

NOTES

LIABILITY UNDER UNIFORM FIDUCIARIES ACT OF BANK RECEIVING TRUST MONEY FROM FIDUCIARY'S PERSONAL ACCOUNT *

IF A depositor places to his personal credit funds held by him in a fiduciary capacity, the depository bank is usually under no common law duty to inquire into the propriety of the deposit.¹ Furthermore, it may honor checks thereafter drawn on the depositor's account without ascertaining whether the payments to third parties constitute a proper use of the money.² But it is on notice of the character of the deposit to the extent that if it receives in payment of a personal debt of the depositor any of the fiduciary funds identifiable as such, it is liable as a participant in the breach of trust for the amount it receives.³ And in many jurisdictions, a bank which wrongfully accepts trust money is liable for all subsequent unlawful payments from the mixed account, whether to itself, the depositor, or third parties.⁴

Either degree of liability imposes an almost insuperable burden on the bank in situations where the fiduciary's personal account is at all active. If there have been deposits and withdrawals of both trust and personal funds, the proportion of each in a mixed account at the time of payment to the bank can only be ascertained by analyzing the amounts and dates (1) of fiduciary deposits, (2) of personal deposits, (3) of withdrawals for fiduciary purposes, (4) of withdrawals for personal purposes.⁵ The bank can thus never be sure that it is not receiving trust money unless it has made a successful inquiry into the object of every withdrawal. Recognizing the practical impossibility of banks' conducting so exhaustive an investigation,⁶ the

* Colby v. Riggs National Bank, 92 F. (2d) 183 (App. D. C. 1937).

1. Empire Trust Co. v. Cahan, 274 U. S. 473, 57 A. L. R. 925 (1927); Whiting v. Hudson Trust Co., 234 N. Y. 394, 138 N. E. 33 (1923). But cf. Fidelity & Dep. Co. of Md. v. Queens County Trust Co., 226 N. Y. 225, 123 N. E. 370 (1919).

2. Kendall v. Fidelity Trust Co., 230 Mass. 238, 119 N. E. 861 (1918); Rogers v. Bankers Nat. Bank, 179 Minn. 197, 229 N. W. 90 (1930). See cases *contra* in (1932) 6 U. OF CIN. L. REV. 448, 452.

3. Union Stock Yards Bank v. Gillespie, 137 U. S. 411 (1890); Allen v. Puritan Trust Co., 211 Mass. 409, 97 N. E. 916 (1912); Comment (1933) 17 MINN. L. REV. 405.

4. Bischoff v. Yorkville Bank, 218 N. Y. 106, 112 N. E. 759 (1916); Wichita Royalty Co. v. City Nat. Bank of Wichita Falls, 127 Tex. 158, 89 S. W. (2d) 394 (1935); see Merrill, *Unforgettable Knowledge* (1936) 34 MICH. L. REV. 474, 479.

5. If the purpose of withdrawals cannot be ascertained, they will be presumed to be from personal funds as long as any remain in the account. Hewitt v. Hayes, 205 Mass. 356, 91 N. E. 332 (1910). One view holds, moreover, that deposits of personal funds after the trust portion of the mixed account has been depleted by misappropriation are presumably intended to replenish this deficit; payment of these ostensibly personal deposits to the bank would presumably render the bank liable. Myers v. Matusck, 98 Fla. 1126, 125 So. 360 (1929) (minority holding). *Contra*: Maryland Casualty Co. v. City National Bank, 29 F. (2d) 662 (C. C. A. 6th, 1928), *cert. denied*, 279 U. S. 847 (1928). See 4 BOGERT, TRUSTS AND TRUSTEES (1935) § 929.

6. See Scott, *Participation in a Breach of Trust* (1921) 34 HARV. L. REV. 454, 480; NATIONAL CONFERENCE OF COMMISSIONERS ON UNIFORM STATE LAWS, HANDBOOK AND PROCEEDINGS (1920) 168.

Commissioners of Uniform Laws sought to relieve them of this responsibility by abolishing the common law rule upon which liability has hitherto been based.⁷ Section 9 of the Uniform Fiduciaries Act provides, in effect, that if a fiduciary deposits trust funds in his personal account, the depository bank is not bound to inquire into the propriety of the deposit, and is authorized to pay the fiduciary's checks without liability, unless it has actual knowledge of a breach of trust or knowledge of facts amounting to bad faith.⁸ To the extent that this provision relates to payments to third parties, Section 9 is merely a codification of the existing law; but the broad privilege to honor checks drawn on a mixed account is seemingly not limited to third party transactions. It is apparent from an examination of the Commissioner's notes that the purport of the section is rather to include all checks drawn by the fiduciary, even those payable to the bank itself.⁹

Although the intended scope of Section 9 seems reasonably clear, some difficulty may be encountered in construing the language requiring as a basis for liability actual knowledge of breach of trust or knowledge of facts amounting to bad faith. Thus, in a recent case, a note brokerage firm, as trustee, opened a special account in the defendant bank to pay the holders of an issue of notes for which it was responsible. The account contained \$2,334,000, of which \$635,000 was borrowed from the bank. The next morning, by a single check payable to its own order, the company transferred the entire \$2,334,000 to its regular account, thereby wiping out a recent overdraft of \$178,000.¹⁰ At the same time, a check was drawn on the regular account, now containing only trust money, to repay the \$635,000 loan, which was not yet due. After the subsequent bankruptcy of the broker, a group of the unpaid noteholders sued the bank for the \$819,000 it had received from the ear-marked fund. The District of Columbia Court of Appeals, applying the case law rules, held the bank liable for the amount of the overdraft.¹¹ The payment of the loan, however, was held to fall within Section

7. 9 UNIFORM LAWS ANN. (1932) 154.

8. The Fiduciaries Act has been enacted in fourteen states and the District of Columbia; two other states have passed it in garbled form. *Id.* at 146. Other statutes similar to § 9 in purpose, but of varying scope, are ARK. DIG. STAT. (Crawford & Moses, Supp. 1927) § 716f; GEORGIA CODE (1933) § 13-2042; MISS. CODE (1930) § 3828; MO. REV. STAT. (1919) § 996, 1 STAT. ANN. (1932) 730.

9. The Commissioners' notes indicate an intention to put a depository bank on the same footing as other creditors. 9 UNIFORM LAWS ANN. (1932) 155. A payment from the mixed account to a third party creditor would impose no liability on him, because he would have no notice of the trust. It was presumably intended that the bank should have the same freedom. This construction is supported by the unqualified sense in which the word *pay* is used elsewhere in the Act, and has been approved in (1938) 85 U. OF PA. L. REV. 322, and (1938) 23 WASH. U. L. Q. 271; *cf.* (1938) 38 COL. L. REV. 495.

10. The overdraft was created on the same day that the loan was made and the trust account opened, but it was not called to the attention of the bank's officers until after the close of business. See *Colby v. Riggs Nat. Bank*, 92 F. (2d) 183, 186 (App. D. C. 1937). The court held that the transfer of the funds to the personal account was not *per se* a breach of trust. *Id.* at 195.

11. Two judges dissented on this point, arguing that § 6 of the Act should apply. Section 6 provides that if a fiduciary draws a check *payable to his own order*, and transfers it "whether in payment of a personal debt or otherwise," the transferee will be

9, and, since the court found no actual knowledge or bad faith on the part of the bank, the noteholders were denied recovery for that amount.¹²

In the absence of guidance from the Act itself on the meaning of "actual knowledge," the court decided that this term should be given the subjective sense in which it is employed in Section 56 of the Negotiable Instruments Law.¹³ The cases arising under this Section have generally held that actual knowledge refers to the state of mind of the individual buying defective paper. Unless he is actually aware of infirmities, he, and through him a corporate principal, are usually treated as a holder in due course.¹⁴ Applied to the instant case, the subjective test requires that some one individual in the bank know that the payment was in breach of trust. It seems clear from the evidence that no single person had such knowledge. The president and vice-president, otherwise thoroughly conversant with the transaction, did not know the source of the funds which paid the loan and overdraft. The teller, the only person in the bank who was aware of the transfer, knew nothing of the overdraft. The bookkeeper whose posting operation cancelled the overdraft had only a deposit slip, which gave no indication of the source of the deposit.¹⁵ Other participants in the transaction, insulated within eight

liable only if he has actual knowledge or bad faith. The check which transferred the trust funds to the regular account and thereby paid the overdraft was in this form; but commentators, as well as the court, have divided on the question of whether such a "payment" falls within the ambit of § 6. See (1938) 51 HARV. L. REV. 563; (1938) 86 U. OF PA. L. REV. 322. But see (1938) 23 WASH. U. L. Q. 271; (1938) 38 COL. L. REV. 495. Section 6 provides a seemingly unwise escape from the case-law restraints, preserved in §§ 4 and 5, on the payment of personal debts with fiduciary paper. But its application to the overdraft payment in the instant case seems logically unavoidable. See (1935) 20 CORN. L. Q. 220, 224.

In view of the exhaustive treatment of § 6 and its relation to the overdraft in the above-cited periodicals, it will receive no further attention in this note. It should be pointed out, however, that the protection given the bank by §§ 6 and 9 applies only where overdrafts and loans are paid by *check*—and in the overdraft case the check must be payable to the fiduciary personally and endorsed to the bank. If it were drawn on the fiduciary account payable directly to the bank, the bank would be liable. Uniform Fiduciaries Act, §§ 7, 8. Even more adventitious, from the bank's point of view, is the fact that, if the bank collected the loan by exercising its right of set-off, common law liability would attach. See (1938) 38 COL. L. REV. 495, 499. There would seem to be no significant difference between payment by check and payment by set-off.

12. *Colby v. Riggs National Bank*, 92 F. (2d) 183 (App. D. C. 1937).

13. The court did not specifically refer to § 56 of the N. I. L., but its reasoning leads to the same result. See *Colby v. Riggs Nat. Bank*, 92 F. (2d) 183, 194-6 (App. D. C. 1937).

14. *First Denton Nat. Bank v. Kenny*, 116 Md. 24, 81 Atl. 227 (1911); *First Nat. Bank of Glasgow v. Carroll*, 46 N. D. 62, 179 N. W. 664 (1920); *Chestnut St. Trust & Sav. Fund Co. v. Record Pub. Co.*, 227 Pa. 235, 75 Atl. 1067 (1910). But *cf.* *Louisa County Nat. Bank v. Burr*, 198 Iowa 4, 199 N. W. 359 (1924) (knowledge of any managing officer is knowledge of bank).

15. The check transferring the funds, which by its signature showed its fiduciary origin, went through the proof department to be debited to the account on which it was drawn; the deposit slip routed to the bookkeeper of the regular account stated only the amount of the deposit. Statement of Evidence 84-85, *Colby v. Riggs Nat. Bank*, 92 F. (2d) 183 (App. D. C. 1937). The check and deposit slip would be similarly separated

different departments of the bank, had only fragmentary information.¹⁶

The liability sought to be abolished by Section 9 was that arising from receipt of trust money from a mixed account complicated by subsequent deposits and withdrawals, the theory being that there is no reasonable safeguard whereby the recipient bank may avoid responsibility.¹⁷ None of these conditions were present in the principal case. Here the account in question contained nothing but trust money, and the entire transaction occupied less than twenty-four hours. At several points the misappropriation might have been frustrated had it not been for the negligent deference of the vice-president to an important customer.¹⁸ Furthermore, any sort of indication from the receiving teller to the bookkeeper that the deposit consisted of fiduciary funds should have sufficed to suspend payment of the overdraft and loan until inquiry was made. Application of the subjective test to such a state of facts puts a premium on negligence and permits a large bank to avoid liability by subdividing and segregating its functions.¹⁹

Although the court's interpretation of the phrase "actual knowledge" was undoubtedly that intended by the Commissioners of Uniform Laws,²⁰ it is not a necessary consequence of the wording of the act. A finding of corporate knowledge, whether actual or constructive, is at best a fiction, for clearly the corporation, itself, knows nothing; any knowledge for which it can be held responsible must necessarily be imputed from its agents.²¹ To measure a

if the check were drawn on another bank. See *New Amsterdam Cas. Co. v. Nat. Newark & Essex Banking Co.*, 117 N. J. Eq. 264, 282, 175 Atl. 609, 617 (Ch. 1934), *aff'd*, 119 N. J. Eq. 540, 182 Atl. 824 (1936).

16. Statement of Evidence *passim*, *Colby v. Riggs Nat. Bank*, 92 F. (2d) 183 (App. D. C. 1937).

17. Scott, *loc. cit. supra* note 6.

18. For example, while the arrangements about opening the trust account were being made, the president of the note brokerage company presented at the city collection window in payment of a note the check which overdrawed the regular account \$173,000. The teller would have ascertained from the bookkeeper whether the check was good, but the vice-president, by his own testimony, told him, "Just take that. That is all right." Statement of Evidence 80, *Colby v. Riggs Nat. Bank*, 92 F. (2d) 183 (App. D. C. 1937). The president of the note company was a director of the bank. *Id.* at 85.

19. The size and complexity of an organization do not ordinarily allow it to escape responsibility; the same standards should apply, other things being equal, to an individual or to an impersonal entity. *United States v. Nat. Exchange Bank of Baltimore*, 270 U. S. 527 (1926). Compare *First Nat. Bank of New Bremen v. Burns*, 88 Ohio St. 434, 103 N. E. 93 (1913), with *Brookhouse v. Union Pub. Co.*, 73 N. H. 363, 62 Atl. 219 (1905).

20. The Commissioners' notes make it clear that the adoption of the actual knowledge or bad faith formula throughout the Act was designed to bring the negotiable instruments transactions of fiduciaries into line with the general rules as to actual knowledge governing holders in due course. Fiduciary paper has long constituted a major exception, since it has been dealt with in terms of constructive knowledge and notice. 9 *UNIFORM LAWS ANN.* (1932) 151. Cf. *Fidelity & Dep. Co. of Md. v. Atchison, T. & S. F. Ry.*, 75 P. (2d) 283 (Kan. 1938).

21. See *Solow v. General Motors Truck Co.*, 64 F. (2d) 105, 107 (C. C. A. 2d, 1933) ("fairlyland of pure fiction"); *Abbot, Notice to a Corporation from Entries on its Books* (1913) 26 *HARV. L. REV.* 237, 238.

corporation's actual knowledge by that of only one of its agents, is, therefore, a permissible but not a necessary rationalization. An equally plausible hypothesis would be to gauge the knowledge of the corporate entity in terms of the sum of the knowledge acquired in the course of their employment by all of its agents. This "composite" knowledge²² has seldom been countenanced in the negotiable instruments field,²³ but has received some support in other phases of the law.²⁴ The obvious advantage of the composite knowledge doctrine is that it recognizes no distinction between large and small organizations. For instance, had this test been applied in the instant case, there can be little doubt that the combined knowledge of the teller and the vice-president would have sufficed to charge the bank with actual knowledge of the breach of trust.²⁵ Nor would a composite knowledge interpretation of Section 9 do violence to the purpose of the Act. If the transactions involving the trustee's personal account had concerned third parties and had extended over a longer period of time,²⁶ the sum total of all the knowledge possessed

22. See *Neal v. Cincinnati Union Stock Yards Co.*, 1 Ohio Cir. Ct. Rep. (N.S.) 13 (1903).

23. See cases cited note 14, *supra*. But where a clerk had received notice of a stolen bond which was later purchased by an officer of the bank who knew nothing of the notice, the bank was charged with actual knowledge that the bonds were stolen, under § 56 of the Negotiable Instruments Law. *Northwestern Nat. Bank of Milwaukee v. Madison & Kedzie State Bank*, 242 Ill. App. 22 (1926). This, though a minority holding, seems to be the better view. See Merrill, *The Wages of Indifference* (1936) 10 TEMP. L. Q. 147; but see (1936) 45 YALE L. J. 539.

Compare the cases holding banks liable for failure to observe a stop-payment order, though these are usually rationalized on an implied-contract theory. See Moore, Sussman, and Brand, *Legal and Institutional Methods Applied to Orders to Stop Payment of Checks* (1933) 42 YALE L. J. 817, 844.

24. In an action for deceit, where it was necessary to show actual knowledge that representations were false, the court held that the knowledge of a foreman was that of the company, and that a belief in their truth by the managing officer who had made the statements would be unavailing. *Meador v. Trout Brook Ice & Feed Co.*, 96 Conn. 454, 114 Atl. 668 (1921). Accord: *Operators Royalty & Producing Co. v. Greene*, 173 Okla. 388, 49 P. (2d) 499 (1935). Where actual knowledge is not required, and notice or constructive knowledge is sufficient, it is commonplace that a corporation is charged with the knowledge of any of its agents acquired in the scope of their employment. 2 МЕРСЕМ, AGENCY (1914) § 1843. But in a case arising under the Fiduciaries Act, the court repudiated the composite knowledge theory as a basis for a finding of bad faith. *New Amsterdam Cas. Co. v. Nat. Newark & Essex Banking Co.*, 117 N. J. Eq. 264, 284, 175 Atl. 609, 618 (1934), *aff'd*, 119 N. J. Eq. 540, 182 Atl. 824 (1936) (history of misappropriations far more complicated than in instant case).

25. Although the question would still remain as to whether the bank's composite actual knowledge of the source of the money would constitute actual knowledge of the breach of trust, as required by § 9, the court in the instant case seemed to have no doubt that the bank would be liable if, under its subjective theory, one person had known of the transfer of the funds and the payment of the loan. *Colby v. Riggs Nat. Bank*, 93 F. (2d) 183, 194 (App. D. C. 1937).

26. Whether, under a composite knowledge rationalization, an agent's forgetfulness of his component item of information would discharge the bank is not clear. See Merrill, *supra* note 4, at 474.

by the bank's various agents would have been insufficient to constitute actual knowledge in the bank.²⁷

But even though such an interpretation of the actual knowledge clause of Section 9 would have obviated the possible inequity of the decision in the instant case, the whole policy underlying this provision and the Uniform Fiduciaries Act in its entirety may be open to serious question. Mixed accounts are often used but are rarely necessary. If unrestrained, they constitute an invitation to defraud, for in them trust funds lose all identity, enabling a dishonest fiduciary to embezzle freely without arousing suspicion or inquiry.²⁸ In the past the courts have been lenient enough with such accounts;²⁹ the Fiduciaries Act goes further and attempts to destroy a liability which, indirectly at least, tended to discourage their creation.³⁰ The Act was predicated upon the hypothesis that honest fiduciaries should be permitted greater freedom in handling trust money.³¹ In order to effectuate this end, some of its provisions place the risk of occasional loss upon the beneficiaries of the trust rather than upon those who deal with the dishonest trustee.³² If the equities of the trustee's creditors were strong, such a shift of liability might be justified. It should be remembered, however, that a bank which extends credit to one who is not only dishonest but probably insolvent would usually lose its money in any event. Consequently its equities in the embezzled funds seem tenuous at best.³³

27. In this event no single agent or group of agents could have known the status of the trustee's account. See notes 5-6 *supra*.

28. See Merrill, *Bankers' Liability for Deposits of a Fiduciary to His Personal Account* (1927) 40 HARV. L. REV. 1077 (advocating liability for all misappropriations from mixed accounts).

29. This is true especially of the executor-administrator type of fiduciary, who is said to have complete dominion over the estate. *Cocke's Adm'rs v. Loyall*, 150 Va. 336, 143 S. E. 881 (1928). Agents of business units, however, are more often restricted in their use of the firm's money, and banks have consequently been penalized for allowing them to deposit it in personal accounts. *Chase & Co., Inc. v. Norfolk Nat. Bank of Commerce*, 151 Va. 1040, 145 S. E. 725 (1928). But see Comment (1926) 35 YALE L. J. 854.

30. N. Y. SURROGATES' COURTS ACT § 231 makes it a misdemeanor for an executor, administrator, or guardian to deposit trust money in a personal account. Cf. N. Y. Laws 1927, c. 473, § 1, amending N. Y. NEGOTIABLE INSTRUMENTS LAW § 95 (bank need not inquire into deposit of corporate funds in personal account by officer of corporation, if it has filed authorization permitting such deposits).

31. 9 UNIFORM LAWS ANN. (1932) 148.

32. See, *e.g.*, §§ 6, 9.

33. There is some authority for the proposition that, regardless of notice or knowledge, the bank cannot retain trust money paid it from a personal account, unless "superior equities" have arisen in its favor, as from an injurious change of position. *Citizens' & Southern Bank v. Fayram*, 21 F. (2d) 998 (C. C. A. 5th, 1927). But the weight of authority seems to be *contra*. *Arnold v. San Ramon Valley Bank*, 184 Cal. 632, 194 Pac. 1012 (1921); see (1938) 38 COL. L. REV. 495, 497.

EFFECT OF ASSIGNMENT OF INCOME CLAUSE IN TRUST INDENTURE AND
SUPPLEMENTAL CONTRACT CONCERNING RENTS AND PROFITS *

DURING the recent depression the mortgagee—usually depicted as a bargain driving money lender whose funds are well secured by the mortgaged property—has found his security to be of uncertain value. The deflation of real estate values in periods of economic stress has given rise to attempts to “milk” mortgaged property by mortgagors desirous of obtaining all possible revenue before their equities are extinguished.¹ Moreover, legislation aimed at staying foreclosures² and at protecting the mortgagor against deficiency judgments, also a product of the depression, has accentuated the tendency to lend mortgage money in reliance upon the income of the property rather than the financial ability of the borrower to repay.³ Together, these phenomena make it extremely important to mortgagees that full effect be given to the “assignment of rents” clause commonly found in mortgage deeds. It has long been conventional doctrine that a clause in a mortgage conveying rents and profits is to be construed as a pledge, to be perfected only when the mortgagee takes possession, actually or constructively by securing the appointment of a receiver ancillary to foreclosure.⁴ But a strict standard of accountability for the fair rental value of the property and liability for waste and mismanagement make the position of the mortgagee in possession rather hazardous.⁵ And although securing the appointment of a receiver may be made easier when the mortgage pledges rents and profits than otherwise,⁶ this proceeding is slow, expensive,⁷ often inefficient, and usually results in foreclosure at an inopportune time and at a heavy capital loss. Consequently, it is not surprising that mortgagees should seek other methods of dealing with defaulting mortgagors which would enable the former to obtain control of the income of the property and yet avoid the liability and expense entailed by the conventional devices.

A recent case illustrates the hazards in which such an attempt may involve the mortgagee. To secure a bond issue, a deed of trust was executed mort-

* Fisher v. Norman Apartments, Inc., 72 P. (2d) 1092 (Colo. 1937).

1. See Comment (1933) 46 HARV. L. REV. 491.

2. E.g., CONN. GEN. STAT. (1930) §§ 5083, 5116; IND. STAT. ANN. (Burns, 1933) §3-1801.

3. See Abelow, *An Historical Analysis of Assignments of Rent in New York* (1936) 6 BROOKLYN L. REV. 25.

4. American Bridge Co. v. Heidelberg, 94 U. S. 798 (1876); Freedman's Saving & Trust Co. v. Shepherd, 127 U. S. 494 (1888); Myers v. Brown, 92 N. J. Eq. 348, 112 Atl. 844 (Ch. 1921); New York Security & Trust Co. v. Saratoga Gas & Elec. Light Co., 159 N. Y. 137, 53 N. E. 758 (1899); 2 JONES, MORTGAGES (8th ed. 1928) § 827.

5. See Comment (1935) 35 COL. L. REV. 1248.

6. Several cases hold that where rents and profits are pledged, it is not necessary to show waste or impairment of the security in order to obtain a receiver. Howard v. Burns, 201 Ill. App. 579 (1916); Ohio Mutual Savings & Loan Co. v. Public Construction Co., 26 Ohio N. P. (n. s.) 371 (1926); see Rhinelander v. Richards, 184 App. Div. 67, 70, 171 N. Y. Supp. 436, 437 (1st Dep't 1918). *Contra*: Aetna Life Ins. Co. v. Broecker, 166 Ind. 576, 77 N. E. 1092 (1906).

7. See Carey, Brabner-Smith, and Landsen, *Studies in Foreclosures in Cook County* (1933) 27 ILL. L. REV. 475, 595, 717, 849.

gaging real estate and assigning the rents and profits of the property. Upon default a bondholders' protective committee was organized. It entered into an agreement with the corporate mortgagor whereby the income from the property was to be deposited in a named bank, subject to check by the joint signatures of an agent of the protective committee and the resident manager of the property, as agent for the debtor. After payment of operating expenses, the residue was to be paid to the trustee under the indenture, who was to apply it upon the indebtedness. Subsequently a creditor of the mortgagor, who had obtained a judgment against it prior to the execution of this contract, attempted to garnish the bank with which the funds had been deposited, and the trustee intervened, claiming title to the moneys under both the original indenture and the subsequent agreement. A judgment for the intervenor was reversed by the Supreme Court of Colorado, one judge dissenting, upon the grounds, first, that there had been insufficient action by the mortgagee to make the assignment clause in the indenture operative, and second, that the contract could not be construed as a direct assignment of rents to the mortgagee.⁸

Although income not yet in being is, in effect, after-acquired property, the difficulties inherent in a rationalization of the legal theory of a mortgage on after-acquired property⁹ are rarely encountered in cases discussing the validity and effect of clauses granting or assigning income.¹⁰ The difficulty is rather that construing the clause granting rents and profits to be an inchoate or executory pledge entails as a corollary the application of the rule that possession of the property must be taken to render the pledge effective. It has long been held that where a mortgage uses words conveying or pledging the rents and profits, the mortgagee is entitled to them only when he takes actual possession or secures the appointment of a receiver.¹¹ However, where, as in the instant case, words of assignment are used, there is no such unanimity of opinion. Under one view no distinction is made between an "assignment" and a "pledge," and the general rule is applied to both.¹² In some jurisdictions this result has been justified by reliance on statutes providing that a mortgagor shall retain possession of the property until foreclosure and sale.¹³ But the conventional doctrine has been expressly rejected

8. *Fisher v. Norman Apartments, Inc.*, 72 P. (2d) 1092 (Colo. 1937).

9. See generally, Blair, *The Allocation of After-Acquired Mortgaged Property Among Rival Claimants* (1926) 40 HARV. L. REV. 222, 224 *et seq.*; Foley and Pogue, *After-Acquired Property Under Conflicting Corporate Mortgage Indentures* (1929) 13 MINN. L. REV. 81, 82 *et seq.*

10. But a grant of income has been held invalid as an attempt to mortgage after-acquired property in violation of statute. *Georgia S. & F. Ry. v. Barton*, 101 Ga. 466, 28 S. E. 842 (1897); *Lubroline Oil Co. v. Athens Saving Bank*, 104 Ga. 376, 30 S. E. 409 (1898).

11. See cases cited *supra* note 4.

12. *In re Israelson*, 230 Fed. 1000 (S. D. N. Y. 1916); *In re Berdick*, 56 F. (2d) 288 (S. D. N. Y. 1931); *Sullivan v. Rosson*, 223 N. Y. 217, 119 N. E. 405 (1918); *One Hundred Forty-Eight Street Realty Co. v. Conrad*, 125 Misc. 142, 210 N. Y. Supp. 400 (Sup. Ct. 1925).

13. *Orr v. Bennett*, 135 Minn. 443, 161 N. W. 165 (1917); *Smith v. Grill*, 64 N. D. 163, 250 N. W. 787 (1933); *Rives v. Mincks Hotel Co.*, 167 Okl. 500, 30 P. (2d) 911 (1934).

in several jurisdictions. Thus, where the assignment of rents was solely for the payment of taxes, insurance premiums, and repairs, the clause was said to become operative upon default since the mortgagor's failure to pay them was waste.¹⁴ Another case, which holds that the mortgagor's assent to the payment of rents to the mortgagee brought the assignment clause into operation, suggests that the general rule is applicable only when the mortgagor resists the claim of the mortgagee.¹⁵ Moreover, some courts have relied upon a statute validating the assignment of rents and profits to hold that an assignment clause transfers title upon default.¹⁶ Other courts have reached the same result without the aid of statutes,¹⁷ and require neither the taking of possession nor judicial action by the mortgagee to defeat the claims of garnishing creditors of the mortgagor.¹⁸ And where no distinction is made between pledge and assignment, it has been intimated that a demand for possession followed by refusal will operate to enforce the mortgagee's claim.¹⁹ In view both of this possibility even under the stricter rule and of the tendency of numerous recent cases to construe an assignment in a trust deed to be self-executing upon default, it would seem that the mortgagee in the instant case took sufficient affirmative action to entitle him to a position superior to that of a garnishing creditor.²⁰

Aside from the question of whether the contract in the instant case made the assignment clause in the trust indenture operative, the contract itself might be considered a valid assignment. But the court maintained that the contract could not be so construed since the word "assign" did not expressly appear and since the mortgagor, through its agent, remained in physical possession of the property. However, the rule that no particular form of words or instrument is necessary to constitute an assignment is of long standing.²¹

14. *Fidelity-Philadelphia Trust Co. v. West*, 178 Minn. 150, 226 N. W. 406 (1929); *Mutual Ben. Life Ins. Co. v. Canby Inv. Co.*, 190 Minn. 144, 251 N. W. 129 (1933).

15. *Farmers' Union Jobbing Ass'n v. Sullivan*, 137 Kan. 196, 19 P. (2d) 476 (1933).

16. *Security Trust Co. v. Sloman*, 252 Mich. 266, 233 N. W. 216 (1930); *Abrin v. Equitable Trust Co.*, 271 Mich. 535, 261 N. W. 85 (1935). The statute is MICH. COMP. LAWS (1929) § 13498.

17. *Paramount Bldg. & Loan Ass'n v. Sacks*, 107 N. J. Eq. 328, 152 Atl. 457 (Ch. 1930); *Stanton v. Metropolitan Lumber Co.*, 107 N. J. Eq. 345, 152 Atl. 653 (Ch. 1930); *New Jersey Nat. Bank & Trust Co. v. Wolf*, 108 N. J. Eq. 412, 155 Atl. 372 (Ch. 1931); *New Jersey Nat. Bank & Trust Co. v. Morris*, 155 Atl. 782 (N. J. Ch. 1931).

18. *Granniss-Blair Audit Co. v. Maddux*, 167 Tenn. 297, 69 S. W. (2d) 238 (1934).

19. See *Dow v. Memphis & L. R. R. R.*, 124 U. S. 652, 654 (1888); *Freedman's Saving & Trust Co. v. Shepherd*, 127 U. S. 494, 503 (1888); *One Hundred Forty-Eight Street Realty Co. v. Conrad*, 125 Misc. 142, 145, 210 N. Y. Supp. 400, 403 (Sup. Ct. 1925). A demand for possession has been held to effectuate an equitable assignment of rents to the mortgagee. *Katz v. Goodman*, 136 Misc. 166, 238 N. Y. Supp. 700 (Sup. Ct. 1929); *First Wisconsin Trust Co. v. Adams*, 218 Wis. 406, 261 N. W. 16 (1935).

20. Not only were the rents on deposit with the bank subject to release only upon the counter-signature of the mortgagee's agent, but the agreement further provided that the mortgagor could incur no unusual or extraordinary expenses without the written consent of the bondholders' committee, and the latter were empowered to exercise control over the eviction of tenants and to bring suit in the mortgagor's name if necessary to collect rents or other accounts receivable.

21. *Iowa Bridge Co. v. Comm'r of Int. Rev.*, 39 F. (2d) 777 (C. C. A. 8th, 1930); *Galbreath v. Wallrich*, 45 Colo. 537, 102 Pac. 1085 (1909); *Porter v. Title Guaranty &*

And although under the usual agreement assigning rents the mortgagee does take possession of, and manage, the property,²² there is authority that the retention of possession by the mortgagor is not inconsistent with a valid assignment. Agreements under which the mortgagor remained in possession, and under which collection of rents was by an agent of the mortgagee²³ or by an agent of the mortgagor²⁴ have been held effective to enforce the former's lien. Under an agreement whereby the mortgagor collected the rents as trustee and remitted the excess over operating expenses to the mortgagee, an attempted garnishment of rents in the hands of tenants was held to be ineffectual, the court stating that since the parties were acting by mutual consent and cooperation, the mortgagee was to all intents and purposes in possession of the property and a valid assignment had been effected²⁵—reasoning which would seem to be peculiarly adaptable to the instant case. Moreover, the requirement that the mortgagee must actually be in possession to effect an assignment has been expressly repudiated by one court, which held that the relative rights of the parties were to be determined by their agreement and not by the fact of possession.²⁶ The court in the principal case, however, apparently felt that the mortgagee must be in complete control of the property before any agreement of the parties could operate to effectuate his lien—a result which reads into the subsequent agreement all the strict prerequisites to the operation of the assignment clause in the original indenture.

The decision in the instant case also seems open to question on other grounds. In the first place, since the federal court in prior bankruptcy proceedings of this debtor had treated the mortgagee's title to the rents as not open to question,²⁷ it would seem that the plaintiff, who was a party to those proceedings, might well be precluded from suing on the theory of *res judicata*. Secondly, since the contract was binding between the immediate parties and would consequently prevent the mortgagor from recovering the rents for its own use, the decision apparently violates a settled rule of Colorado law that a garnishing creditor can recover from the garnishee no more than could

Surety Co., 21 Idaho 312, 121 Pac. 548 (1912); *Wheless v. Meyer & Schmid Grocer Co.*, 140 Mo. App. 572, 120 S. W. 708 (1909).

22. See *e.g.*, *Reichert v. Guaranty Trust Co.*, 261 Mich. 315, 246 N. W. 132 (1933); *Mass. Mut. Life Ins. Co. v. Sutton*, 278 Mich. 457, 270 N. W. 748 (1936).

23. *Netzeband v. Knickmeyer-Fleer Realty & Inv. Co.*, 103 S. W. (2d) 520 (Mo. App. 1937).

24. *Dailey v. Doherty*, 237 Mass. 365, 129 N. E. 678 (1921).

25. *Kershaw v. Squier*, 137 Kan. 855, 22 P. (2d) 468 (1933); *cf. Hall v. Goldsworthy*, 136 Kan. 247, 14 P. (2d) 659 (1932) (agreement between mortgagor and mortgagee that third party should collect and hold rents until rights of the parties were judicially determined vested title to rents so held in mortgagee).

26. *Farmers' Trust Co. v. Prudden*, 84 Minn. 126, 86 N. W. 887 (1901). In *Bank of Commerce & Trust Co. v. Memphis*, 155 Tenn. 63, 290 S. W. 990 (1927), where the parties stipulated in the trust indenture that all income was to be deposited in a named bank subject to withdrawal only by an authorized agent of the mortgagor for certain specified purposes, it was held that this agreement operated to vest control and possession of the income in the mortgagee even before default.

27. *Morrison v. Rockhill Improvement Co.*, 91 F. (2d) 639 (C. C. A. 10th, 1937).

the primary debtor himself.²⁸ Finally, there is no compelling reason why the courts should not favor the claims of a mortgagee who wishes to avoid the expense of a receivership and still not be deprived of the security of the rents.²⁹ Not only is it desirable that the mortgagee should be able to rely on available funds in the order of his priority over general creditors, but such an attitude would also be in harmony with policy of recent statutes delaying foreclosure proceedings and preventing deficiency judgments. The instant decision effectively precludes such a solution, invites a creditor's race immediately upon default, gives the plaintiff a preference over all other creditors both old and new who have contributed capital in reliance upon the contract, and leaves no alternative but receivership.

THE STATUTE OF LIMITATIONS AS APPLIED TO STOCKHOLDER'S DERIVATIVE SUIT *

THE HYBRID nature of the stockholder's derivative suit¹ makes it difficult to select the appropriate limitation upon an action of this type.² Since the right enforced is that of the corporation, the stockholder's cause of action is cognizable only in equity. Hence a number of courts have held that the Statute of Limitations applicable to actions strictly equitable in character must govern the derivative suit.³ But even though the suit is technically an equitable proceeding brought in the stockholder's name, the real party in interest is the corporation itself, for, in the event of recovery, it alone is entitled to the award.⁴ Consequently, the majority opinion has been that the relationship of the parties is in itself unimportant and, that the limitation period applied should be the one which would have controlled had the corporation brought the suit.⁵ Yet some argument may be made for the minority view. Thus, the application of the equitable statute is consistent with the

28. *Universal Fire Ins. Co. v. Tabor*, 16 Colo. 531, 27 Pac. 890 (1891); *State of Colo. v. Elkins*, 84 Colo. 409, 270 Pac. 875 (1928); *Collins v. Thuringer*, 92 Colo. 433, 21 P. (2d) 709 (1933).

29. See Comment (1933) 43 *YALE L. J.* 107.

**Potter v. Walker*, 276 N. Y. 15, 11 N. E. (2d) 335 (1937).

1. For a discussion of the formal steps required of the stockholder in bringing a derivative action, see Comment (1931) 15 *MINN. L. REV.* 453.

2. Some states, however, have no equitable Statute of Limitations, and consequently the problem is whether to apply the legal bar or the doctrine of laches.

3. *Venner v. Central Trust Co. of N. Y.*, 204 Fed. 779 (C. C. A. 2d, 1913); *Backus-Brooks Co. v. Northern Pac. Ry.*, 21 F. (2d) 4 (C. C. A. 8th, 1927); *cf. Greenfield Savings Bank v. Abercrombie*, 211 Mass. 252, 97 N. E. 897 (1912).

4. *Whitten v. Dabney*, 171 Cal. 621, 154 P. 312 (1916); see 13 *FLETCHER, CORPORATIONS* (Perm. ed. 1931) § 6028. There are exceptions to this rule. *Di Tomasso v. Leverro*, 250 App. Div. 206, 293 N. Y. Supp. 912 (2d Dep't 1937), (1937) 51 *HARV. L. REV.* 164 (the plaintiff was allowed to recover damages as he was the only innocent stockholder).

5. *Wallace v. Lincoln Savings Bank*, 89 Tenn. 630, 15 S. W. 448 (1891). And see cases cited in *STEVENS, CORPORATIONS* (1936) § 152.

fact that in some states the plaintiff stockholder is deprived of his right to a jury trial in a derivative suit.⁶ Furthermore, a strong case can be made for the minority view simply because the equitable Statute of Limitations is generally longer than the legal one. The autocratic control exercised by directors over corporate affairs places dishonest directors in a peculiarly advantageous position to prevent discovery of their wrongs. So long as they constitute a majority of the board of directors, it is obvious that the corporation will never bring the suit.⁷ And even when the management changes hands, the complicated nature of corporate accounts may prevent an immediate disclosure of the irregular acts. In such event, the corporation may be unable to sue until the statutory period has passed; and therefore the application of the equitable Statute of Limitations to the stockholder's suit may be desirable since it does allow a longer period in which recovery may be had by the corporation through the process of the derivative suit.

The problem of selecting the statutory bar for these actions was cogently presented by a recent case. Plaintiff, a stockholder of the Pan American Petroleum and Transport Company, brought a derivative suit in June, 1933, against the directors of that corporation for acts committed by them as such during the years 1924 and 1925. The relief demanded was twofold: first, an accounting of losses incurred by the corporation and profits obtained by certain of the directors as a result of various complicated transactions whereby these directors wrongfully appropriated funds belonging to the Pan American Company for the purpose of purchasing in their own name stock of that and another corporation;⁸ secondly, damages for negligence against other directors who had not participated in the above transactions but who had approved or acquiesced in these and other illegal acts.⁹ The defendants moved to dismiss the complaint on the ground that the action was barred by the six year Statute of Limitations which applies to all contractual obligations and injuries to property.¹⁰ The court of Special Term granted this motion, dismissing

6. *Bookbinder v. Chase National Bank*, 244 App. Div. 650, 280 N. Y. Supp. 393 (1st Dep't 1935) (holding that § 61 of the N. Y. GEN. CORP. LAW, which permits a jury trial for the legal issues in a suit brought by a corporation against the directors on legal and equitable causes of action, does not apply to the derivative suit).

7. *Cf. Beal v. Smith*, 46 Cal. App. 271, 189 Pac. 341 (1920).

8. The first cause of action of the third amended complaint alleged a complicated conspiracy whereby certain of the directors purchased the stock of X Co. in the name of Pan American. They then deposited the purchase price with a dummy corporation, later applying the money so deposited to the purchase of Pan American stock in their own names.

The seventh cause of action alleged the formation of a "director's syndicate" for the purpose of engaging in various stock transactions with money supplied by Pan American and thus acquiring certain stock held by Pan American in another corporation. See Record pp. 116, 168, *Potter v. Walker*, 276 N. Y. 15, 11 N. E. (2d) 335 (1937).

9. The fourth cause of action alleged negligence against the defendants in having approved a gift of \$150,000 by Pan-American, to one Robert W. Steward, Chairman of the Board of Directors of Standard Oil and a director of Pan-American. The gift was alleged to be *ultra vires* and a waste of corporate funds. Record, p. 185, *Potter v. Walker*, 276 N. Y. 15, 11 N. E. (2d) 335 (1937).

10. N. Y. C. P. A. § 48 [since amended, N. Y. Laws, 1936, c. 558].

all counts against the directors.¹¹ The Appellate Division affirmed the dismissal of the causes of action charging negligence but reversed as to the rest,¹² holding that although the apposite Statute of Limitations was the one which would have applied if the corporation had sued, the request for an accounting was a demand for equitable relief and must, therefore, be governed by the ten year period of limitations applicable to actions of this type.¹³ The Court of Appeals affirmed this decision in its entirety,¹⁴ thus overruling previous dicta and several lower court decisions which had expressed a contrary view.¹⁵

Once the court had adopted as its premise the proposition that the stockholder's derivative suit is to be bound by the same Statute of Limitations which would govern a suit by the corporation, it followed that the cause of action based on negligence was outlawed, since the only possible action by the corporation was legal in form.¹⁶ But the problems incurred by the request for an accounting in equity present some difficulty, for the corporation had a remedy at law.¹⁷ And it is well settled that when concurrent legal and equitable remedies exist, equity will consider itself bound by the legal Statute of Limitations.¹⁸ The court in the instant case refused to apply this rule, however, predicating its refusal upon the alleged inadequacy of the plaintiff's remedies at law.¹⁹ This restriction upon the concurrent remedy theory rep-

11. *Potter v. Walker*, 159 Misc. 339, 287 N. Y. Supp. 806 (Sup. Ct. 1936).

12. *Potter v. Walker*, 293 N. Y. Supp. 161 (App. Div., 1st Dep't 1937).

13. N. Y. C. P. A., § 53: "An action, the limitations of which is not specifically prescribed in this article, must be commenced within ten years after the cause of action accrues." This section applies to every form of equitable action. *Pitcher v. Sutton*, 238 App. Div. 291, 264 N. Y. Supp. 488 (4th Dep't 1933), *aff'd*, 264 N. Y. 638, 191 N. E. 603 (1934).

14. *Potter v. Walker*, 276 N. Y. 15, 11 N. E. (2d) 335 (1937).

15. *Chance v. Guaranty Trust Co. of N. Y.*, 164 Misc. 346, 298 N. Y. Supp. 17 (Sup. Ct. 1937), *aff'd*, 251 App. Div. 855, 297 N. Y. Supp. 293 (2d Dep't 1937); see *Brinckerhoff v. Bostwick*, 99 N. Y. 185, 193, 1 N. E. 663, 667 (1885) (This case has been the source of most of the confusion in New York).

16. The statute begins to run from the date of the negligent act, and not from the date that the full extent of the injury is ascertained. *Dykman v. Keeney*, 154 N. Y. 483, 48 N. E. 894 (1897); *Brown v. Tenn. Coal Co.*, 19 Tenn. App. 123, 83 S. W. (2d) 568 (1935). A different rule applies where there is a fraudulent concealment of the cause of action. *Dawson*, *Fraudulent Concealment and Statutes of Limitation* (1933) 31 MICH. L. REV. 875.

17. See note 25, *infra*.

18. *Heard v. Houston Gulf Gas Co.*, 78 F. (2d) 189, 191 (C. C. A. 5th, 1935); *Kelley v. Woodley*, 228 Ala. 401, 153 So. 745 (1934); *Backus v. Kirsch*, 264 Mich. 73, 249 N. W. 469 (1933); *Keys v. Leopold*, 241 N. Y. 189, 149 N. E. 828 (1925); *Hotchkin v. McNaught-Collins Imp. Co.*, 102 Wash. 161, 172 P. 864 (1918).

19. See *Potter v. Walker*, 276 N. Y. 15, 26, 11 N. E. (2d) 335, 336 (1937). But *cf.* 1 POMEROY, EQUITY JURISPRUDENCE § 139 ("The fact that the legal remedy is not full, adequate, and complete, is, therefore, the real foundation of the concurrent branch of the equity jurisprudence.")

It is arguable that the application of the equitable statute is consistent with the fact that the plaintiff loses his right to a jury trial in an accounting action. *Whiton v.*

resents²⁰ a substantial variation from the doctrine that the mere existence of a legal cause of action, however inadequate, will suffice.²¹ Indeed, the comparative sufficiency of the alternative remedies appears to have been discussed principally in those cases where the courts have applied the legal Statute of Limitations, stating *obiter dicta* that the remedy at law was perfectly adequate.²² Moreover, it is by no means clear that the legal remedies open to the plaintiff in the instant case were as unsatisfactory as the court seems to have assumed. Although courts of equity first took jurisdiction over suits for an accounting because of the inadequacy of the common law action of account,²³ this extension of the chancellor's jurisdiction soon resulted in a general liberalization of the equivalent procedure at law to meet the increasing competition of equity.²⁴ It is, therefore, possible that an action for money had and received²⁵ coupled with a pre-trial discovery²⁶ would have enabled the plaintiff to recover the profits made by the directors without resorting to

Spring, 74 N. Y. 169 (1878); *In re Doherty's Estate*, 155 Misc. 396, 279 N. Y. Supp. 401 (Surr. Ct. 1935). See *supra*, p. 1004.

20. The court relied upon the decisions in *Hanover Fire Insurance Co. v. Morse Dry Dock & Repair Co.*, 270 N. Y. 86, 200 N. E. 589 (1936) (although the plaintiff had no available remedy at law, the court adopted similar language in order to refute the argument that the plaintiff insurance company had a valid defense if sued at law), and *Falk v. Hoffman*, 233 N. Y. 199, 135 N. E. 243 (1922) (which merely held that the inadequacy of the legal remedy entitled the plaintiff to sue in equity for an accounting).

21. *Hart v. Goadby*, 72 Misc. 232, 129 N. Y. Supp. 892 (Sup. Ct. 1911); *City of Milwaukee v. Drew*, 220 Wis. 511, 265 N. W. 683 (1936); see *Minion v. Warner*, 238 N. Y. 413, 418, 144 N. E. 665, 666 (1924).

22. See *Butler v. Johnson*, 111 N. Y. 204, 213, 18 N. E. 643, 645 (1888); *Holt v. Hopkins*, 63 Misc. 537, 541, 117 N. Y. Supp. 177, 180 (Sup. Ct. 1909).

23. 4 POMEROY, EQUITY JURISPRUDENCE (4th ed. 1919) § 1420.

24. See *Sloane v. United Feature Syndicate*, 135 Misc. 365, 366, 238 N. Y. Supp. 91, 93 (N. Y. City Ct. 1929).

Consequently courts of equity have tended to limit their jurisdiction in accounting actions to situations where a fiduciary relationship exists. See *Sloane v. United Feature Syndicate*, 135 Misc. 365, 367, 238 N. Y. Supp. 91, 94, (N. Y. City Ct. 1929). Where there is a fiduciary relationship, an accounting will be granted as a matter of right [*Royal Indemnity Co. v. Knott*, 101 Fla. 1495, 136 So. 474 (1931)], and the defense that the plaintiff has an adequate remedy at law will not prevail [*United States Trust Co. v. Greiner*, 124 Misc. 458, 209 N. Y. Supp. 105 (Sup. Ct. 1925)]. An accounting may also be based on the need of a discovery or on the complicated nature of the accounts. 4 POMEROY, EQUITY JURISPRUDENCE, § 1421.

25. Cf. *McClure v. Law*, 161 N. Y. 78, 55 N. E. 388 (1899). Such an action may be maintained for the recovery of secret profits. *Portsmouth Cotton Oil Corp. v. Fourth Nat. Bank of Montgomery*, 280 Fed. 879 (M. D. Ala. 1922), *aff'd*, 284 Fed. 718 (C. C. A. 5th, 1922) (holding that an action for money had and received is governed by equitable principles and may be brought "where one party has received money which in equity and good conscience belongs to another"). And see SHIPMAN, COMMON LAW PLEADING (3d ed. 1923) 162.

26. Cf. *Bradford v. Indiana Harbor Belt R.R.*, 300 Fed. 78 (C. C. A. 7th, 1924). The right to a discovery in an action at law is entirely statutory. See N. Y. RULES OF CIVIL PRACTICE, 140, 141.

the remedy in equity.²⁷ But by refusing to apply the shorter Statute of Limitations to the suit against the active directors in the instant case the court avoided the clearly undesirable result of preventing any recovery by the corporation.

The very fact that the plaintiff encountered these difficulties in maintaining his suit illustrates the inadequacy of present rules of limitation governing actions of this type. So long as the determination of the appropriate Statute of Limitations depends upon the arbitrary distinction between legal and equitable cause of action, the duration of directors' liability is largely a matter of chance. Specific statutory amendments would seem to afford the only practical solution to the problem. For instance, the legislature might recognize the facility with which corporate directors may conceal their wrongful acts, and specifically provide that in suits against directors, whether brought by the corporation itself or its stockholders, the cause of action shall not accrue until the corporation has knowledge of the wrong. An amendment of this kind would have its counterpart in the statutory provision relating to actions sounding in fraud, for in such actions the Statute of Limitations does not start to run until the fraudulent act has been brought to light.²⁸ But the court would still be faced with the difficult problem of determining when the corporation has notice of the breach. While there is authority in the fraud cases for holding that the corporation receives notice and that the cause of action accrues upon the election of one new director,²⁹ the better decisions hold that the statute does not begin to run until the defendant directors no longer compose a majority of the board of directors.³⁰ Yet even under this view it is possible that neither the new directors nor the stockholders will discover the cause of action before the period of limitations has run against them. To avoid this result, it would be necessary to require that actual notice of the wrongful acts, as distinguished from constructive notice, be received by the officers and stockholders. A second and more drastic method of obviating the difficulties facing the plaintiff in the instant case would

27. Cf. *The Fur & Wool Trading Co. v. Fox, Inc.*, 245 N. Y. 215, 156 N. E. 670 (1927).

28. *E.g.*, N. Y. C. P. A. 48(5). See generally Dawson, *Fraudulent Concealment and Statutes of Limitation* (1933) 31 MICH. L. REV. 875. The plaintiff in the instant case strenuously contended that the actions of the directors were tantamount to a fraud upon the corporation [Answer Brief for Plaintiff, p. 25, *Potter v. Walker*, 276 N. Y. 15, 11 N. E. (2d) 335 (1937)], but the Court of Appeals did not mention this argument in its opinion, either because it did not consider the gravamen of the action to be fraud or because no showing of fraud had been made. Cf. *Carr v. Thompson*, 87 N. Y. 160 (1881).

29. *Anderson v. Gailey*, 33 Fed. (2d) 589 (N. D. Ga. 1929). In the instant case it is barely possible that the court, though considering the action as one sounding in fraud, adopted this view, since one new director was appointed more than six years before the institution of the suit [Answering Brief for Defendants, p. 26, *Potter v. Walker*, 276 N. Y. 15, 11 N. E. (2d) 335 (1937)]. Such a holding would be in keeping with the fact that limitation statutes are usually accorded a strict interpretation [*Pietsch v. Milbrath*, 123 Wis. 647, 101 N. W. 388 (1905)].

30. *Beal v. Smith*, 46 Cal. App. 271, 189 P. 341 (1920).

be to abolish the defense of limitations in actions of this type. South Dakota has already taken a step in this direction.³¹

Although there would seem to be no objection to the above amendments in actions against directors which are brought by the corporation itself, it may be argued that neither should apply to the stockholder's suit. The notion has long been prevalent that most derivative actions are in the nature of "strike suits,"³² instigated by an individual stockholder anxious to achieve a personal settlement with the directors. And since the unwarranted compromise of a derivative suit may prejudice the corporation's cause of action,³³ it has been felt that the stockholder's remedy should be hedged about with all possible restrictions.³⁴ Extension of the present period of limitations would undoubtedly open up further opportunities for "strike suits." But the alleged evil of such suits might be curbed by two measures. The plaintiff-stockholder might be denied the right to terminate the suit unless permission is granted by the presiding judge in his discretion.³⁵ And a fine or penalty might be imposed upon stockholders attempting to secure personal benefit by bargaining for a settlement. If some such precautionary measures were adopted, there could be no objection to extending the period during which a derivative suit might be brought. An amendment to this effect would have the additional advantage of affording a healthy check upon the activities of directors.³⁶

CREDITOR'S LIABILITY FOR MISMANAGEMENT OF DEBTOR CORPORATION *

BANKER participation in the management of industrial and merchandising borrowers has become an established method of providing security for "slow" loans.¹ The desired control is almost always obtained either as a condition to the extension of additional credit or by a threat of suit on maturing obligations.² Often this control is merely negative in character;³ sometimes it is

31. S. D. COMPILED LAWS (1929) § 8789, removing the statute of limitations as a defense in suits against directors for the wrongful use of capital stock. For the various types of limitation statutes enacted to govern suits against directors, see 3 FLETCHER, CORPORATIONS (Perm. Ed. 1931) § 1304.

32. See Comment (1934) 34 COL. L. REV. 1308.

33. See (1934) 29 ILL. L. REV. 393.

34. See note 32, *supra*.

35. Whitten v. Dabney, 171 Cal. 621, 154 P. 312 (1916).

36. The derivative suit has, however, been criticized as an ineffective method of control over directors. Bulack, *Stockholders Suits—A Possible Substitute* (1937) 35 MICH. L. REV. 597.

* In the Matter of Prima Co., U. S. Dist. Ct. N. D. of Ill. E. D., No. 63,923, July 14, 1937, C. C. H. Bankr. Serv. ¶ 4705.

1. DEWING, FINANCIAL POLICY OF CORPORATIONS (2d ed. 1926) 1133 *et seq.*; Gleason, *When the Banker Needs Help* (1935) 131 BANKERS MAGAZINE 459; Rude, *Reorganization and Workout Problems* (1931) 12 BULL. CAL. BANKERS ASS'N 105.

2. STRONCK AND EIGELBERNER, BANK LOAN MANAGEMENT (1930) 189; Rude, *supra* note 1, at 124.

3. Undated resignations of the officers and directors are often handed over to be used at the bank's option [Martin v. Peyton, 246 N. Y. 213, 158 N. E. 77 (1927)], per-

advisory or supervisory.⁴ More frequently, however, the banks take over the entire management for the period of the "workout" of the loan. For this purpose some banks have maintained a "sick business" department; others keep a "business doctor" or hire some experienced individual for each particular job; and still others employ management firms.⁵ Finally, a type of control that accords more closely with recognized legal forms has also been secured by means of creditors' committees or voting trusts whose trustees are nominees of the creditor bank.⁶

In view of the variety of enterprises over which a bank may assume control, it is not surprising that mismanagement should sometimes occur. But attempts have rarely been made to place responsibility for such mismanagement upon the creditor bank,⁷ and a recent decision is almost unprecedented in finding such responsibility. A brewing company had borrowed heavily from the defendant bank, giving as security its notes endorsed with the personal guaranties of its officers. Although the company had incurred heavy losses, prospects of repayment were considered good. Nevertheless, the banks threatened to call the loans and sue on the notes and guaranties unless the management was turned over to X. The debtor's board, after voicing strenuous objections, finally hired X. By the terms of the contract, X was to have complete control of finances, production, sales, and personnel, subject only to the approval of the banks, and he was to be discharged only with their consent. Through a consistent course of gross mismanagement, this nominee rendered the debtor hopelessly insolvent. In reorganization proceedings under Section 77B, the trustee secured a judgment against the banks for all losses and diminution of assets caused by their nominee's mismanagement. Two theories of liability were advanced: (1) by the use of "undue influence" the banks obtained control of the debtor's business and hence were chargeable as trustees *de son tort*; (2) by assuming actual control of the debtor's assets the banks became parties to the management contract as if they had signed it, and were liable as principals for the losses caused by the mismanagement of their agent.⁸

sonal guaranties of the loans may be obtained from the officers [see Rude, *supra* note 1], or the company's stock may be pledged [Little & Ives Co. v. Acceptance Corp., 215 App. Div. 427, 213 N. Y. Supp. 606 (1st Dep't 1926)].

4. Efficiency experts may be hired to pass on routine matters [Stout, *A Business Specialist Advises Each Borrower* (1937) 54 RAND McNALLY BANKERS MONTHLY 524], an officer of the bank may be placed on the board of directors [1 MORAWETZ, CORPORATIONS (2d ed. 1886) 495], or a bank officer's signature may be required on the borrower's checks [EBERSOLE, BANK MANAGEMENT (1935) 487].

5. DEWING, *op. cit. supra* note 1, at 1146-1147; Gleason, *supra* note 1, at 460.

6. *E.g.*, Irving Bank-Columbia Trust Co. v. Stoddard, 292 Fed. 815 (C. C. A. 1st, 1923); Bullivant v. First Nat. Bank of Boston, 246 Mass. 324, 141 N. E. 41 (1923). See generally CUSHING, VOTING TRUSTS (1927) 33, 168; Dewing, *Creditor's Committee Receiverships* (1922) 1 HARV. BUS. REV. 31.

7. Explanation may perhaps be found in the facts that most of these suits arise only upon insolvency, and that the large creditor bank through its domination of bankruptcy and receivership proceedings is able to prevent such suits. See SECURITIES AND EXCHANGE COMMISSION, REPORT ON PROTECTIVE & REORGANIZATION COMMITTEES (1936-7) PART I, 157, 243-329.

8. In the Matter of Prima Co., U. S. Dist. Ct. N. D. of Ill. E. D., No. 63988, July 14, 1937, C. C. H. Bankr. Serv. ¶ 4705, (1937) 32 ILL. L. REV. 365, (1938) 51 HARV. L. REV. 551.

Aside from the difficulty of proving the minimum prerequisites of any theory of action—negligence,⁹ agency,¹⁰ and proximate cause¹¹—the trustee in bankruptcy who attempts to impose liability upon a bank for its agent's mismanagement will have trouble in formulating a theory of liability. By assuming control of a debtor corporation, a bank has occasionally rendered itself liable as partner or co-principal on the debtor's contracts with third parties.¹² In a suit for mismanagement, there is apparently no duty, contractual or fiduciary, owed directly to creditors or stockholders for whose breach they may sue; managers as fiduciaries are said to owe their duty only to the corporation.¹³ But both stockholders, through a derivative suit, and creditors upon insolvency, through a trustee in bankruptcy or a receiver, may sue for breach of this duty.¹⁴ Upon this theory the trustee might be allowed recovery against the managing agent. But since both debtor and bank are equally responsible for the agent's acts, in a suit against the bank the trustee will run afoul of the rule that co-principals are not liable to each other for the negligence of their common agent.¹⁵ Yet there is no need to extend to the creditor in a suit for mismanagement the defenses available to a co-owner, for he is being subjected to the duties of a manager rather than those of a "co-owner."¹⁶

9. Two factors make negligence difficult to prove: first, it consists of something more than mere mistakes in judgment, 3 FLETCHER, CORPORATIONS (1931) § 1039; secondly, impending insolvency may justify actions a reasonable man would not take under ordinary circumstances. But in the instant case there was ample evidence on which the court could base its finding of negligence.

10. Ordinarily the agent's contract relations are only with the debtor, and plaintiff must rely almost entirely on circumstantial evidence. See 1 MECHEM, AGENCY (2d ed. 1914) § 300. But where contractual relations exist between the banks and their nominee, as where the banks regularly employ a "business doctor" or keep a "sick business" department, agency could be easily established on the "lent servant" theory.

11. It may be difficult to show that losses were caused by the banks' negligence rather than by the general economic depression or the debtor's own mistakes before the banks assumed control. In the instant case this difficulty was avoided by a presumption that losses were due to the banks' negligence. But the federal rule is apparently directly *contra*. Warner v. Penoyer, 91 Fed. 587, (C. C. A. 2d, 1893); United States v. Stone Cliff Coal & Coke Co., 6 F. Supp. 1 (S. D. W. Va. 1934).

12. Otoe County Nat. Bank v. Delany, 88 F. (2d) 238 (C. C. A. 8th, 1937); Shawnee Nat. Bank v. Purcell Wholesale Grocery Co., 34 Okl. 34, 124 Pac. 603 (1912); Johnson Bros. v. Carter & Co., 120 Iowa 355, 94 N. W. 850 (1903).

13. Kelly v. Dolan, 233 Fed. 635 (C. C. A. 3d, 1916); Bailey v. Mosher, 63 Fed. 483 (C. C. A. 8th, 1894); BALLANTINE, CORPORATIONS (1930) § 185. But *cf.* Minnis v. Sharpe, 198 N. C. 364, 151 S. E. 735 (1930), (1930) 8 N. C. L. REV. 459. See Comment (1935) 2 U. OF CHI. L. REV. 317.

14. See Glenn, *The Stockholders Suit—Corporate and Individual Grievances* (1924) 33 YALE L. J. 580. Damages recoverable from officers for mismanagement are considered assets of the corporation collectible for the creditors by the trustee in bankruptcy. BALLANTINE, CORPORATIONS (1930) § 120.

15. Chapman Co. v. Dowling Hardware Co., 205 Ala. 586, 88 So. 748 (1921).

16. To hold the bank liable as co-owners, their participation must look like an act of entrepreneurship involving profit-sharing. See Douglas, *Pecarious Liability and the Administration of Risk* (1929) 38 YALE L. J. 721. But in mismanagement suits it is enough that the banks exercise control merely as a security device, so long as they can be identified as managers.

Consequently, it might well be said that the banks were the actual managers and could not escape liability by acting through an agent.

If legal doctrines must be stretched to allow a recovery upon this theory, the courts might still impose liability upon the banks as constructive trustees or trustees *de son tort*.¹⁷ Where it is obvious that no technical trust results, the courts have often employed trust doctrine as a remedial device to impose a duty upon one who takes possession and control of another's property.¹⁸ In fact, this doctrine was used to impose liability on the creditor in *Little & Ives Co. v. Acceptance Corporation*,¹⁹ the single action of this type which has heretofore been brought. But the case is not necessarily a guiding precedent. For in that case, besides securing the appointment of its nominee as treasurer, the creditor also obtained the registration in its own name of the debtor's common stock. The principal obstacle to recovery on this theory in the instant case is the fact that the debtor retained the power to restore its own management if the creditors' nominee proved unsatisfactory,²⁰ for a constructive trust is seldom raised in behalf of one who has consented to the wrong for which he is attempting to hold the trustee.²¹

This difficulty might, however, be avoided on several theories. In the first place, creditors might enforce liability through a trustee in bankruptcy, despite the debtor's consent to the nominee, although in very few situations have creditors or a representative of creditors been allowed a recovery which would be denied to the corporation.²² Secondly, if the banks' control was obtained by the exercise of undue influence or duress, it might be said that the debtor's consent was vitiated.²³ Yet despite the instant court's apparent reliance on this escape from the consent doctrine, it is quite generally conceded that the threat of enforcing a legal obligation is not taking such unfair advantage of the obligor as to amount to undue influence or duress.²⁴ Finally, the consent that would bar recovery is consent to the wrongful acts rather than consent to the taking of control. While it might be argued that acquiescence resulted from a failure to discharge the bank's nominee in the instant case, the bank's strongly entrenched position was such assurance of

17. A person who intermeddles with and assumes the management of property without authority becomes a trustee *de son tort*, liable for the damages occasioned by his intermeddling. 1 PERRY, TRUSTS AND TRUSTEES (7th ed., 1929) § 245.

18. *Morris v. Joseph*, 1 W. Va. 256 (1886); *Bailey v. Bailey*, 67 Vt. 494, 32 Atl. 470 (1895); see 1 BOGERT, TRUSTS AND TRUSTEES (1935) §§ 11-38.

19. 215 App. Div. 427, 213 N. Y. Supp. 606 (1st Dep't 1926).

20. Although the debtor might be liable in damages, it could have fired X, since equity will not grant specific performance of an employment contract unless it is coupled with an interest. *Lane Mortgage Co. v. Crenshaw*, 93 Cal. App. 411, 269 Pac. 672 (1928); Comment (1930) 39 YALE L. J. 110. In the instant case the employment could be coupled with an interest only if the banks were parties to the contract.

21. 4 BOGERT, TRUSTS AND TRUSTEES (1935) § 941; 2 POMEROY, EQUITY JURISPRUDENCE (4th ed. 1918) §§ 818-820.

22. (1937) 46 YALE L. J. 1229.

23. 2 POMEROY, *op. cit. supra* note 21, § 951.

24. *French v. Shoemaker*, 81 U. S. 314 (1871); *Atkinson v. Allen*, 71 Fed. 58 (C. C. A. 8th, 1895); *Connolly v. Bouck*, 174 Fed. 312 (C. C. A. 8th, 1909).

non-exercise of this power that no consent to the wrongful acts should be implied. Support for this theory may be found in the court's statement in the *Little & Ives Company* case, that a fiduciary duty arises whether the debtor gave the creditor control because of confidence in the proposed management or by reason of necessity and duress.²⁵ And liability under analogous legal relationships is imposed for mere control, even though yielded voluntarily. For instance, a pledgee or bailee owes a duty to be reasonably careful in his custody of the property;²⁶ and a mortgagee in possession is liable for waste of his debtor's property caused by mismanagement.²⁷ Moreover, there is a growing tendency for the courts to deal with the controllers of management as the management itself and subject them to the same fiduciary obligations. Although this development in the law of corporate responsibility has been applied principally to the "dominant stockholders,"²⁸ there seems to be no reason why the courts cannot reach the same result when the domination is by a creditor.²⁹

A further theory of liability is one founded upon the bank's participation in the breach of a trust³⁰ based upon the fiduciary relationship existing between directors and corporation at all times, and between directors and creditors when the corporation is insolvent.³¹ Under this view, any acquiescence of the directors that may be inferred from failure to use their power to discharge the incompetent manager would not be imputed to the corporation so as to bar a recovery by the corporate debtor.³² But there is the further difficulty of finding a breach of trust. If the banks were merely exercising their privilege of conditioning extension of their notes upon appointment of a certain manager, there might well be no such breach. On the other hand, if the threats of personal liability coerced the directors to act contrary to the

25. *Little & Ives Co. v. Acceptance Corporation*, 215 App. Div. 427, 428, 213 N. Y. Supp. 606, 607 (1st Dep't 1926).

26. JONES, *COLLATERAL SECURITIES AND PLEDGES* (3rd ed. 1912) § 410; *Cutler v. Fitch*, 231 App. Div. 8, 246 N. Y. Supp. 28 (4th Dep't 1930) (the creditor, who secured deposit of a majority of debtor's voting stock as condition of renewal of the loans, was held liable as a pledgee for all mismanagement losses).

27. See Comment (1935) 35 *COL. L. REV.* 1248. Western banks have frequently been held liable for failing to exercise proper care of cattle which the borrower was required to place in hands of the bank's agent until his notes were paid off. *Sutley v. Polk County Bank*, 162 Minn. 118, 202 N. W. 338 (1925); *National Cattle Loan Co. v. Ward*, 113 Tex. 312, 255 S. W. 160 (1923); *White City State Bank v. St. Joseph Stockyards Bank*, 90 Mo. App. 395 (1901).

28. *Wheeler v. Abilene Nat. Bank Bldg. Co.*, 159 Fed. 391 (C. C. A. 8th, 1908); *Hyams v. Calumet & Hecla Mining Co.*, 221 Fed. 529 (C. C. A. 6th, 1915); see Berle, *Non-Voting Stock & "Bankers' Control"* (1926) 39 *HARV. L. REV.* 673.

29. See *Southern Pacific v. Bogert*, 250 U. S. 483, 492 (1919); BERLE AND MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* (1932) 238-240; see S. E. C. *op. cit. supra* note 7, PART II, at 173-4.

30. See generally Scott, *Participation in a Breach of Trust* (1921) 34 *HARV. L. REV.* 454.

31. 3 FLETCHER, *CORPORATIONS* (2d ed. 1931) § 838; 15 *id.*, at § 7386. Since at the time of X's employment the debtor corporation was sufficiently insolvent to have availed itself of a 77B reorganization, such a relationship existed in the instant case.

32. 4 BOGERT, *TRUSTS AND TRUSTEES* (1935) § 913.

best interests of the company and solely to protect themselves,³³ or if the directors divested themselves of complete control so as to make their act *ultra vires*,³⁴ there would be little difficulty in finding a breach of trust in which the bank participated.

Upon broader grounds the decision in the instant case would seem desirable. Bankers should not necessarily incur any penalty for removing a management in order to protect their security. But when such action entails bank management of the debtor's entire business, it might well be accompanied by an equivalent responsibility; for in many cases the banks will not have a sufficient supply of experts capable of producing good management.³⁵ Furthermore, the bankers' self-interest is not necessarily an assurance that good management will result. The banker's opportunities for reorganization profiteering³⁶ may easily make him indifferent to his management responsibility and in some instances even desirous of driving the business into insolvency.³⁷ Although the imposition of liability may cause the banker to discontinue loan extensions and resort much sooner to bankruptcy and receivership proceedings³⁸—a result that may not be wholly undesirable,³⁹ it is likely to drive banks to the use of management corporations,⁴⁰ in the hope that these firms may be regarded as independent contractors and thus insulate the banks altogether from liability. Such a solution may be the best one possible, for it would assure the employment of competent as well as financially responsible personnel.⁴¹

33. *American Agricultural Chemical Co. v. Robertson*, 273 Mass. 66, 172 N. E. 871 (1930).

34. *Davis v. Flagstaff Silver Mining Co.*, 2 Utah 74 (1877); see BALLANTINE, CORPORATIONS (1930) § 101.

35. Dewing, *op. cit. supra* note 1, at 1147; Gleason, *supra* note 1, at 460.

36. These opportunities are by no means insignificant. Once control of the management has been obtained, the bank can ensure itself of domination over the reorganization and the new corporation, the advantages of which are notorious. See S. E. C. *op. cit. supra* note 7, PART II, at 11 *et seq.*

37. *E.g.*, *Willett v. Herrick*, 242 Mass. 471, 136 N. E. 366 (1922) (jury verdict of \$10,000,000 against creditors for conspiracy to dispossess debtor of his business); *Kono v. Roeth*, 237 App. Div. 252, 260 N. Y. Supp. 662 (1st Dep't 1932); *Farmers Loan & Trust Co. v. N. Y. & N. Ry.*, 150 N. Y. 410, 44 N. E. 1043 (1896). See generally Frankfurter and Landis, *Bankers and the Conspiracy Law* (1925) 41 NEW REPUBLIC 218.

38. DEWING, FINANCIAL POLICY OF CORPORATIONS (3rd ed. 1934) 1268-1270.

39. See Cover, *Business and Personal Failure and Readjustment in Chicago* (1933) 3 U. CHI. J. OF BUS. 106; Comment (1937) 46 YALE L. J. 1177, 1207.

40. See Gleason, *supra* note 1, at 461-2.

41. See Steffen, *Independent Contractor and the Good Life* (1935) 2 U. CHI. L. REV. 501.

CONSTRUCTION OF "GUARANTY OF PAYMENT" WHERE PROMISEE IS ITSELF A
GUARANTOR OF THE PRINCIPAL OBLIGATION *

MARKET-SEVENTEENTH Streets Corporation, a subsidiary of Fox Theatres Corporation, sought a loan of \$1,800,000 on its bond and mortgage, and on the lender's requirement, obtained a policy of guaranty of interest and principal from the Philadelphia Company for Guaranteeing Mortgages. The Philadelphia Company, however, unwilling to issue its guaranty without security, required a guaranty from Fox for payments of interest on the loan, taxes on the mortgaged property, and premiums on the policy of guaranty. All the agreements were executed on the same day, except Philadelphia's policy of guaranty, which was issued to the creditor three days later. Market subsequently defaulted upon all its obligations, the default on interest and tax payments amounting to \$371,436.90.¹ The mortgagee did not attempt, however, to foreclose or to hold the Philadelphia Company on its guaranty. The only loss sustained by the latter was \$30,134.06 which it had paid out on interest and taxes, and \$18,000 in defaults on premium payments. Both Fox and the Philadelphia Company had meanwhile become insolvent. Receivers for the Philadelphia Company filed a claim² in the Fox receivership for \$389,436.90—the total amount of defaulted interest, taxes, and premiums. The District Court allowed the claim for only \$48,134.06—the amount of premium defaults plus reimbursement for Philadelphia's payments on interest and taxes.³ On appeal to the Circuit Court of Appeals, the order was upset, and the full amount of the claim allowed.⁴

Although Fox's three "guaranties" of payment of premiums, taxes, and interest were combined in a single clause, the Circuit Court considered the legal effect of each separately, for no single theory could apply to all alike. Fox's guaranty of premiums fits readily into the category of an absolute guaranty of payment; on this obligation Philadelphia was the creditor of Market, the principal debtor, whose payment on the due date was guaranteed by Fox for the accommodation of the debtor. Under such a tripartite arrangement, Philadelphia could sue Fox when the premiums were due without first proceeding against the principal debtor.⁵ The court therefore found no difficulty

* *Chicago Title & Trust Co. v. Fox Theatres Corporation*, 91 F. (2d) 907 (C. C. A. 2d, 1937).

1. This is a net amount. The defaults on interest and taxes totalled \$445,962.71, but pursuant to agreement, \$74,525.81 collected in rents was deducted from this figure. See p. 4, Brief for Appellants, *Chicago Title & Trust Co. v. Fox Theatres Corporation*, 91 F. (2d) 907 (C. C. A. 2d, 1937).

2. The claim was originally filed by the Philadelphia Company before its receivership; thereafter the receivers filed an amended claim in which the operating trustee of the reorganized company joined as co-claimant.

3. *Chicago Title & Trust Co. v. Fox Theatres Corporation*, 15 F. Supp. 109 (S. D. N. Y. 1936).

4. *Chicago Title & Trust Co. v. Fox Theatres Corporation*, 91 F. (2d) 907 (C. C. A. 2d, 1937).

5. *Westchester Mortgage Co. v. Thomas B. McIntire*, 168 App. Div. 139, 153 N. Y. Supp. 437 (2d Dep't 1915); *Schlesinger v. Schroeder*, 210 Wis. 403, 245 N. W. 666 (1933); *ARNOLD, SURETYSHIP AND GUARANTY* (1927) § 23; *STEARNS, SURETYSHIP* (4th ed. 1934) § 61.

in sustaining this part of the claim.⁶ The tax guaranty was wholly different, because taxes were owed, not to the Philadelphia Company, but to the city. Philadelphia Company was interested in their prompt payment not only to avert an accelerated liability on its guaranty of principal⁷ but also to prevent impairment of the mortgage security, which furnished assurance of reimbursement for any payments pursuant to its guaranty of principal and interest. In allowing the total claim for taxes, the opinion contains no indication whether or not Philadelphia Company shall retain anything in excess of the amount necessary to reimburse itself for taxes paid; but there seems little doubt that this balance is to be held for the taxing authorities.⁸

Fox's guaranty of interest raises the most perplexing problem. Payment of this item was guaranteed by Philadelphia to the creditor, and by Fox to Philadelphia. The issue on this point as presented by the arguments of counsel was whether Fox's "guaranty" constituted an indemnity against loss, or an indemnity against liability.⁹ If an indemnity against loss, Philadelphia could recover only an amount sufficient to reimburse itself for sums previously paid out on interest.¹⁰ But if an indemnity against liability, Market's total defaults on interest could be recovered.¹¹ The court, in deciding upon the latter interpretation, was influenced by several factors: (1) the failure of the parties to differentiate between premiums and the other two guaranteed payments in the Fox contracts; (2) the confession of judgment clause in the contract; and (3) the stipulation in Philadelphia's guaranty policy that interest was to be payable within five days after default, whereas principal was not to be payable until eighteen months after maturity—viewed in conjunction with the fact that Fox "guaranteed" interest and not principal.¹²

6. *Chicago Title & Trust Co. v. Fox Theatres Corporation*, 91 F. (2d) 907, 909 (C. C. A. 2d, 1937).

7. Under the bond and mortgage a thirty day default on interest or taxes gave the mortgagee the option to declare the principal immediately due. Although Philadelphia was not liable for taxes under its guaranty, it had in fact paid out \$1,988 in taxes. See p. 4, Brief for Appellants, *Chicago Title & Trust Co. v. Fox Theatres Corporation*, 91 F. (2d) 907 (C. C. A. 2d, 1937).

8. The taxing authorities might assert that the receivers for Philadelphia were constructive trustees as to this portion of the recovery. *Cf. City of Norfolk v. Norfolk County*, 120 Va. 356, 91 S. E. 820 (1917).

9. Although the words "indemnity against loss" or "indemnity against liability" were not used in the contract, the terminology is by no means conclusive. The factual relationship of the parties, the objects sought to be attained, and the circumstances surrounding execution of this contract and the other contracts made at the same time, should be considered. Comment (1935) 44 YALE L. J. 1053.

10. *Moberly v. Leonard*, 339 Mo. 791, 99 S. W. (2d) 58 (1936); ARNOLD, *op. cit. supra* note 5, § 73; Comment (1935) 24 CALIF. L. REV. 193.

11. *McManus v. Tralles*, 253 S. W. 406 (Mo. App. 1923); *Churchill v. Hunt*, 3 Denio 321 (N. Y. 1846); *McGee v. Roen*, 4 Abb. Pr. 8 (N. Y. 1856); 24 CALIF. L. REV. 193, at 194; Comment (1936) 50 HARV. L. REV. 93, at 95.

12. The court also relies somewhat on an analogy to reinsurance cases, in which the relationship of reinsurer to reinsured has been construed generally as one of indemnification against liability. *Allemannia Ins. Co. v. Firemen's Ins. Co.*, 209 U. S. 326 (1908); Comment (1936) 50 HARV. L. REV. 93, at 95. But *cf. Fidelity & Deposit Co. of Md. v. Pink*, 58 Sup. Ct. 162 (1937). Though the relationship of the creditor, Philadel-

The first two considerations moved the court to decide that the parties intended interest as well as premiums to be payable to Philadelphia the moment any liability on its part should arise under its guaranty policy, with Fox confessing judgment for the entire amount of the liability. The third factor was relied upon as further assurance that the Philadelphia Company's apparent objective was to insure against the necessity of putting up its own money for Market's defaults; for although Philadelphia had sufficient time to discharge its liability for a default on principal, it needed assurance of funds to meet interest payments promptly.

While the contract therefore seems clearly one of indemnification against liability rather than against loss, there remains the important question of whether the recovery awarded to the receiver for Philadelphia Company is to be held for the benefit of its creditors or in trust for the mortgagee. By omitting any reference to this point, the opinion seems to contemplate a distribution of the recovery to the creditors of Philadelphia Company. In that event, the result is certain to be an inequitable one. If, on the one hand, the mortgagee fails to file a claim in the Philadelphia receivership before the bar date,¹³ the portion of the payment representing indemnification against liability rather than reimbursement will pass as a gratuity to the other creditors of Philadelphia.¹⁴ The possibility of this windfall at the expense of the creditors of Fox and, perhaps, at the ultimate expense of the mortgagor,¹⁵ might be avoided by a decree stipulating that in the event of the mortgagee's failure to file a claim before the bar date, Philadelphia's recovery of interest in excess of the amount necessary for its reimbursement be returned to the Fox receiver. If, on the other hand, the more likely situation is supposed, *i.e.*, that the mortgagee will present a claim against Philadelphia, an improper adjustment of the burden of loss will probably still result. Though it is possible that even after Philadelphia became insolvent the mortgagee might have obtained the full amount of Philadelphia's claim against Fox for defaulted interest by seeking equitable execution of that claim,¹⁶ this remedy would not

phia, and Fox is similar to that of the insured, reinsured, and reinsurer, there is a difference in the fact that the insured can usually be expected to attempt to collect from the reinsured, whereas in this case the creditor, with the mortgagor and the security of a mortgage to rely upon, may choose not to collect from the Philadelphia Company.

13. The creditor's failure to act is unexplained. Respondent's brief suggests that he may have been delaying foreclosure in expectation of a rise in market values. But it is difficult to understand why he has not proceeded against Philadelphia on its guaranty. A possible explanation is that the plan of reorganization for Philadelphia provided that creditors could prove claims only for the difference between the value of the mortgaged premises and the amount of the mortgage plus arrears in interest. See p. 5, Brief for Respondent, *Chicago Title & Trust Co. v. Fox Theatres Corporation*, 91 F. (2d) 907 (C. C. A. 2d, 1937). But since Philadelphia had made an absolute guaranty of the payment of interest and principal, it would seem that the creditor could claim for the full amount.

14. See GLENN, *LIQUIDATION* (1935) § 455.

15. See note 21, *infra*.

16. *Freedman's Savings & Trust Co. v. Earle*, 110 U. S. 710 (1884); *Travis Glass Co. v. Ibbetson*, 186 Cal. 724, 200 Pac. 595 (1921); *cf. McConnell v. Scott*, 15 Ohio 401 (1846); *Comment* (1933) 42 *YALE L. J.* 919; (1934) 34 *COL. L. REV.* 1140.

be available after the appointment of a receiver for either Fox¹⁷ or Philadelphia.¹⁸ The mortgagee must therefore file his claim in the Philadelphia receivership as a general creditor,¹⁹ and if the ratio of the amount recovered from Fox in excess of reimbursement to the amount of the mortgagee's claim against Philadelphia for interest exceeds the ratio of Philadelphia's other assets to its other liabilities, the creditors of Philadelphia other than the mortgagee receive a windfall²⁰ at the expense of the creditors of Fox or of the mortgagor.²¹ If the first ratio is less than the second, the other creditors of Philadelphia will suffer a deprivation.²²

These objectionable consequences could be avoided by an order that the recovery be held in trust for the mortgagee to the extent of full satisfaction of his claim for defaulted interest. Doctrinally, this solution is facilitated by viewing the arrangement effected by the series of related contracts as one of successive suretyship.²³ Although successive suretyship is usually associated

17. Assets in receivership are not subject to attachment or garnishment. See 1 CLARK, RECEIVERS (1929) § 571.

18. Though a separate suit against Philadelphia by the mortgagee would not be stayed, the judgment obtained would serve merely as an adjudication of the claim, and could not be collected by execution upon the assets or by assertion of a preference in the receivership. *Chicago Title & Trust Co. v. Fox Theatres Corporation, In re Fox*, 69 F. (2d) 60 (C. C. A. 2d, 1934); GLENN, *op. cit. supra* note 14, § 461.

19. Unless, of course, he could persuade the receivership court that this recovery should be impressed with a trust in his favor.

20. If Philadelphia's other assets were \$1,000,000 and its other liabilities \$2,500,000, and if the liability to the mortgagee had never been undertaken, the general creditors of Philadelphia would have received 40 cents on the dollar in payment of their claims. If the amount recovered from Fox in excess of reimbursement is \$200,000, while the mortgagee's claim for interest is \$300,000, the total assets will be increased to \$1,200,000, and the total liabilities to \$2,800,000, so that the general creditors will now get approximately 43 cents on the dollar. See Comment (1936) 50 HARV. L. REV. 93, at 97, n. 20, demonstrating how a similar windfall may occur in reinsurance cases.

21. This outcome depends on whether Fox has a right to reimbursement against Market for the total amount paid to Philadelphia, or only for the amount of the mortgagee's recovery in the Philadelphia receivership. That Fox is entitled to reimbursement for the latter amount at least seems clear. *Cf. Howell v. Commissioner of Internal Revenue*, 69 F. (2d) 447 (C. C. A. 8th, 1934). Allowing Fox to prove for only this amount would protect Market from claims for interest in excess of \$300,000 [the figure is based on the assumption made in note 20, *supra*]; but the creditors of Fox would thereby suffer a loss.

If it be assumed, however, that Fox would be permitted to sue for full reimbursement [see STEARNS, *op. cit. supra* note 5, § 283], the loss falls ultimately upon Market, because, due to the insolvency of Philadelphia, the mortgagee's collection of interest from Philadelphia will be less than Fox's payments to the Philadelphia receiver.

22. If the amount recovered from Fox was only \$100,000, the other amounts stated in note 20, *supra*, remaining the same, each creditor would then get only about 39 cents on the dollar. This deprivation would be merely temporary, however, until the Philadelphia receiver sued the mortgagor for reimbursement to the extent of the difference between Fox's payment and the amount paid by Philadelphia to the mortgagee.

23. See STEARNS, *op. cit. supra* note 5, § 264. This description of the arrangement is not inconsistent with the court's interpretation of the Fox contract as one to indemnify against liability, or to exonerate from liability [*Chicago Title & Trust Co. v. Fox Thea-*

with the signing of a note or a bond as indorser or guarantor,²⁴ there is no reason why such a relationship may not arise by virtue of a series of contractual documents as well as by indorsements upon a single piece of negotiable paper. Fox's agreement was not independent, but was related to the other contracts to which the mortgagee, Philadelphia Company and the mortgagor were parties,²⁵ for Philadelphia Company would not guarantee the interest and principal of Market's loan unless Fox would guarantee the interest.²⁶ Since Fox thus appears to have assumed ultimate liability as between itself and Philadelphia Company for the interest, the latter seems entitled to the remedies of a successive surety against a prior surety, not only for reimbursement,²⁷ but also for exoneration.²⁸ In view of the insolvency and receivership of Fox, the exoneration might be effected by the method provided for under the Bankruptcy Act, whereby a surety may file a claim in the creditor's name against a bankrupt principal when the creditor has failed to do so.²⁹ This result is possible on the theory that Fox, as prior surety, stands in the relation of principal to Philadelphia, as successive surety. The Philadelphia receiver's claim against Fox would be proved for one hundred per cent of Market's interest default, as in the instant case, but would be regarded as having been filed in the creditor's behalf.³⁰ The receiver would share in the amount realized only to the extent of any surplus remaining after full

tres Corporation, 91 F. (2d) 907, 910 (C. C. A. 2d, 1937)]; it merely emphasizes the interrelationship of all the parties, including the mortgagee and mortgagor as well as the two parties to the Fox contract.

24. *Noble v. Beeman-Spaulding-Woodward Co.*, 65 Ore. 93, 131 Pac. 1006 (1913); *Jaronko v. Czerwinski*, 117 Conn. 15, 166 Atl. 388 (1933); *Mann v. Bradshaw's Adm'r*, 136 Va. 351, 118 S. E. 326 (1923); see 1 BRANDT, SURETYSHIP AND GUARANTY (3d ed. 1905) § 286.

25. See Comment (1935) 44 YALE L. J. 1053.

26. *Cf. Noble v. Beeman-Spaulding-Woodward Co.*, 65 Ore. 93, 131 Pac. 1006 (1913) (plaintiff refused to guarantee corporation note unless individual members of the corporation would sign as makers).

27. *Ibid.*; *cf. Hartwell v. Smith*, 15 Ohio St. 200 (1864); ARANT, SURETYSHIP (1931) § 12. Arant uses the term "supplemental" to refer to the relationship herein discussed as successive suretyship.

28. See ARNOLD, *op. cit. supra* note 5, § 125. Since a surety prior in liability stands in the position of principal to the surety whose liability is successive, the suit by the latter before payment is analogous to a surety's suit for exoneration against the principal debtor. See ARANT, *op. cit. supra* note 27, § 72.

29. BANKRUPTCY ACT § 57 (i), 30 STAT. 544 (1898), 11 U. S. C. A. § 93 (i) (1927); see Comment (1931) 31 COL. L. REV. 1348, at 1351 *et seq.*

30. The surety is in no case entitled to any portion of the dividends paid on the creditor's claim against the bankrupt principal until the creditor has been made whole. *Westinghouse Elec. Mfg. Co. v. Fidelity & Deposit Co.*, 251 Mass. 418, 146 N. E. 711 (1925). And if the creditor does file a claim, the surety cannot claim against the bankrupt estate at all. *In re Hanson & Tyler Auto Co.*, 286 Fed. 161 (N. D. Iowa, 1922). This principle of allowing only the creditor's claim to be proved has been adopted in some cases where the principal is in receivership. See Comment (1928) 41 HARV. L. REV. 384, at 386, n. 14. *Cf. American Surety Co. of New York v. National Bank of Barnesville*, 17 F. (2d) 942 (S. D. Ohio 1927) (creditor claiming in competition with surety against the principal in receivership forced to reduce his claim by deducting the amount paid him by the surety); STEARNS, *op. cit. supra* note 5, § 252, n. 53.

satisfaction of the creditor's claim for defaulted interest.³¹ This seems the most reasonable procedure, regardless of the label employed to describe the relationship of the parties.

RECOGNITION OF FOREIGN BANKRUPTCY DISCHARGES *

THE federal bankruptcy courts are vested with power to discharge all provable debts, irrespective of the residence of the creditor, the place of contract, or the place of performance.¹ But foreign discharges will be accorded a more limited recognition. Under the rule attributed to the Supreme Court of the United States and to the New York courts,² a foreign discharge will be given effect only if the creditor was a resident in the bankruptcy jurisdiction, or a participant in the proceedings.³ Under the more generally prevailing rule recognition is also given⁴ to discharges issued by courts in the

31. See cases cited note 30, *supra*. The receiver for Philadelphia Company would have a right of reimbursement against Market for the deficiency remaining after the proceedings against Fox. ARANT, *op. cit. supra* note 27, § 73.

The suggested disposition of the Philadelphia receiver's recovery against Fox for interest favors the mortgagee over the receiver, whereas the proposed distribution of the tax recovery (see text p. 1016 *supra*) prefers the receiver over the tax authorities. Justification for the difference is to be found in the fact that the mortgagee was the party for whose benefit the series of contracts were drafted, but the tax authorities were not parties to any of the related contracts, and no benefit to them was intended.

* Johnstone v. Johnstone, N. Y. Sup. Ct., N. Y. L. J., Oct. 6, 1937, p. 1014, col. 7.

1. 30 STAT. 550 (1898), 11 U. S. C. § 35 (1934). This construction of the statute seems to be generally accepted. Morency v. Landry, 79 N. H. 305, 108 Atl. 855 (1919); 2 BEALE, CONFLICT OF LAWS (1935) § 375.1. See, in general, Comment (1930) 39 YALE L. J. 559.

2. In *Ogden v. Saunders*, 12 Wheat. 213 (U. S. 1827), it was held that a discharge pursuant to a state insolvency law could not bind out of state creditors. While this decision, like others involving state insolvency laws, turned on the constitutional restriction against impairment of the obligations of contracts, the court erroneously assumed [STORY, CONFLICT OF LAWS (8th ed. 1883) § 335] that its decision was consistent with the American doctrine of conflict of laws governing discharges in bankruptcy in a foreign country. The New York court in *Phelps v. Borland*, 103 N. Y. 406, 9 N. E. 307 (1886) felt obligated to follow this declaration by the Supreme Court, although no constitutional question was in issue, and although prior New York decisions had ruled otherwise [Olyphant & Sons v. Atwood, 4 Bos. 459 (N. Y. Super. Ct. 1859)]. But the rule in state insolvency proceedings that personal jurisdiction is not sufficient to validate a discharge when the contract has been made elsewhere [Lowenberg v. Levine, 93 Cal. 215, 28 Pac. 941 (1892)] has not been carried over to international conflicts situations. See, in general, DuBois, *The Significance in Conflict of Laws of the Distinctions Between Interstate and International Transactions* (1933) 17 MINN. L. REV. 361.

3. This rule has received only slight support in the treatises. It is adopted in 2 WHARTON, CONFLICT OF LAWS (3d ed. 1905) § 531. See, also, MINOR, CONFLICT OF LAWS (1901) § 191.

4. *A fortiori*, courts following this rule recognize a discharge when the bankruptcy court has had personal jurisdiction over the creditor. *Norris v. Breed*, 7 Cush. 44 (Mass. 1851), *Glass v. Keogh*, 4 Wyatt, W. & A'B 189 (Vict. 1867); *cf.* *Harris v. Mandeville*,

place of contract and of performance.⁵ Still undecided is the problem of whether courts that follow the majority rule will sanction a discharge rendered by a court in the place of contract or of performance alone,⁶ though in England a discharge in the place of performance alone would probably be recognized.⁷

There have been indications that the minority view is losing some of its support, for it has been undermined by the Supreme Court in cases where discharges were obtained in proceedings analogous to bankruptcy. Thus compliance with a statute of the place of contract and performance which allowed a debtor to obtain a discharge by depositing in court the amount he claimed to be due on a disputed claim has been held to bar a suit by a local creditor.⁸ And in a suit by an American resident on bonds payable in the United States, the court has given effect to a Canadian statute, passed in order to bind dissenters in a reorganization of the obligor, a Canadian corporation.⁹ To justify its decision the court said that a bondholder who contracted with a foreign corporation agreed to be bound by the law under which the corporation was chartered. This doctrine goes even farther than the majority rule, for at least in the case of corporations, it accords recognition to all discharges made by courts in the country of the debtor's residence.¹⁰

Ignoring these portents, a lower New York court has recently reaffirmed the minority rule.¹¹ A separation agreement executed in England between the plaintiff, a New York resident, and the defendant, an English resident, provided for monthly payments to the plaintiff in New York. After the plaintiff secured a final divorce decree without alimony in New York, the defendant obtained a discharge in bankruptcy in England. Although aware of these proceedings, the plaintiff did not participate; instead she brought an action in New York for accrued payments under the separation agreement. On a motion by the plaintiff for summary judgment, the court held that

2 Dall. 256 (Pa. 1796) (citizenship apparently held to confer jurisdiction). But *cf.* *Gibbs & Sons v. Société des Métaux*, 25 Q. B. D. 399 (1890) (filing of claim).

5. *Very v. McHenry*, 29 Me. 206 (1848); *May v. Breed*, 7 Cush. 15 (Mass. 1851); *Peck v. Hibbard*, 26 Vt. 698 (1854); *Bartley v. Hodges*, 1 B. & S. 375 (Q. B. 1861). A discharge of a tort claim in the jurisdiction where the liability arose is held valid. *Phillips v. Eyre*, 6 Q. B. D. 1 (1870).

6. In *Green v. Sarmento*, 10 Fed. Cas. No. 5,760 (C. C. D. Pa. 1810), the court charged the jury, ". . . that the law of the country where a contract is made, is the law of the contract, wherever performance is demanded; and the same law which creates the charge, will be regarded, if it operate a discharge of the contract."

7. *Beniam v. Debono* [P. C. 1924] A. C. 514; CHESHIRE, *PRIVATE INTERNATIONAL LAW* (1935) 192, 390. The "place of performance" may sometimes be split: the creditor may be required to complete shipment at one place, and the debtor to make payment at another.

8. *Zimmerman v. Sutherland, Alien Property Custodian*, 274 U. S. 253 (1927).

9. *Canada Southern Ry. Co. v. Gebhard*, 109 U. S. 527 (1883). The court seemed to regard the place of contract as unimportant.

10. The decision can be construed to apply to bankruptcy discharges, for the court termed the reorganization scheme a "species of bankruptcy."

11. *Johnstone v. Johnstone*, N. Y. Sup. Ct., N. Y. L. J., Oct. 6, 1937, p. 1014, col. 7, (1937) 51 HARV. L. REV. 736.

since the English court did not have personal jurisdiction over the plaintiff, the discharge would not be recognized.¹²

Even if the court had applied the majority rule, it might have reached the same result, for it would have been faced with the undetermined issue whether or not recognition will be accorded when the power of the discharging court is founded solely on the fact that the contract was made within its jurisdiction. And whatever rule was invoked, the court might have refused to acknowledge the discharge on the ground that it was contrary to the public policy of the forum, since claims of the type in issue are not dischargeable under the American bankruptcy act.¹³

Choice of the appropriate principle to govern recognition of foreign discharges should not be determined, however, by abstract legal theories, but rather by conscious efforts to effectuate the purposes of bankruptcy statutes, for refusals to sanction discharges not only thwart attempts to grant debtors complete releases from their debts, but also penalize subsequent creditors who have extended credit on the faith of a blanket discharge. It is clear that both the majority and minority rules operate in rather haphazard fashion to curtail recognition of discharges; yet neither rule is supported by persuasive countervailing considerations. The majority view has sometimes been said to carry out the intention of the parties.¹⁴ But this rationale is based on the assumptions that the parties to a contract contemplate bankruptcy proceedings by the debtor and that they deliberately arrange the geographical incidents of the contract to furnish the key to the proper law. The minority or personal jurisdiction rule perhaps rests on firmer ground, for it may represent a fumbling attempt to recognize discharges only when the creditor is likely to have received notice of the proceedings. But such solicitude would seem to be misplaced, for bankruptcy statutes generally provide that notice be sent to all creditors.¹⁵ And a firm that extends international credit will normally be apprised of any major changes in the financial position of its foreign debtors. It seems sound, therefore, to revise the personal jurisdiction rule to fit its basic content; recognition should at least be granted when the

12. The court relied on § 375 of the RESTATEMENT, CONFLICT OF LAWS (1934), which states, "A discharge in bankruptcy bars in accordance with the terms of the bankruptcy law all creditors who are subject to the jurisdiction of the bankruptcy court." While the rule fails to define jurisdiction, it is likely that personal jurisdiction over the creditor was intended. See RESTATEMENT, CONFLICT OF LAWS (Proposed final Draft, 1927) § 398 which included the word "personal" before "jurisdiction." The various state annotations interpret the rule to mean personal jurisdiction, but they rely on cases involving state insolvency laws as authority. See note 2, *supra*.

13. 32 STAT. 798 (1903), 11 U. S. C. § 35 (1934); *In re Ridder*, 79 F. (2d) 524 (C. C. A. 2d, 1935), *cert. denied*, 297 U. S. 721 (1936). But since in the instant case the divorce decree could have been reopened and an alimony award made [N. Y. C. P. A. § 1170], it might be argued that the discharge did not run counter to the public policy of New York. The defendant desired to have the divorce decree reopened. Communication to the YALE LAW JOURNAL from counsel for the defendant, Dec. 28, 1937.

14. *Blanchard v. Russell*, 13 Mass. 1 (1816); *Gibbs & Co. v. Société des Métaux*, 25 Q. B. D. 399 (1890).

15. 36 STAT. 841 (1910), 11 U. S. C. § 94 (1934); Bankruptcy Act, 1914, 4 & 5 Geo. 5, c. 59, § 13 (2) (Sched. I, 3).

creditors have actually been aware of the proceedings. Indeed, so long as the statutory requirements of notice are complied with, a foreign discharge might be held binding, even when a creditor has not actually received legal notice, or has not otherwise acquired knowledge of the proceedings.¹⁶ This rule is followed under the American Act¹⁷ and is in accord with accepted jurisdictional principles, for bankruptcy proceedings, like other in rem proceedings,¹⁸ may bind all the world.¹⁹ Operating to limit the effect of this rule would be the customary restrictions of conflict of laws doctrines. Thus discharges would not be recognized when they were entered in proceedings regarded as dissimilar in basic essentials from the bankruptcy law of the forum,²⁰ or when the discharge of the claim in issue ran strongly counter to the public policy of the forum.²¹ Even with these limitations, well-nigh universal recognition would be accorded foreign discharges; and adoption of this rule by American courts might serve to induce foreign courts, as a matter of comity, to grant wider recognition to American discharges.²²

16. Recognition of the power of foreign bankruptcy courts to discharge claims of local creditors would not operate to insulate the debtor's local assets. For while local creditors would no longer be able to attach local assets, the foreign trustee in bankruptcy would be able to collect such assets. Under the American rule his title is good except against claims of local creditors. *Disconto Gesellschaft v. Umbreit*, 203 U. S. 570 (1903). And all such claims would by hypothesis be discharged.

17. *Kreitlein v. Ferger*, 238 U. S. 21 (1915).

18. That bankruptcy proceedings are *in rem*, see *Hanover National Bank v. Moysen*, 186 U. S. 181 (1902).

19. Similarly, if the statutory requirements of notice have been complied with, an order to probate a will can not be vacated on the ground that an heir has not received actual notice or had any knowledge of the proceedings. *In re Sieker's Estate*, 89 Neb. 216, 131 N. W. 204 (1911).

20. In *Prentiss v. Savage*, 13 Mass. 20 (1816), the court held a discharge under a temporary insolvency law requiring creditors to file claims within thirty days to be inapplicable to local creditors, even though the contract was made and to be performed in the discharging country. But a mere dissimilarity between statutes should not elicit non-recognition. *Chubbuck v. Holloway*, 182 Minn. 225, 234 N. W. 314, 868 (1931).

In *Canada Southern Ry. Co. v. Gebhard*, 109 U. S. 527, 543 (1893) [see note 9, *supra*] the dissent urged that the discharge could not be upheld, since there was no provision in the statute requiring notice to be given to creditors.

21. In *Canada Southern Ry. Co. v. Gebhard*, 109 U. S. 529 (1883), the court recognized a discharge which concededly impaired the obligation of the creditor's contract. See, also, note 13 *supra*. For general discussions of the public policy concept in conflict of laws, see (1937) 47 *YALE L. J.* 292, at 295; Comment (1933) 33 *COL. L. REV.* 503.

22. Compare *Ritchie v. McMullen*, 159 U. S. 235 (1895) (applying the doctrine of reciprocity in giving a foreign judgment conclusive effect), with *Hilton v. Guyot*, 159 U. S. 113 (1895). See Lorenzen, *The Enforcement of American Judgments Abroad* (1919) 29 *YALE L. J.* 188.

POWER OF BROKER TO CLOSE OUT ADEQUATELY-MARGINED ACCOUNTS *

AS COLLATERAL for his margin loans, a stock broker customarily retains the securities he has purchased for his customer.¹ The powers of the broker, as creditor-pledgee,² are usually defined, though with varying degrees of precision, in a contract between the parties. The model agreement drawn up by the Association of Stock Exchange Firms states that the broker may sell without notice when in his opinion the margin becomes insufficient, and that the customer will, upon demand, pay his indebtedness to the broker and take his securities. It also provides that all transactions are subject to the rules, regulations, customs, and usages of the exchange on which they are executed.

While it is unusual for a broker to terminate his dealings with a customer for any reason other than a shortage of margin, in several situations he may feel constrained to close an adequately margined account. Thus the customer may have engaged in transactions which might involve the broker in litigation over the title to the securities. Or the broker would be guilty of violating the Stock Exchange Rules if he continued to carry the account of a customer who has accepted employment with a bank or an insurance company³ or has indulged in the practice of three day riding.⁴ In such circumstances the broker usually asks the customer to transfer his account, and the customer almost invariably complies with the request.

A recent case defines the rights of the parties when they can reach no agreement as to the disposition of the account.⁵ The plaintiff customer had adopted an antagonistic attitude toward the defendant broker, the Louisiana branch of a New York firm, and he was therefore asked to transfer his account. Shortly after receipt of this request, the plaintiff left on a business trip. He thus did not receive subsequent communications advising him that he would be sold out unless he paid his debit balance or gave orders for the delivery of his account. Although aware that the plaintiff had not received this ultimatum, the defendant sold the pledged securities. Upon his return to the city, the plaintiff repurchased the securities and brought suit to recover the loss occasioned him by a rise in the market, on the ground that the contract only made provision for closing the account in the event of lack of margin. A judgment in his favor was affirmed by the Court of Appeal⁶ and the Supreme Court of Louisiana.⁷ While the court apparently conceded that

* *Rembert v. Fenner & Beane*, 177 So. 247 (Sup. Ct. of La. 1937).

1. Frequently the customer will pledge other securities as well.

2. This analysis of the broker-client relationship is adhered to everywhere but in Massachusetts. *Richardson v. Shaw*, 209 U. S. 365 (1907); *Markham v. Jaudon*, 41 N. M. 235 (1869); MEYER, STOCKBROKERS AND STOCK EXCHANGES (1931) §§ 39, 41; RESTATEMENT, SECURITY (Tent. Draft No. 1, 1937) § 12.

3. Without the consent of the employer, no firm may carry such an account. Rules, New York Stock Exchange, c. 12, § 7.

4. Rules, New York Stock Exchange, c. 15, § 8 (b) (adopted Feb. 16, 1937); Board of Governors of the Federal Reserve System, Regulation T, § 3 (e) (effective Jan. 1, 1938).

5. There is no question, of course, that the broker can refuse to conduct any new transactions.

6. *Rembert v. Fenner & Beane*, 173 So. 551 (La. Ct. of Appeal, 1937).

7. *Rembert v. Fenner & Beane*, 177 So. 247 (Sup. Ct. of La., 1937).

the defendant had a right to sell the pledged securities, it ruled that he had not complied with the Louisiana Civil Code, which requires a judgment against the pledgor before a pledge can be liquidated.⁸

Pledges that secure demand loans may be liquidated when the pledgor defaults by refusing to pay the loan on request.⁹ Since the maturity of margin loans is rarely indicated in the contract, they have customarily been characterized as demand transactions.¹⁰ But it could perhaps be argued that a margin loan is extended for a period terminable only when the customer fails to deposit the requisite margin. This construction is especially plausible in the instant case, for the contract only gave the broker power to close the customer's account when it was insufficiently margined; it did not contain the provision of the Association agreement that the customer will pay his indebtedness to the broker upon demand. Although this argument gains support from the suggestion that customer's agreements, like insurance policies, should be construed strictly against the party who draws them,¹¹ it is hardly likely to be accepted in the courts. For while there have been no direct holdings, the courts have repeatedly said that a broker is not obligated to carry an account any longer than he desires, and that the customer is bound to take up his shares whenever his broker requires.¹² And in the case of short sales, courts have held that the broker may close an account when he wishes.¹³ This view is in accord with sound practical policy, for a customer

8. LA. CIV. CODE ANN. (Dart. 1932) art. 3165. See DENIS, LAW OF PLEDGE (1893) § 306.

9. JONES, COLLATERAL SECURITIES AND PLEDGES (3d ed. 1912) §§ 589, 607, 603.

10. See cases cited note 12, *infra*.

11. See Comment (1936) 46 YALE L. J. 97, at 99.

12. See Richardson v. Shaw, 209 U. S. 365, 374 (1907); Skiff v. Stoddard, 63 Conn. 193, 220, 26 Atl. 874, 881 (1893); Markham v. Jaudon, 41 N. Y. 235 (1869); Stenton v. Jerome, 54 N. Y. 480, 483 (1873); Drake v. Hodgson, 192 App. Div. 676, 678, 183 N. Y. Supp. 486, 488 (1st Dep't, 1920); *cf.* Hughes v. Barrell, 167 Ill. App. 100, 120 (1912). Writers on the subject treat these dicta as establishing a rule of law. CAMPBELL, STOCKBROKERS (3d ed. 1927) 50; 1 DOS PASSOS, STOCKBROKERS AND STOCK EXCHANGES (2d ed. 1905) 385, 386; GILMAN, STOCK EXCHANGE LAW (1923) 169; MEYER, *op. cit. supra* note 2, 79; MOSES, STOCKBROKERAGE LAW FOR STOCKBROKERS AND THEIR EMPLOYEES (1937) 74.

13. White v. Smith, 54 N. Y. 522 (1874); Barber v. Ellingwood (no. 1), 144 App. Div. 512, 129 N. Y. Supp. 414 (1st Dep't, 1911); MEYER, *op. cit. supra* note 2, at 361; *cf.* Sterling and Bunting v. James, 48 Barb. 459 (N. Y. 1867); Hess v. Rau, 95 N. Y. 359 (1884); dissenting opinion, Matter of Mills, 139 App. Div. 54, 62, 123 N. Y. Supp. 671, 677 (1st Dep't, 1910).

In the case of a short sale, there is no pledge relation unless the customer deposits other securities. But the existence or non-existence of a pledge is only of importance in determining the procedure for liquidating; problems of construing the broker-customer agreement are common to both long and short accounts.

Some of the cases involving short accounts concede that the broker has the right to close the account, but say that the customer must be given a reasonable opportunity to make his expected profit before he can be forced to cover. But it is actually no more difficult to transfer a short account than it is to transfer a long one, except perhaps when a stock is very inactive, and it is difficult to borrow the securities. If the distinction is thought to have any substance, it would be better expressed by imposing a longer notice requirement than is imposed in the case of long sales. See note 16, *infra*.

will normally be able to transfer his account to another brokerage firm without undue difficulty. Indeed, adoption of a contrary rule might make it inconvenient for a firm to wind up its affairs, or to carry through a merger.¹⁴

While the court in the instant case conceded that the broker could close the account, it held that he had not followed the statutory procedure for liquidating a defaulted pledge. Though the Louisiana requirement of a judgment is unique, provisions in other state statutes for liquidating pledges may sometimes be almost equally cumbersome. Typically, they require notice for a specified period of the time and place of sale.¹⁵ These statutes are of course superseded by specific contractual provision when an account is inadequately margined. And while there is no need for immediate liquidation when a broker seeks to close a fully-margined account, statutes such as that in the instant case—and others somewhat less stringent—perhaps impose too onerous a burden on brokers. It could conceivably be argued that these statutes were not designed to govern stock trading, and that the common law of reasonable notice¹⁶ should be applied. Or it could perhaps be maintained that the provision subjecting the transactions to the customs of the exchange was sufficient to vest the broker with a special contractual power to liquidate on short notice. Even if the statute were held inapplicable, the court could still have reached the same result in the principal case by finding the notice insufficient. But speculation as to the devices open to courts who wish to circumvent the statutory requirements is probably academic, for the instant decision will in all likelihood lead to the insertion in customer's agreements of clauses empowering brokers to close accounts at will, if a specified short notice is given.¹⁷

GORDON H. SMITH †

USE OF CORPORATE DEVICE TO EFFECT ACCUMULATION OF ESTATE INCOME *

SUBSTANTIAL portions of the decedents' estates in two recent cases consisted of the entire stock issues of corporations which owed the estates unsecured debts. Through control as shareholders, the testamentary trustees were able to force the application of corporate income to the reduction of these indebtednesses. The life tenants brought suit to recover income withheld by the

14. While there would normally be no difficulty in obtaining customer consent, in some cases it might be impossible to reach certain customers.

15. See, e.g., GA. CODE (1933) c. 12, § 609 (30 days); ME. REV. STAT. (1930) c. 105, §§ 80, 81 (60 days); MASS. ANN. LAWS (Lawyer's Co-op, 1935) (60 days); N. Y. LIEN LAW §§ 201, 202 (10 days).

16. Jones, *op. cit. supra* note 9, § 610. For a discussion of the notice problem, see Comment (1930) 43 HARV. L. REV. 628.

17. A provision that no notice need be given might be held against public policy; for, unlike the case of an inadequately margined account, there is no pressing need for speedy liquidation when an account is adequately margined.

† Member of the second-year class, Yale School of Law.

* *In re Adler's Estate*, 299 N. Y. Supp. 542 (Surr. Ct. 1937); *In re McLaughlin's Estate*, 299 N. Y. Supp. 559 (Surr. Ct. 1937).

trustees and, further, to reach corporate earnings applied to reserves for depreciation and improvements. In each case the Surrogate's Court held that these applications of corporate income were not binding in a contest between life tenant and remainderman and ordered the amounts which had been withheld by both the trustees and the corporations distributed to the life tenants on the ground that they were invalid accumulations under the New York statute¹ and improper allocations under the ordinary rules of distribution between life tenants and remaindermen.²

At common law, a testator or settlor could direct the accumulation of income so long as the persons to take interests under the instrument were definitely ascertained within the period permissible under the Rule against Perpetuities.³ But since such dispositions of property tended to prevent the full present enjoyment of income from trust estates,⁴ the Thelluson Act,⁵ outlawing certain directions to accumulate, was enacted in England. This Act has served as a pattern for American statutes,⁶ which generally sanction directions to accumulate only during a minority and for the benefit of the particular minor involved.⁷ Under these acts, express directions to accumu-

1. N. Y. PERS. PROP. LAW § 16; N. Y. REAL PROP. LAW § 61.

2. *In re Adler's Estate*, 299 N. Y. Supp. 542 (Surr. Ct. 1937); *In re McLaughlin's Estate*, 299 N. Y. Supp. 559 (Surr. Ct. 1937); (1938) 51 HARV. L. REV. 937.

3. *Thelluson v. Woodford*, 11 Vesey, Jr. 112 (1805); *Clafin v. Clafin*, 149 Mass. 19, 20 N. E. 454 (1889); *First Camden Nat. Bank & Trust Co. v. Collins*, 114 N. J. Eq. 59, 168 Atl. 275 (1933). But, in England a beneficiary *sui generis* could defeat further accumulation by demanding the distribution of income prior to the time set therefor. *Saunders v. Vautier*, 4 Beav. 115 (1841). And some American courts have indicated that trusts to accumulate will be refused execution beyond the period provided by the Rule against Perpetuities, even though the beneficial interest is vested. See *Girard Trust Co. v. Russell*, 179 Fed. 446, 452 (C. C. A. 3d, 1910); *Colonial Trust Co. v. Waldron*, 112 Conn. 216, 222, 152 Atl. 69, 71 (1930); *Melvin v. Hoffman*, 290 Mo. 464, 493, 235 S. W. 107, 116 (1921).

4. The public policy against accumulations seems founded on the same grounds as that against undue suspension of the power of alienation but is thought even more objectionable since both income and principal are tied up. See *Goldtree v. Thompson*, 79 Cal. 613, 619, 22 Pac. 50, 52 (1889); *Carrier v. Carrier*, 226 N. Y. 114, 122, 123 N. E. 135, 137 (1919); 2 SIMES, *THE LAW OF FUTURE INTERESTS* (1936) § 589. But see *Congdon v. Congdon*, 160 Minn. 343, 364, 200 N. W. 76, 83 (1924).

5. 39 & 40 GEO. III, c. 98 (1800); Law of Property Act, §§ 164-166; Stat. 15, GEO. V, c. 20 (1925).

6. For a listing and discussion of these statutory provisions, see 2 SIMES, *op. cit. supra* note 4, § 590; Schnebly, *Some Problems Under the Illinois Statute Against Accumulations* (1932), 26 ILL. L. REV. 491, 492; Runk, *American Statutory Modifications of the Rule Against Perpetuities, of Trusts for Accumulation and of Spendthrift Trusts* (1932), 80 U. OF PA. L. REV. 397, 399-400. Of these statutes, those of Arizona, Michigan, Minnesota and Wisconsin apply only to accumulations of rents and profits from real property.

7. Both these conditions must exist concurrently to sustain an accumulation under this exception. *Pray v. Hegeman*, 92 N. Y. 508 (1833); *Washington's Estate*, 75 Pa. 102 (1874); *In re Lowe's Estate*, 326 Pa. 375, 192 Atl. 405 (1937). In addition to accumulations for minorities, three states relax the statutory prohibition where charities are concerned. N. Y. PERS. PROP. LAW § 16, N. Y. REAL PROP. LAW § 61; Pa. Stat. (Purdon, 1936), tit. 20, § 3251; WIS. STAT. (1937) § 230.37.

late income are invariably invalidated unless falling within some statutory exception.⁸ Likewise, provisions which are not express directions to accumulate but which result in accumulation have been construed as implied directions falling within the statutory ban.⁹ This invalidation may be by elision of the offending direction from the instrument where the claim of severability is recognized through statutory requirement¹⁰ or rule of law,¹¹ or the entire instrument may fall where the invalid provision is an integral part of a general scheme of disposition.¹²

But where accumulations result from either directions only incidently producing accumulation or from discretionary action of the trustees, doctrinal difficulties occur, for the typical statute outlaws only *express* directions. As a result, some jurisdictions refuse to hold such accumulations within the statutory ban.¹³ Others utilize the absence of a direction to accumulate to sustain only temporary accumulations such as those that occur when income is withheld to equalize periodical distributions to the life tenant¹⁴ or to protect a life tenant incompetent to be intrusted with the full income.¹⁵ But in each case the courts have been careful to state that the income so reserved

8. *Hawley v. James*, 16 Wend. 16 (N. Y. 1836); *Kilpatrick v. Johnson*, 15 N. Y. 322 (1857); *Pray v. Hegeman*, 92 N. Y. 508 (1883).

9. *Vail v. Vail*, 4 Paige Ch. 317 (N. Y. 1834) (direction for payment of trust income to beneficiary for support and maintenance only); *Thorn v. De Breteuil*, 179 N. Y. 64, 71 N. E. 470 (1904) (direction for reinvestment of trust income in subsisting business of decedent after payment of certain annuities); *Neel's Estate*, 252 Pa. 394, 97 Atl. 502 (1916) (direction for payment of trust income to beneficiary for support and maintenance only).

10. Mandatory provisions for invalidation of express or implied directions to accumulate only insofar as such accumulations exceed the permissible minority term are found in CAL. CIV. CODE (Deering, 1937) § 725, *Estate of Hinckley*, 138 Cal. 457 (1881); IND. ANN. STAT. (Burns, 1933) § 51-102; MINN. STAT. ANN. (Mason, 1927) § 8068; N. D. COMP. LAWS (1913) § 5293; PA. STAT. (Purdon, 1936) tit. 20, § 3251, *Brown v. Williamson's Exrs.*, 36 Pa. 338 (1860); and S. D. COMP. LAWS (1929) § 300.

11. *Williams v. Williams*, 8 N. Y. 525 (1853); *Kalish v. Kalish*, 166 N. Y. 368, 59 N. E. 917 (1901); *Bankers Trust Co. v. Moy*, 148 Misc. 38, 265 N. Y. Supp. 77 (Sup. Ct. 1933); see RESTATEMENT, TRUSTS (1935) § 65, comment *c*.

12. *Dresser v. Travis*, 39 Misc. 358, 79 N. Y. Supp. 924 (Sup. Ct. 1902), *aff'd*, 87 App. Div. 633, 84 N. Y. Supp. 1124 (1st Dep't 1903); *Herzig v. Herzig*, 140 App. Div. 514, 125 N. Y. Supp. 402 (1st Dep't 1910).

13. *Gerin v. McDonald*, 64 F. (2d) 394 (C. C. A. 8th, 1933) (construing the South Dakota statute); *Henderson v. Henderson*, 210 Ala. 73, 97 So. 353 (1923); see *Camp v. Presbyterian Soc. of Sacket's Harbor*, 105 Misc. 139, 153, 173 N. Y. Supp. 581, 589 (Sup. Ct. 1918).

14. *Curtis v. Curtis*, 184 App. Div. 274, 171 N. Y. Supp. 510 (1st Dep't 1918); *In re Sinnott's Estate*, 310 Pa. 463, 165 Atl. 244 (1933); *In re Mathers' Estate*, 322 Pa. 358, 185 Atl. 768 (1936). But see *In re Kilborne*, 232 App. Div. 580, 582, 251 N. Y. Supp. 113, 115 (1st Dep't 1931).

15. *Hendricks v. Hendricks*, 3 App. Div. 604, 38 N. Y. Supp. 402 (1st Dep't 1896); *In re Hoyt*, 116 App. Div. 217, 101 N. Y. Supp. 557 (1st Dep't 1906); *Neel's Estate*, 252 Pa. 394, 97 Atl. 502 (1916); see *Hair v. Farrell*, 103 S. W. (2d) 918, 924 (Tenn. 1936). *Contra*: *Craig v. Craig*, 3 Barb. Ch. 76 (N. Y. 1848); *Gasquet v. Pollock*, 1 App. Div. 512, 37 N. Y. Supp. 357 (1st Dep't 1896), *aff'd*, 158 N. Y. 134, 53 N. E. 1125 (1899); see *Antelo's Estate*, 24 Pa. Dist. 181, 183 (1915).

belongs ultimately to the life tenant or to his estate, and is not to be treated as principal. Generally, however, courts invalidate any accumulation not expressly or implicitly authorized by the dispositive instrument on the theory that any accumulation of income that results is impliedly directed.¹⁶ Where an accumulation has occurred as a result of the trustee's discretionary administration the court is unable to invalidate any provision of the instrument but must act directly upon the trustee¹⁷—action which is taken not only to prevent an accumulation but also to compel conformance to an intent imputed to the testator to avoid accumulations.¹⁸

The fact of accumulation is generally readily discoverable. But in difficult cases resort has often been had to the rules of apportionment between life tenant and remainderman to determine what amounts to an accumulation. Under these rules the use of trust income to reduce mortgage encumbrances on the trust estate is not permissible.¹⁹ Thus, while a few courts have said that an explicit direction to apply the income emanating from a particular parcel of land to the reduction of a mortgage is not an invalid accumulation,²⁰ the majority rule is that such provisions violate the statute.²¹ Where an unsecured indebtedness is the principal obligation, as in the instant cases, there is even less reason to sustain such an allocation of income.²² The fact of accumulation can hardly be denied since the estate held both the proceeds of debt and the corporate shares whose equity was increased by a removal of corporate indebtedness.

Under the rules of apportionment the burden of depreciation must, in the absence of directions to the contrary, likewise be borne by the remainder-

16. *Thorn v. De Breteuil*, 179 N. Y. 64, 71 N. E. 470 (1904); *St. John v. Andrews Institute*, 191 N. Y. 254, 83 N. Y. 981 (1908); *Billing's Estate*, 263 Pa. 67, 110 Atl. 768 (1920).

17. *State Bank & Trust Co. v. Foss*, 257 Ill. App. 435 (1930); *Watson v. Kennard*, 77 N. H. 23, 86 Atl. 257 (1913); *Matter of Jones*, 136 Misc. 122, 238 N. Y. Supp. 753 (Surr. Ct. 1930); see RESTATEMENT, TRUSTS (1935) §§ 182, 226.

18. *Belcher v. Phelps*, 109 Conn. 7, 144 Atl. 659 (1929); *Matter of Bird*, 241 N. Y. 184, 149 N. E. 827 (1925); *Matter of Rooker*, 248 N. Y. 361, 162 N. E. 283 (1928).

19. *Garrett v. Snowden*, 226 Ala. 30, 145 So. 493 (1933); *Heald v. Michigan Trust Co.*, 274 Mich. 225, 264 N. W. 351 (1936); *Faulkenberg v. Windorf*, 194 Minn. 154, 259 N. W. 802 (1935); *Hascall v. King*, 162 N. Y. 134, 56 N. E. 515 (1900). *Contra*: *Hutchins v. Security Trust & Savings Bank*, 208 Cal. 463, 281 Pac. 1026 (1928), *rev'd*, 270 Pac. 219 (Cal. App. 1928); see *Russell v. Russell*, 109 Conn. 187, 205, 145 Atl. 648, 655 (1929); 3 SIMES, THE LAW OF FUTURE INTERESTS (1936) § 634; (1930) 65 A. L. R. 1069.

20. *In re Dolan*, 79 Cal. 65, 21 Pac. 545 (1889); *Hutchins v. Security Trust & Savings Bank*, 208 Cal. 463, 281 Pac. 1026 (1929).

21. *Hawley v. James*, 16 Wend. 62 (N. Y. 1836); *Hascall v. King*, 162 N. Y. 134, 56 N. E. 515 (1900); *Walker's Estate*, 16 Berks 185 (Pa. 1924); see 3 SIMES, THE LAW OF FUTURE INTERESTS (1936) § 634; Note (1930) 65 A. L. R. 1069.

22. *Guaranty Trust Co. v. Halsted*, 245 N. Y. 447, 157 N. E. 739 (1927); *Hegner v. Hegner*, 9 Ohio App. 147 (1917); *Rhodes' Estate*, 147 Pa. 227, 23 Atl. 553 (1892). The Thelluson Act, however, expressly excepted provisions for payments of debts from income. But this exception is included in only one American statute. ILL. REV. STAT. (Smith-Hurd, 1937) c. 30, § 153.

man.²³ While the life tenant is apportioned responsibility for current expenses, ordinary repairs, taxes and insurance,²⁴ the trust income can not be charged for permanent improvements, special assessments, or rehabilitation,²⁵ even though the life tenant consents or will benefit through increased income.²⁶ Although variation of these rules of apportionment in favor of the life tenant by direction will be sustained, there is but little indication that a testator may direct the deduction of depreciation in computing income.²⁷ Any intimation²⁸ to this effect in these decisions might well be questioned; for under such a rule the propriety of a depreciation reserve would depend solely upon the testator's intent. It is true that the court stated that the cost of improvements which had already been made but for which no depreciation reserves could be properly set aside, might be amortized against income for the duration of the life estate.²⁹ But this result, which adopts one of two possible methods of placing the cost of improvements upon the life tenant,³⁰ would not sanction maintenance of a depreciation reserve for future replacements.

Even if both of these practices caused invalid accumulations, the intervention of a corporate entity creates difficulties in ordering the distribution of both funds to the life tenant. The income used to repay the debt, which was already in the hands of the trustee, could be given to the life tenant by direct order to the trustee without doing violence to established precedents, for courts have generally exhibited little reluctance to investigate the source

23. *In re Chapman*, 32 Misc. 187, 66 N. Y. Supp. 235 (Surr. Ct. 1900), *aff'd*, 59 App. Div. 624, 69 N. Y. Supp. 1131 (3d Dep't 1901), *aff'd*, 167 N. Y. 619, 60 N. E. 1108 (1901); *In re Edgar's Will*, 157 Misc. 10, 282 N. Y. Supp. 795 (Surr. Ct. 1935); see *In re Hilliard's Will*, 299 N. Y. Supp. 788, 805 (Surr. Ct. 1937); *In re Matthews' Estate*, 210 Wis. 109, 114, 245 N. W. 122, 124 (1932). *Contra: In re Housman*, 4 Denio 404 (N. Y. 1886). This rule is reflected in federal income taxation by refusal to allow life tenants to deduct for depreciation. *Freuler v. Helvering*, 291 U. S. 35 (1934). But *cf. Fidelity-Philadelphia Trust Co. v. Comm'r of Int. Rev.*, 47 F. (2d) 36 (C. C. A. 3d, 1931) (state accumulations statute preventing establishment of depreciation reserve held not to prevent deduction by federal government of depreciation in computing taxable profit from sale of trust property).

24. *In re Van Riper's Estate*, 90 N. J. Eq. 217, 107 Atl. 55 (1919); *Stevens v. Melcher*, 152 N. Y. 551, 46 N. E. 965 (1897); see 3 BOGERT, TRUSTS AND TRUSTEES (1935) § 600; STRACHAN, LAW OF TRUST ACCOUNTS (2d ed. 1937) 37-43; (1931) 71 A. L. R. 417.

25. *Rendahl v. Hall*, 160 Minn. 502, 200 N. W. 744 (1924); *Spooner v. Dunlap*, 87 N. H. 384, 180 Atl. 256 (1935); *Hudson County Nat. Bank v. Woodruff*, 122 N. J. Eq. 444, 194 Atl. 266 (1937); *Chamberlin v. Gleason*, 163 N. Y. 214, 57 N. E. 487 (1900); see RESTATEMENT, TRUSTS (1935) § 233; 3 SIMES, THE LAW OF FUTURE INTERESTS (1936) §§ 629, 635, 636.

26. *Matter of Schaefer*, 110 Misc. 628, 180 N. Y. Supp. 638 (Surr. Ct. 1920); *Bankers Trust Co. v. Moy*, 148 Misc. 38, 265 N. Y. Supp. 77 (Sup. Ct. 1933). But *cf. Croker v. Croker*, 117 Misc. 558, 192 N. Y. Supp. 666 (Sup. Ct. 1921).

27. See *In re Chapman*, 32 Misc. 187, 190, 66 N. Y. Supp. 235, 237 (Surr. Ct. 1900).

28. *In re Adler's Estate*, 299 N. Y. Supp. 542, 558 (Surr. Ct. 1937).

29. *Id.* at 558.

30. If the replacement is charged against the remainderman, he will have to finance it by a loan, and the life tenant will bear the cost by paying interest on the money borrowed.

of corporate distributions, especially when these are extraordinary.³¹ But since the depreciation reserves were retained by the corporation and would not constitute funds in the hands of the trustee until actually distributed,³² other solutions had to be found. In one of the instant cases a solution was reached by ordering the trustees as stockholders to distribute the reserves to the life tenant.³³ This action in effect amounted to a disregard of the corporate entity—a result which may perhaps be questioned on the doctrinal level. In the absence of fraud courts do not interfere in private litigation with discretionary withholdings of corporate income;³⁴ in fact, courts will enjoin the declaration of dividends whose payment will be prejudicial to creditors.³⁵ Moreover, an early decision had suggested by way of dictum, subsequently disapproved but never directly overruled, that the statutory ban against accumulations might be avoided by use of the corporate device.³⁶ And finally, a failure to maintain sufficient reserves violates fundamental principles of corporate accounting.³⁷ On the other hand, there should be no cavil over the decision on the policy level. A failure to disregard the corporate entities would tend to produce confusion in accounting since estate and corporate accounts are maintained on different bases. And, more important, where the corporate device has been used in an attempt to evade a statutory prohibition or an established expression of public policy, courts have been quite willing to disregard the corporate entity.³⁸ This tendency has been most pronounced in estate cases when remaindermen are trustees, as they were in the instant cases, or directors.³⁹

31. Cf. *In re Gartenlaub's Estate*, 185 Cal. 375, 197 Pac. 90 (1921); *Hagedorn v. Arens*, 106 N. J. Eq. 377, 150 Atl. 4 (1930); *In re Chauncey's Estate*, 303 Pa. 441, 154 Atl. 814 (1931); RESTATEMENT, TRUSTS (1935) § 236 (a); 3 SIMES, THE LAW OF FUTURE INTERESTS (1936) § 692.

32. *Managers Securities Co. v. Mallery*, 77 F. (2d) 186 (C. C. A. 3d, 1935); *Anderson v. Bean*, 272 Mass. 432, 172 N. E. 647 (1930); *Forest City Mfg. Co. v. Levy*, 33 S. W. (2d) 984 (Mo. App. 1931).

33. *In re Adler's Estate*, 299 N. Y. Supp. 542, 556 (Surr. Ct. 1937).

34. *Wabash Ry. v. Barclay*, 280 U. S. 197 (1930); *Schmitt v. Eagle Roller Mill Co.*, 199 Minn. 382, 272 N. W. 277 (1937); *City Bank Farmers' Trust Co. v. Hewitt Realty Co.*, 257 N. Y. 62, 177 N. E. 309 (1931); see FLETCHER, CORPORATIONS (perm. ed. 1931) §§ 5325, 5326; STEVENS, CORPORATIONS (1936) §§ 99, 101.

35. *Powers v. Heggie*, 268 Mass. 233, 167 N. E. 314 (1929); *Ulness v. Dunnell*, 61 N. D. 95, 237 N. W. 208 (1931); *Gaunce v. Schoder*, 145 Wash. 604, 261 Pac. 393 (1927).

36. *Matter of Rogers*, 22 App. Div. 428, 437, 48 N. Y. Supp. 175, 181 (2d Dep't 1897); cf. *Congdon v. Congdon*, 160 Minn. 343, 200 N. W. 76 (1924); *In re Stevens*, 46 Misc. 623, 95 N. Y. Supp. 297 (Surr. Ct. 1905).

37. 1 FINNEY, PRINCIPLES OF ACCOUNTING (1937) 379-394; KESTER, ADVANCED ACCOUNTING (3d Rev. ed. 1933) 571-578; MONTGOMERY, AUDITING—THEORY AND PRACTICE (5th ed. 1934) 534-570.

38. *Chicago, M. & St. P. Ry. v. Minneapolis Civic Ass'n*, 247 U. S. 490 (1918); *United States v. Milwaukee Refrig. Transit Co.*, 142 Fed. 247 (E. D. Wis. 1905); see LATTY, SUBSIDIARIES AND AFFILIATED CORPORATIONS (1936) 5-40; Wormser, *Piercing the Veil of Corporate Entity* (1912) 12 COL. L. REV. 496.

39. *Ochs v. Maydole Hammer Co.*, 138 Misc. 665, 246 N. Y. Supp. 539 (Sup. Ct. 1930); see *Matter of Gerbereaux*, 148 Misc. 461, 466, 266 N. Y. Supp. 134, 140 (Surr. Ct. 1933); *Matter of Steinberg*, 153 Misc. 339, 345, 274 N. Y. Supp. 914, 922 (Surr.

In the other of the instant cases, the screen to the accumulation established by the corporate entity was removed by the expedient of dissolving the corporation.⁴⁰ This seems to be an unnecessarily drastic solution since the funds were already in the hands of the trustee. Support may be found for this result in the fact that courts have often sanctioned a merger of corporate and estate accounts.⁴¹ Also, continuance of the testator's business by use of the corporate device runs counter to the established public policy in favor of speedy liquidation of decedents' estates.⁴² Further, a heavy burden would be placed upon the Surrogates' Courts if they were forced to reconcile corporate and estate accounts. But it is difficult to find authority for such action in the statute conferring jurisdiction on the Surrogate's Court.⁴³ And where the testator was not the sole owner of the corporate shares, it would seem wiser to leave these disputes to courts of general jurisdiction.⁴⁴

Ct. 1934); *Matter of Lesser*, 154 Misc. 364, 366, 277 N. Y. Supp. 123, 125 (Surr. Ct. 1935).

40. *In re McLaughlin's Estate*, 299 N. Y. Supp. 559 (Surr. Ct. 1937).

41. *Farmers' Loan & Trust Co. v. Pierson*, 130 Misc. 110, 222 N. Y. Supp. 532 (Surr. Ct. 1927); *In re Ebbett's Estate*, 149 Misc. 260, 267 N. Y. Supp. 268 (Surr. Ct. 1933); *Matter of Steinberg*, 153 Misc. 339, 274 N. Y. Supp. 914 (Surr. Ct. 1934); *Matter of Lesser*, 154 Misc. 364, 277 N. Y. Supp. 123 (Surr. Ct. 1935); *In re Densen's Estate*, 163 Misc. 232, 296 N. Y. Supp. 567 (Surr. Ct. 1937).

42. *Marshall Field & Co. v. Himmelstein*, 253 Mich. 355, 235 N. W. 181 (1931); *In re Kohler*, 231 N. Y. 353, 132 N. E. 114 (1921); *In re Nagle's Estate*, 305 Pa. 36, 156 Atl. 309 (1931); see 3 BOGERT, TRUSTS AND TRUSTEES (1935) §§ 571-574.

43. N. Y. SURROGATE'S COURT ACT § 40.

44. Pennsylvania applies this rule in all cases. *Goetz Estate*, 236 Pa. 630, 85 Atl. 65 (1912); *Brown v. Maxwell*, 288 Pa. 398, 136 Atl. 232 (1927); *Watson's Estate*, 314 Pa. 179, 170 Atl. 254 (1934).