11 MINN. L. REV. 541; COOLEY, TAXATION (3d ed. 1924) § 742. Cemeteries are sometimes exempt for analogous reasons. See COOLEY, TAXATION (3d ed. 1924) § 736.

40. Third Congregational Society of Springfield v. City of Springfield, 147 Mass. 396, 398, 18 N. E. 68, 69 (1888).

41. Immanuel Presbyterian Church v. Payne, 90 Cal. App. 176, 265 Pac. 547 (1928). Cf. All Saints' Parish v. Inhabitants of Brookline, 178 Mass. 404, 59 N. E. 1003 (1901); Enochs v. City of Jackson, 144 Miss. 360, 109 So. 864 (1926).

42. St. Pauls Church v. City of Concord, 75 N. H. 420, 75 Atl. 531 (1910).

43. People ex rel. Thompson First Congregational Church, 232 Ill. 158, 83 N. E. 536 (1907); Gerke v. Purcell, 25 Ohio St. 229 (1874); Trinity M. E. Church v. San Antonio, 201 S. W. 669 (Tex. Civ. App. 1918). For exceptionally liberal construction of exemption rule see Trinity Evangelical Lutheran Church v. Board of Commissioners of Wyandotte County, 118 Kan. 742, 236 Pac. 809 (1925); *Contra*: State v. Kittle, 87 W. Va. 526, 105 S. E. 775 (1921); State ex rel. Eveland v. Erickson, 44 S. D. 63, 182 N. W. 315 (1921). See generally Note (1921) 13 A. L. R. 1197.

olic dioceses have endeavored without success to secure exemption for the houses of priests on the ground that religious activities are customarily carried on within,[44] yet parts of camp-meeting grounds used to house those in attendance, as a store to dispense supplies, or premises to stable horses have at times been held exempt.[45] Religious societies such as societies for Bible, Sunday school, or missionary purposes have on the whole been less successful in securing exemption.[46] This has not been so much due to judicial unwillingness as because they form a less distinct class and hold their property in forms less susceptible to simple purpose analysis. Y. M. C. A. organizations and other similar church societies that have sought exemption as religious organizations have met varying fates,[47] although it is difficult to see how they could in any respect qualify under the customary statutory terms of "exclusively religious" purpose, unless specifically named in the statute.

Even more unsettled than the exemption of religious organizations is that of educational institutions, since the legitimate activity of these can assume so many forms and aspects. First, the public school system is so universally exempted that there is no litigation thereon. Exemption to private schools not run for profit is usually freely granted,[48] although sometimes limited to those offering higher education.[49] It is universally conceded, though rarely if ever

44. Watterson v. Halliday, 77 Ohio St. 150, 82 N. E. 962 (1907); St. Joseph's Church v. Assessors of Providence, 12 R. I. 19 (1880).

45. Davis v. Cincinnati Camp Meeting Association, 57 Ohio St. 257, 49 N. E. 401 (1897) (called a charitable rather than a religious exemption, but this is unimportant as the purpose of the exempt property was, and was termed, religious). *Contra*: Alton Bay Camp Meeting Association v. Town of Alton, 69 N. H. 311, 45 Atl. 95 (1898) (as to stock of groceries); Inhabitants of Fox Croft v. Pisquataqua Valley Camp Meeting Association, 86 Me. 78, 29 Atl. 951 (1893); cf. Ferry Beach Park Association v. City of Saco, 127 Me. 130, 142 Atl. 65 (1928).

46. For a more complete account see Baker, *Tax Exemption* (1928) 7 TEX. L. REV. 384, 406; Baker, *Tax Exemption Cases* (1928) 8 TEX. L. REV. 196, 204. Typical examples of this kind of case are the following: a Boston society owned buildings, partly for storage, partly for lease to religious organizations, partly for worship by the owners. Exemption was refused. Evangelical Baptist Benevolent Society v. City of Boston, 204 Mass. 28, 90 N. E. 572 (1910). A Philadelphia Society maintained a store for the sale and occasional free distribution of religious works. It also sold Webster's dictionary and other standard moral works. All income went for religious purposes but it was held only partially exempt. American Sunday School Union v. Taylor, 161 Pa. St. 307, 29 Atl. 26 (1894). A similar society in Illinois was held exempt under a substantially similar statute, although the only distinction that even the court could find, other than a weak verbal one, in the exemptions law of the states was that the latter organization did not sell Webster's Dictionary. Congregational Sunday School and Publishing Society v. Board of Assessors, 290 Ill. 108, 125 N. E. 7 (1919). Cf. North West Publishing House v. City of Milwaukee, 177 Wis. 401, 188 N. W. 636 (1922). A trust fund for the maintenance of an evangelist to preach through Kentucky the doctrines of the Primitive Christians was held taxable. Commonwealth v. Thomas, 119 Ky. 208, 83 S. W. 572 (1904). In this case, however, as there was no suitable religious exemption in Kentucky, it was sought to call it "charitable." This blurring of terms is not unusual.

47. People ex rel. Gore v. Y. M. C. A., 157 Ill. 403, 41 N. E. 557 (1895); Commonwealth v. Y. M. C. A., 116 Ky. 711, 76 S. W. 522 (1903).

48. Phillips Academy v. Inhabitants of Andover, 175 Mass. 118, 55 N. E. 841 (1900); St. John's Military Academy v. Edwards, 143 Wis. 551, 128 N. W. 113 (1910).

49. Common Council of Indiana v. McLean, 8 Ind. 328 (1856).

adjudicated, that dancing schools, riding academies, and so forth, are not exempt. Business schools may be exempt if not run for a profit—a sine qua non with all exemptions.[50] Given an exempt institution then, is it entirely exempt, and if not, what parts of it are exempt? Universally, buildings and land used for educational, literary, or scientific purposes (which may include the farm land of an agricultural college) are exempt.[51] So likewise are campuses and playgrounds.[52] Dormitories and dining halls are generally exempt,[53] following the authority of the famous *Yale University* case,[54] which by exhaustive historical argument proved that eating and sleeping have traditionally been part of the Anglo-Saxon educational process. The houses of professors and university presidents are by the majority rule taxable on the ground that they, like parsonages, are used primarily for residential purposes.[55] The contrary rule, however, is strong.[56] Property used for income or endowment is sometimes exempted from taxation but more often not.[57] Where the property is of mixed use—partly for educational purposes, partly for income, it is often taxed on the portion producing an income and exempt on the remainder.[58] Property necessary to the proper functioning of the exempt organization and which only incidentally produces revenue is usually exempt.[51] Often the only

50. Lawrence Business College v. Bussing, 117 Kan. 436, 231 Pac. 1039 (1925).

51. In re Syracuse University, 124 Misc. Rep. 788, 209 N. Y. Supp. 329 (Sup. Ct. 1925).

52. Yale University v. Town of New Haven, 71 Conn. 316, 42 Atl. 87 (1899); Emerson v. Trustees of Milton Academy, 185 Mass. 414, 70 N. E. 442 (1914); Where, however, an athletic field was leased for hire to non-students, even although this leasing took place at times when no students were able to use it, exemption was refused. People of New York ex rel. Adelphi College v. Wells, 97 App. Div. 312, 90 N. Y. Supp. 315 (2d Dep't, 1904).

53. City of Chicago v. University of Chicago, 228 Ill. 605, 81 N. E. 1138 (1907); President of Harvard v. Assessors of Cambridge, 175 Mass. 145, 55 N. E. 844 (1900); In re Syracuse University, 124 Misc. Rep. 788, 209 N. Y. Supp. 329 (Sup. Ct. 1925).

54. Yale University v. Town of New Haven, 71 Conn. 316, 42 Atl. 87 (1899).

55. Ibid; Knox College v. Board of Review of Knox County, 308 Ill. 160, 139 N. E. 56 (1923); St. James Educational Institute v. City of Salem, 153 Mass. 185, 26 N. E. 636 (1891); President etc. of Williams College v. Assessors of Williamstown, 167 Mass. 505, 46 N. E. 394 (1897).

56. Phillips Academy v. Inhabitants of Andover, 175 Mass. 118, 55 N. E. 841 (1900); President of Harvard v. Assessors of Cambridge, 175 Mass. 145, 55 N. E. 844 (1900); Emerson v. Trustees of Milton Academy, 185 Mass. 414, 70 N. E. 442 (1914); In re Syracuse University, 124 Misc. 788, 209 N. Y. Supp. 329 (1925). Factors which seem of weight in assisting the minority to their decision are (1) that the houses are on the campus, (2) that all right and title remain in the educational corporation, (3) that as in the case of a president's house, such property is an emolument of office and used in fulfilling its duties.

57. *Non-exempt*: People ex rel. Kochersperger v. Board of Directors Chicago Theological Seminary, 174 Ill. 177, 51 N. E. 198 (1898); Knox College v. Board of Review of Knox County, 308 Ill. 160, 139 N. E. 56 (1923); State ex rel. Boss v. Hess, 113 Ohio St. 52, 148 N. E. 347 (1925); cf. State ex rel. Farr v. Martin, 105 W. Va. 600, 143 S. E. 356 (1928). *Exempt:* State ex rel. Waller v. Trustees of William Jewell College, 234 Mo. 299, 136 S. W. 397 (1911).

58. Knox College v. Board of Review, 308 Ill. 160, 139 N. E. 56 (1923); Ottawa University v. Board of County Commissioners of Franklin County, 48 Kan. 460, 29 Pac. 598 (1892).

question before the court is the interpretation of a special charter or legislative grant, and of course there is no general rule for these.[59]

The taxable status of the college fraternity appears to be midway between the educational institution and the charitable organization. The fraternity has sought exemption on either or both grounds and has been allowed it on both, although practically all of the eastern courts and many western courts have refused to exempt it at all unless compelled by specific statute.[60]

Exemption as a charity has been the most abused category: organizations for the relief of the helpless, the ill, or the indigent, hospitals, sanatoria, orphanages, camps, low-cost lodging or eating houses,[61] benevolent and protective associations, such as the B. P. O. E., Odd Fellows, Masons, etc.,[62] burial

59. People ex rel. Kochersperger v. Board of Directors, Chicago Theological Seminary 174 Ill. 177, 51 N. E. 198 (1898); State ex rel. Waller v. Trustees of William Jewell College, 234 Mo. 299, 186 S. W. 397 (1911).

60. *Non-exempt*: People ex rel. Carr v. Alpha Pi of Phi Kappa Sigma Educational Association of the University of Chicago, 326 Ill. 573, 158 N. E. 213 (1927); Inhabitants of Orono v. Sigma Alpha Epsilon Society, 105 Me. 214, 74 Atl. 19 (1909); Inhabitants of Orono v. Kappa Sigma Society, 108 Me. 320, 80 Atl. 831 (1911); People ex rel. D. K. E. of Hamilton College v. Lawler, 74 App. Div. 553, 77 N. Y. Supp. 840 (4th Dep't 1902), aff'd 179 N. Y. 553, 71 N. E. 1136 (1904). *Exempt*: State ex rel. Daggy v. Allen, 189 Ind. 369, 127 N. E. 145 (1920); Kappa Kappa Gamma House Association v. Pearey, 92 Kan. 1020, 142 Pac. 294 (1914); Beta Theta Pi Corp. v. Board of Commissioners of Cleveland County, 108 Okla. 78, 234 Pac. 354 (1925); see generally Chamberlain, *Tax Exemption of Greek Letter Fraternities* (1930) 4 U. OF CIN. L. REV. 186; (1914) 52 L. R. A. (N. S.) 995.

61. Hospitals, sanatoria and homes for the indigent offering charity to all without discrimination are exempt without question. Board of Review of Cook County v. Chicago Policlinic, 233 Ill. 268, 84 N. E. 220 (1908); In re Application for Judgment against Certain Lots, 27 Minn. 460, 8 N. W. 595 (1881); Adams Co. v. Catholic Diocese of Natchez, 110 Miss. 890, 71 So. 17 (1916); In re House of the Good Shepherd of Omaha, 113 Neb. 489, 203 N. W. 632 (1925); Corporation of Sisters of Mercy v. Lane County, 123 Ore. 144, 261 Pac. 694 (1927); Santa Rosa Infirmary v. City of San Antonio 259 S. W. 926 (Tex. Civ. App. 1924); cf. Johnson v. Mississippi Baptist Hospital, 140 Miss. 485, 106 So. 1 (1925). There is often exemption, however, even when charity is offered only to some specific class, sometimes so narrowly classified as to include only members of a particular organization. Kansas Masonic Home v. Board of Commissioners, 81 Kans. 859, 106 Pac. 1082 (1910); Grand Lodge of Masons v. Board of Review, 281 Ill. 480, 117 N. E. 1016 (1917); Nat. Navy Club of N. Y. v. City of N. Y., 122 Misc. 89, 203 N. Y. Supp. 114 (Sup. Ct. 1923); People ex rel. Masonic Hall Asylum Land v. Farrell, 130 Misc. 142, 223 N. Y. Supp. 660 (Sup. Ct. 1927); cf. Trustees of Academy of Protestant Episcopal Church v. Taylor, 150 Pa. 565, 25 Atl. 55 (1892); But see St. Louis South Western Ry. Co. v. Gates, 23 F. (2d) 283 (C. C. A. 8th, 1927); Morning Star Lodge v. Hayslip, 23 Ohio St. 144 (1872). Such institutions do not lose their exemption by taking fees from those who can pay. School of Domestic Arts & Science v. Carr, 322 Ill. 562, 153 N. E. 669 (1926); New England Sanitarium v. Inhabitants of Stoneham, 205 Mass. 355, 91 N. E. 385 (1910); Corporation of Sisters of Mercy v. Lane County, 123 Or. 144, 261 Pac. 694 (1927). But see Girls' Friendly Society v. Stafford, 46 R. I. 29, 124 Atl. 470 (1924). Exemption was sustained even in the case of a working girls' summer home taking mainly those who could pay their own maintenance. Women's Christian Ass'n of Philadelphia v. Lippincott, 153 Atl. 261 (1908).

62. Courts denying exemption have done so generally on the ground that the property was used principally for social purposes and only incidentally for charitable purposes. St.

societies, fraternities, Y. M. C. A., Y. W. C. A., Y. M. H. A.,[63]—almost every kind of organization not run for profit[64] and not exclusively a social or sporting club has sought to escape taxation as a charitable institution. The courts have had to flounder in a morass of strange facts and have held both ways on almost every question. Courts are not usually technical in their analysis of these cases, and the statutory phrases "exclusively used for charitable purposes," "purely public charity" seem to mean less than nothing.

Property of the federal government has been so long and so thoroughly exempt that there is no litigation of present concern regarding its taxability.[65] Most states make similar exemption of their own property throughout their lesser political subdivisions although it has been held that property of another state or its political subdivision was not exempt.[66] The question of whether public property is held for a governmental purpose arises usually in regard to municipal corporations. Generally property held to be used for a governmental purpose is exempt whether situated either within or without the owner-municipality.[67] Whether waterworks, drainage systems, electric light plants, etc. are for "governmental" or "proprietary" purposes, which are not exempt, depends either on the economic views of the court or on the particular lan-

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Louis Lodge B. P. O. E. v. Koeln, 262 Mo. 444, 171 S. W. 329 (1914); Wilson v. Licking Aerie, 104 Ohio St. 545, 135 N. E. 545 (1922); People v. Mizpah Lodge (Odd Fellows) 228 N. Y. 245, 126 N. E. 703 (1920); State v. McDowell Lodge, 96 W. Va. 611, 123 S. E. 561 (1924). (This case, p. 563, has an excellent list of cases in other jurisdictions on same point.) Trustees of Green Bay Lodge v. City of Green Bay, 122 Wis. 452, 100 N. W. 837 (1904). Courts granting exemption presumably have merely chosen to overlook the social purposes. Horton v. Colorado Springs Masonic Building Society, 64 Colo. 529, 173 Pac. 61 (1918); Salt Lake Lodge, B. P. O. E. v. Groesbeck, 40 Utah 1, 120 Pac. 192 (1911).

63. *Non-exempt*: State (Trustees of Y. M. C. A.) v. City of Patterson, 61 N. J. L. 420, 39 Atl. 655 (1898); City of San Antonio v. Y. M. C. A. 285 S. W. 844 (Tex. Civ. App. 1926); People ex rel. Young Men's Association for Mutual Improvement v. Sayes, 23 Misc. 1, 50 N. Y. Supp. 8 (Sup. Ct. 1898). *Exempt:* Little v. Newburyport, 210 Mass. 414, 96 N. E. 1032 (1912); Commonwealth v. Lynchburg Y. M. C. A. 115 Va. 745, 80 S. E. 589 (1913).

64. A few courts have even held the activities of D. A. R. Chapters, or at least the activities of certain D. A. R. chapters, charitable within the meaning of the exemption statute. People ex rel. Greer v. Thomas Walters Chapter of the D. A. R. 311 Ill. 304, 142 N. E. 566 (1924). Probably the most extraordinary exemption decision of all time is the one holding the exclusive Keystone Battery A of the National Guard a "purely public charity." City of Philadelphia v. Keystone Battery A, National Guard, 169 Pa. 526, 32 Atl. 428 (1895).

65. See Comment (1934) 44 YALE L. J. 326, 335-340.

66. People ex rel. Murray v. City of St. Louis, 291 Ill. 600, 126 N. E. 529 (1920).

67. City of New London v. Perkins, 87 Conn. 229, 87 Atl. 724 (1913); City of Frankfurt v. Commonwealth, 29 Ky. L. Rep. 699, 94 S. W. 648 (1906); Commonwealth v. City of Louisville, 133 Ky. 845, 119 S. W. 161 (1909); Town of Canaan v. Enfield Village Fire District, 74 N. H. 517, 70 Atl. 250 (1908); City of Newark v. Inhabitants of Verona Tp., 59 N. J. L. 94, 34 Atl. 1060 (1896); Commonwealth v. City of Richmond, 116 Va. 69, 81 S. E. 69 (1914). For a distinction made between realty and personality in exemption see City of Pasadena v. Los Angeles County, 182 Cal. 171, 187 Pac. 418 (1920). *Contra*: Sanitary District of Chicago v. Gibbons, 293 Ill. 519, 127 N. E. 691 (1920).

guage of the charter or statute authorizing them.[68] Generally, a municipal enterprise producing more than incidental revenue, or whose primary purpose is revenue, is not exempt.[69] Public parks and recreation grounds are exempt, including property left in trust, income of which was to be used for the maintenance of parks and recreation grounds.[70]

There remains the more limited field of special exemption to individuals or to classes such as to railroad corporations, to manufacturers, or to builders of houses in a time of housing shortage.[71] Where such exemptions are permitted by state constitutions the usual ground is public policy of a special or exigent kind,[72] and they are universally declared to be subject to strict interpretation.[73] The rule requiring "strict interpretation", however, does not always preclude a court from extending the meaning of the word "manufacturing."[74] In other instances courts which profess to employ the same rule of strict construction have overlooked irregularities in making the award,[75] and the operative term "machinery" has been applied with singular looseness.[76] In general, although the special grant was favored during the expansion periods of the nineteenth century and was revived during and after the World War, it has grown less in repute and is likely to diminish in extent unless the trend of public opinion should again change.[77]

68. City of Frankfurt v. Commonwealth, 29 Ky L. Rep. 699, 94 S. W. 648 (1906); Commonwealth v. City of Louisville, 133 Ky. 845, 119 S. W. 161 (1909); Traverse City v. East Bay Tp., 190 Mich. 327, 157 N. W. 85 (1916); City of Providence v. Hall, 49 R. I. 230, 142 Atl. 156 (1928); Village of Swanton v. Town of Highgate, 81 Vt. 152, 69 Atl. 667 (1908).

69. *Exempt*: State v. City of Columbia, 115 S. C. 108, 104 S. E. 337 (1920); Commonwealth v. City of Richmond, 116 Va. 69, 81 S. E. 69 (1914). *Non Exempt*: State v. Clinton Township, 49 N. J. L. 370, 8 Atl. 296 (1887); Swanton v. Highgate, 81 Vt. 152, 69 Atl. 667 (1908).

70. Burr v. City of Boston, 208 Mass. 537, 95 N. E. 208 (1911); cf. People v. City of Chicago, 124 Ill. 636, 17 N. E. 56 (1888).

71. E.g., N. Y. CONSOL. LAWS (1920) c. 62, § 4b.

72. Held constitutional on this ground in Hermitage Co. v. Goldfogle, 204 App. Div. 710, 199 N. Y. Supp. 382 (1st Dep't, 1923), aff'd 236 N. Y. 554, 142 N. E. 281 (1923). Held unconstitutional in Koch v. Essex County Board of Taxation, 97 N. J. L. 61, 116 Atl. 328 (1922).

73. Deleware Registration Trust Co. v. Delaware Forge & Steel Co., 15 Del. Ch. 381, 138 Atl. 620 (1927); Caverly-Gould Co. v. Village of Springfield, 83 Vt. 396, 76 Atl. 39 (1910); See also cases in notes 74, 75, 76, *infra*.

74. Commonwealth v. W. J. Sparks Co., 222 Ky. 606, 1 S. W. (2d) 1050 (1928); State v. Sugar-Refining Co., 108 La. 603, 32 So. 965 (1902). But see H. M. Rowe Co. v. Beck, 149 Md. 251, 131 Atl. 509 (1925).

75. Colton v. City of Montpelier, 71 Vt. 413, 45 Atl. 1039 (1899).

76. David J. Joseph Co. v. City of Ashland, 223 Ky. 203, 3 S. W. (2d) 218 (1928). Where farm products rather than machinery are the language of exemption, this term also takes on new meanings. See Clay County v. Hogan, 145 Miss. 857, 860, 111 So. 373, 374 (1927). But see H. M. Rowe Co. v. Beck, 149 Md. 251, 255, 131 Atl. 509, 511 (1925). Some western states exempt mining claims for the practical reason that it is impossible to estimate their value, but such exemptions are not extended to improvements made or minerals extracted. Hart v. Plum, 14 Cal. 148 (1859).

77. See Stimson, *Exemption of Property from Taxation* (1934) 18 MINN. L. REV. 411, 417.

Taking exemption decisions as a whole, it is safe to say that no institution deserving exemption on any of the customary grounds has failed to win it. It might also be said, almost categorically, that no institution not deserving an exemption on any such grounds has failed to be refused one in some jurisdiction. What has occurred, however, is that in all jurisdictions some abuses have crept in, and these have opened the door to many others, some by logical necessity, some by the political leverage of the first exemption. Regarded individually, many of these questionable exemptions might appear reasonable, but when the general consequences of exempting such a class of property are visualized, the harm done by diminishing the tax base far outweighs any possible good. That an organization of a certain kind is wealthy, or that there are many similar organizations of great aggregate wealth, would not seem a logical reason for refusing an exemption concededly sound if granted to a poor or to an isolated type of institution. Practically, however, viewed in the light of the larger public policy of raising adequate revenue for governmental purposes, such a discrimination is necessary if exemptions are to be granted at all. Nevertheless, this larger view is precisely what almost all of the courts refuse to take. Each case is considered in isolation, and as a result the law is in confusion and its workings almost wholly harmful.

This result is not compelled by the legal principles governing exemption, which like those of valuation, are too vague for real guidance. Thus, the declaration that exemption statutes must be strictly construed is repeated as if by rote in some of the loosest constructions.[78] Exemption is often said to be granted because the exempt property is said to be sustaining a burden that might otherwise fall upon the state but this phrase is seldom used for purposes of refusal.[79] The absence of a profit motive seems always to be essential,

78. People ex rel. McCullough v. Deutsche Evangelische Gemeinde, 249 Ill. 132, 94 N. E. 162 (1911); People ex rel. Greer v. Thomas Walters Chapter D. A. R., 311 Ill. 304, 142 N. E. 566 (1924); School of Domestic Arts and Science v. Carr, 322 Ill. 562, 153 N. E. 669 (1926); People ex rel. Carr v. Alpha Pi of Phi Kappa Sigma Educational Association of the University of Chicago, 324 Ill. 573, 158 N. E. 213 (1927); Santa Rosa Infirmary v. City of San Antonio, 259 S. W. 926 (Tex. Civ. App. 1924).

Connecticut avoids the necessity of applying such a rule to religious or educational organizations by declaring that these were never exempted from taxation but are nontaxable. Yale University v. Town of New Haven, 71 Conn. 316, 42 Atl. 87 (1899).

Other states modify the rule of strict construction by saying that regard must be had to the intent of the legislature. Phillips Academy v. Inhabitants of Andover, 175 Mass. 118, 55 N. E. 841 (1900); In re Syracuse University, 124 Misc. 788, 209 N. Y. Supp. 329 (1925); People ex rel. Masonic Hall Asylum Fund v. Farrell, 130 Misc. 142, 223 N. Y. Supp. 660 (1927); State v. Kittle, 87 W. Va. 526, 105 S. E. 775 (1921).

Other courts frankly admit that the rule of strict construction, although applicable to private exemptions, is not to be used with respect to those granted for religious, educational, charitable or public purposes. City of Pasadena v. Los Angeles County, 182 Cal. 171, 187 Pac. 418 (1920); State ex rel. Waller v. Trustees of William Jewell College, 234 Mo. 279, 136 S. W. 397 (1911); State v. City of Columbia, 115 S. C. 108, 104 S. E. 337 (1920); Commonwealth v. City of Richmond, 116 Va. 69, 81 S. E. 69 (1914); cf. Beta Theta Pi Corp. v. Board of Commissioners of Cleveland County, 108 Okla. 78, 234 Pac. 354 (1925).

79. See Trustees of Academy of Protestant Episcopal Church v. Taylor, 150 Pa. 565, 569, 25 Atl. 55, 57 (1892). But see Layman Foundation v. City of Louisville, 232 Ky. 259, 264, 22 S. W. (2d) 622, 625 (1929) (this formula actually used to refuse exemption to a charity operating entirely in another state).

but it is in no sense a test of exemptibility.[80] Service rendered to members of a community without discrimination is a frequently employed phrase but the courts have permitted so many special discriminations while giving lip service to this criterion, that it cannot any longer be considered of value.[81] If an exemption is to be refused, it is almost always on the strict construction rule.[82] Yet if the courts were to overrule or distinguish on the facts decisions which encroach upon principles meant to be rules of limitation, the conventional legal phrases could still be used, and the break with the past effectually masked. It would be better, however, if courts recognized openly that public policy has changed and that it is no longer desirable to interpret statutes loosely in order to help some institution theoretically carrying a burden which would otherwise fall upon the state. It is doubtful whether the governmental unit would consciously choose to take on the "burdens" either in the way or to the extent that the private organization has assumed them. And it is certain that even if the governmental unit were to take on these burdens it would not and could not allocate the expenses with the local discrimination inherent in the concealed subsidy of an exemption.

Again, of course, the legislative branch of the government could render valuable assistance if it chose to do so. The repeal of present exemption statutes, honeycombed with extensions, would ease the task of judges trying to effect a reversal of policy. New and more explicit statutes would be free of present abuses and would, at the worst, take time to accumulate new ones. A declaration of legislative policy in restraint of existing exemptions would furnish a starting point for a new type of judicial opinion. But whether or not legislatures assist, the ultimate responsibility and the ultimate control, both as regards valuation and as regards exemption rest with the courts. Determination of the tax base is only broadly legislative. The application of the legislative will to each individual unit thereof, being judicial, or quasi-judicial, comes eventually under the close and detailed review of the courts. In the quality of this review of particular cases and in the effectiveness of the principles therein laid down for general administrative guidance lies the most important factor in the present day adequacy of the general property tax.

80. Lawrence Business College v. Bussing, 117 Kan. 436, 231 Pac. 1039 (1925); Traverse City v. East Bay Township, 190 Mich. 327, 157 N. W. 85 (1916); People ex rel. Young Men's Association for Mutual Improvement v. Sayles, 23 Misc. 1, 50 N. Y. Supp. 8 (Sup. Ct. 1898); Trustees of Green Bay Lodge v. City of Green Bay, 122 Wis. 452, 100 N. W. 837 (1904).

81. Grand Lodge of Masons v. Board of Review, 281 Ill. 480, 117 N. E. 1016 (1917); Kansas Masonic Home v. Board of Commissioners, 81 Kan. 839, 106 Pac. 1082 (1910); Kappa Kappa Gamma House Association v. Pearcy, 92 Kan. 1020, 142 Pac. 294 (1914); *Contra*: Morning Star Lodge v. Hayslip (Odd Fellows), 23 Ohio St. 144 (1872).

82. St. Louis South Western Rr. Co. v. Gates, 23 F. (2d) 283 (C. C. A. 8th 1927); People ex rel. Breymeyer v. Watseka Camp-Meeting Association, 160 Ill. 567, 43 N. E 716 (1896); People ex rel. McCullough v. Deutsche Evangelische Gemeinde, 249 Ill. 132, 94 N. E. 162 (1911); People ex rel. Murray v. City of St. Louis, 291 Ill. 600, 126 N. E. 529 (1920); State ex rel. Farr v. Martin, 105 W. Va. 600, 143 S. E. 356 (1928); Methodist Episcopal Church Barasa Club v. City of Madison, 167 Wis. 207, 167 N. W. 258 (1918); For example of very strict construction without mention of the rule of strict construction see: Johnson v. Mississippi Baptist Hospital, 140 Miss. 485, 106 So. 1 (1925).