NOTES

SELF-PROTECTION OF DESIGN CREATION IN
THE MILLINERY INDUSTRY*

The difficulty of adapting a loosely worded “rule of reason” derived from trade association activities of other industries to the specialized women's apparel business is illustrated by the recent struggle of the judiciary and the Federal Trade Commission with the caprices of ladies' hats. The tribunals' difficulty stemmed primarily from the knotty problem of analysis raised by the tripartite market in the ladies' retail hat industry. Components of this industry are the small original hat market, characterized by its patrons' zeal for exclusiveness and utter disregard of price; the somewhat larger, intermediate, high-grade copy market where price continually interplays with the desire for exclusiveness so that a sufficient price differential between an original and a well-fabricated copy will lead to the purchase of the copy; and the low-price copy market where 80% of the hats are sold, and where consumer emphasis is focused upon price and a desire to participate in, rather

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2. The total net wholesale sales of ladies' hats in 1938 were divided as follows: 18.0% were sold at $7.50 per dozen and below; 37.0% were sold at from $7.50 to $13.50 per dozen; 20.3% were sold at from $13.50 to $24.00 per dozen; 15.9% were sold at from $24.00 to $48.00 per dozen; 8.8% were sold at above $48.00 per dozen. See Nienburg, CONDITIONS IN THE MILLINERY INDUSTRY IN THE UNITED STATES (U. S. Dep't Labor 1939) 21. These figures do not include millinery production for self-use and the important custom millinery trade.
3. The exclusive hat market ranges from $48.00 per dozen up. However, since the Guild members' hats sold at not less than $8.00 per hat wholesale, the 8.8% figure for exclusive hats appears high. The hats in this group retail at $12.50 per hat and above, and it has been estimated that such sales constitute but 4% of the industry's total. $200,000,000 Worth of Hats, FORTUNE (Jan. 1935) 50, 53. The list of Guild members includes the names of virtually all the country's haute coutures, whose total trade has been estimated at but 1% of the industry's total. FORTUNE, supra at 54. However, this figure is too small for all sales directed at the exclusive hat market. On the other hand, Nienburg's 8.8% figure, supra note 2, probably includes some hats which fall into the high-grade copy field. A liberal estimate of the exclusive hat market's stake in the total retail market would be 6%.
4. The high-grade copy field, represented in note 2 supra, as 15.9%, appears slightly excessive. The lower price division of this group competes with the volume hat market and not with the exclusive, while some 3% of the hats listed as exclusives would fall into the high-grade copy group. Probably not more than 12% of the total hats sold are high-grade copies.
5. The 80% figure is a conservative estimate. The upper price limits of this volume market reach into the better department stores selling $4.95 and $5.95 hats.

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than pace, a style trend. Sharp inter-market competition exists between producers of low price copies and high grade copies, between producers of high-grade copies and exclusive originals, but not between producers of exclusive originals and low-price copies.

A significant factor in this competitive pattern is the costly ritual of style creation: the designer's expensive voyage of inspiration to Paris, culminating in the origination and manufacture of a series of designs, few of which ever catch the popular fancy. Astute manufacturers, perceiving the substantial saving to be realized by copying designs instead of originating them, early seized upon style piracy to achieve a competitive advantage. This style piracy, it has been claimed, is socially desirable; it feeds the latest fashions to style-hungry mass consumers. But the claimed social benefits do not extend to the high-grade copy field, where the function of plagiarism is not so much to make style available to the masses as it is to secure the competitive advantage.

6. The qualitative distinctions between the various markets seems to be the consensus opinions of manufacturers interviewed by the author and of commentators. See Johnson and Fitch, Design Piracy (Nat'l Recov. Admin. 1936) 197; Fortune, supra note 3, passim.

7. An exclusive hat, made to sell for not less than $12.50 retail, scarcely competes with hats selling around $1.95.


9. "A style is a characteristic or distinctive, artistic expression or presentation. . . . A fashion, on the other hand, is a style accepted and used by people. . . . A design is a particular or individual interpretation of a style. . . ." Nyström, Fashion Merchandising (1932) 33. The purposes of this Note do not require that these verbal distinctions be strictly heeded. However, it should be noted that the Guild members were attempting to protect their "designs" and not their "styles." To illustrate this distinction: "... to speak as a layman, if the bow is on the right side, if the designer revamps it and puts it underneath the hat, then it is an entirely different hat, and that is an original design." Millinery Creators' Guild v. Federal Trade Comm., 109 F. (2d) 175 (C. C. A. 2d, 1940), Record, f. 681.

10. The most cogent argument for the protection of style stems from the industrial demoralization and economic losses caused by style piracy. Copying sharply reduces the "style life" of an article, thereby resulting in rapid obsolescence of merchandise. By compelling retailers to make small initial purchases, this obsolescence renders production inefficient. Seasonal peaks, present in any ladies' apparel industry, are thus aggravated. The shock of rapid obsolescence is felt not only by the retailer but by the consumer who must necessarily pay for the waste inherent in such a competitive system. Worthy, The Millinery Industry (Nat'l Recov. Admin. 1936) 35.

11. Since the only positive factor favoring style piracy, apart from the self-interest of the copyists, is the availability of latest style to the lowest purchasing classes, consumer interest vanishes when we deal with the luxury products: the high-grade copy and exclusive hats.

12. Although competition theoretically weeds out the inefficient producer and results ultimately in better and more reasonably priced products, the millinery industry is an exception. The millinery manufacturer is sandwiched between a handful of well-established, soundly financed material supply houses and large, powerful retail syndicates. The manufacturer, falling between a seller's market for supply goods and a buyer's market for his finished product (Nienburg, op. cit. supra note 2, at 5), finds the cost of his product constant and the price for the finished article driven down. The result
In the absence of legislation, the courts have permitted appropriation of another's design so long as the copyist could not be accused of such unfair competition as fraud or deceitful "palming off" of goods as those of a competitor. Nor have the legislative monopolies of patent, design patent and copyright protected the style creator. Not only do most original styles fail to meet the patent law requisites of "invention" and "novelty," but the expense of patenting all designs, successful or otherwise, and the delay involved in making the necessary search, would render nugatory any such protection. Copyright, although not subject to the delay of search, has been an annual industrial mortality rate estimated in excess of 20%. Worthy, supra note 11, at 15. But the elimination of the inefficient producers has not led to efficiency since the gaps left by those who have failed have been rapidly filled by new firms, induced by the little capital and even less business acumen required for entry into hat manufacturing. Worthy, supra note 11, at 12.


14. To procure a judgment against copying in a suit for unfair competition, the injured party must prove that the appearance of his goods has become associated with its source in the minds of the purchasers ("secondary meaning") and that there has been a consequent "palming-off" of the defendant's goods as the plaintiff's because of customer confusion as to source. Upjohn Co. v. Merrell Chemical Co., 269 Fed. 209 (C. C. A. 6th, 1920), cert. denied, 257 U. S. 638 (1921); Enterprise Mfg. Co. v. Landers, Frary & Clark, 131 Fed. 240 (C. C. A. 2d, 1904); Restatement, Torts (1938) § 741. Since manufacturers rarely insert trade names in their hats, there is scant chance for their product to become known in the public mind and, therefore, no basis for a claim of "palming-off." It is difficult to imagine protection for the style creator from the law of unfair competition.


17. To be novel a design must possess an appearance which impresses the ordinary observer differently from any preceding published or patented design. Goudy v. Hansen, 247 Fed. 782 (C. C. A. 1st, 1917), cert. denied, 246 U. S. 667 (1918). The amount of novelty has been said to be immaterial. Redway v. Ohio Stove Co., 38 Fed. 582 (C. C. S. D. Ohio 1889). However, originality and novelty without invention are insufficient. Frankart, Inc. v. Apt Novelty Co., Inc., 57 F. (2d) 757 (S. D. N. Y. 1931); Showermaker, Patents for Designs (1929) 76.

18. The grant of legal protection to design is beset with practical difficulties. Not only are the most likely copyists hard to locate for purposes of suit, but more often than not, they are judgment proof. Even successful legal action is ineffectual, since the
held inapplicable to designs used in commercial and industrial production. This lack of adequate legal protection for the designer is not apt to be remedied by legislature or judiciary. Courts are presently wedded to a policy of cutting down exclusive rights, while remedial legislation would doubtless meet sharp opposition from powerful industrial and consumer groups and from a Congress already under pressure to relax the existing patent and copyright monopolies.

To cope with the competitive advantage of the copyists, ostensibly sanctioned by this failure of adequate legislative and judicial protection of style creation, a substantial majority of manufacturers of expensive and originally-styled ladies’ hats—who constitute but a small percentage of the total industry—combined to form the Millinery Creators’ Guild. In short order the Guild established a registration bureau; once a model was accepted by the bureau it was regarded as the original design of the registrant and any copy or imitation was to be treated as piratical. Registration, however, was not conclusive; originality was finally determined by a committee of one or more members, officers or employees of the Guild. Apparently, however, the concept of originality was narrow; a minor change could create an original design. The members agreed that they would neither copy the others’ styles nor sell to any retailer who had not pledged support to the Guild by signing a declaration of cooperation—a promise by the retailer to countenance no style piracy and “to recognize the Guild members’ property rights in original designs.” To effectuate this program, cooperating retailers agreed to insist that manufacturers warrant that their products were not copies of styles originated by Guild members, and that breach of warranty would remedies of damages and injunction are small solace to an industry dependent upon ephemeral styles.


20. Since 1914 some twenty-one bills on design protection have been introduced into Congress. Although some have had success in one branch of Congress, none has yet been enacted. See Comment (1931) 31 Col. L. Rev. 477 (discussing extensively the Vestal Design Copyright Bill). Most foreign countries have afforded legislative protection to commercial designs. Ladas, International Protection of Literary and Artistic Property (1938) 879-1119; Johnson & Fitch, op. cit. supra note 6, at 122-129.


22. In the hearings on the Vestal Design Copyright Bill before the Senate Committee on Patents a number of manufacturers strongly disapproved of the Bill, arguing that design copyright registration was unnecessary and fraught with dangers. Hearings Before Senate Committee on Patents on H. R. 11852, 71st Cong., 3d Sess., (1931) 117.

23. Of the 33 manufacturers catering to the exclusive hat market (Kienburg, op. cit. supra note 2 at 38), 26 are Guild members.

24. At the time of the Federal Trade Commission proceedings the Guild was entitled “Millinery Quality Guild.”

25. For a test of what constitutes originality, see excerpt from the Record, cited supra note 9.
justify a return of merchandise.\textsuperscript{26} Almost all the high-grade department and specialty stores in the country subscribed.\textsuperscript{27}

Upon investigation, the Federal Trade Commission found\textsuperscript{28} that the Guild's practices, "by limiting manufacturers of stylish hats for women as to the outlets of their products . . . by limiting retailers as to their source of supply, . . . and by depriving the public of the benefits of normal price competition . . ."\textsuperscript{29} constituted unfair competition under Section 5 of the Federal Trade Commission Act.\textsuperscript{30} Thereupon the Commission issued a sweeping cease and desist order which prohibited both the actual operation of the plan and any other similar combination or method of cooperation by Guild members to eliminate style piracy. In affirming the Commission's order, the Second Circuit Court said that the Guild's purpose was to establish a property right in their designs and thereby to protect their markets and price levels.\textsuperscript{31} The court held that it would not sanction the establishment of a monopoly in an unpatentable idea when the effect of such approval would be to eradicate style piracy, a socially desirable form of competition.

To be contrasted with the conclusion in the principal case is the contrary decision of the First Circuit Court in\textit{Filene v. Fashion Originators' Guild of America},\textsuperscript{32} the only other case deciding the same issues.\textsuperscript{33} There it was held, upon almost identical facts, that the restraint imposed by the Dress Guild (after which the Hat Guild was modeled) was reasonable. In the\textit{Filene} case, as in the principal case, the Guild members comprised a very small minority of the members of the industry, and accounted for but a small fraction (6%) of the industry's total production;\textsuperscript{34} nevertheless, they dominated the high-price dress market.\textsuperscript{35} The opinions in these two cases, defy-
reconciliation, evidence conflict between the two circuits both upon the social desirability of style piracy and upon the approach to a determination of the illegality of Guild restraints. The First Circuit Court regarded the style pirate as a pariah and turned the case on the extent of the restraint imposed by the Dress Guild upon the entire industry, concluding that a restraint imposed by a maximum of 6% of the industry's total production could not be unlawful. By contrast, the opinion of the Second Circuit Court emphasized the social desirability of style piracy, and for that reason struck down the Hat Guild as an attempt to restrict the distribution of style.

The conflict of opinion between the First and Second Circuit Courts concerning the social desirability of style piracy has but remote relevance to the problems involved in the Millinery Guild case. There is no indication that the attempt to eliminate style piracy made by the Guild members—producers only of expensive, original hats—was directed at producers and retailers of cheap hats. Certainly the members were not competitors of low-price producers. Nor is it probable that the high-grade retailers who signed the declaration of cooperation dealt extensively in the inexpensive product. Moreover, it is at least arguable that Guild members were benefited by the rapid turnover in style caused by intensive, large-scale copying. If, then, the activities of the low-price copyists—vendors to at least 80% of the market—were comparatively unaffected by the Guild's activities, there appears to be scant basis for the contention that the Guild's attempt to combat style piracy would deprive the mass consumer of cheap stylish hats.

On the other hand, the reasonableness of the Guild's restraint cannot be resolved by the simple "percentage of the total market" formula adopted by the First Circuit Court. It should rather be gauged by measuring the effect of the restraint upon each of the three markets in the millinery industry. Such an analysis indicates not only that the bulk low-price market is unaffected, but also that the Guild members, oligopolists by virtue of the elite's recurrent demand for exclusive hats, are scarcely concerned with restraints within their own domain. None of the members is a pirate, or threatened with loss of trade from his ultra-fashionable clientele. True, customer dissatisfaction,

36. A few days before the Filene case was decided, the F. T.C. promulgated the cease and desist order which gave rise to the principal case. As a result, the First Circuit Court felt compelled to mention the order, but distinguished the Millinery case on the grounds that the facts there found by the Commission differed from those found by the master in the Filene case. Filene v. Fashion Originators' Guild of America, Inc., 50 F. (2d) 556, 562 (C.C.A. 1st, 1937). In coming to a decision contrary to that in the Filene case, the Second Circuit Court noted the fact that in the Filene case the Dress Guild had "no controlling position in the industry for it contains only a limited number of manufacturers, producing less than 6% of the yearly output of ready-to-wear dresses," but did not feel it necessary expressly to distinguish it. Millinery Creators' Guild, Inc. v. Federal Trade Comm., 109 F. (2d) 175, 178 (C.C.A. 2d, 1940).
39. The argument of this Note may be weakened to the extent that cooperating retailers may carry low-priced copies; admittedly there is no available statistical evidence
resulting in loss of trade, may be registered when a hat sold as exclusive soon appears in a cheap copy. But because the haute couture’s customer is interested in originality and not in price, dissatisfied trade will be channeled to another unit in the exclusive hat field and will not be shifted to a competitive market. To search for an unlawful restraint in the exclusive hat field, then, seems futile; indeed, it might be maintained that restraints in this field should be considered beneficial to consumer, retailer and manufacturer, alike, all of whom would favor any means to enhance exclusiveness.

With the Guild members’ exclusive market assured to them and the low-price copy market of no competitive concern, any possible restraint of the Guild must have been focused upon the small segment of the market remaining — the intermediate, high-grade copy field. It is probable that the Guild, by its plan, sought to neutralize the high-grade copyists’ competitive advantage and thereby to extend the market for exclusive hats to those purchasers of high-grade copies who wavered between exclusiveness and price. The natural vehicle for this attempt was the high-grade retailer, who, compelled to carry exclusive hats, usually had to deal with a Guild member. The Guild’s threat to refuse to sell to those retailers if they persisted in selling copies had real force. By conditioning continued dealing in the monopolistic product (exclusive hats) upon the discontinuance of the non-monopolistic product (the high-grade copy), the plan resembled various types of “tying leases” and exclusive sale contracts which are illegal. Since the force of the Guild’s refusal to deal was derived not from an individual’s monopoly, but from that of a combination, the generally illicit group boycott cases also strike at the legality of the plan.

affirming or negating the contention that these retailers did not deal extensively in the cheap product. The Guild could meet this objection, however, by revamping the declaration of cooperation to prohibit retail purchases of copies selling in the high-grade copy price range but allow purchases of cheaper copies. Thus the “boycott” would be directed at the product, not the manufacturer, and a manufacturer might sell cheap copies, but not high-grade copies to a cooperating retailer. If the cleavage were made at a high enough price level, there could be no justifiable contention that the Guild’s plan deprived the mass consumer of stylish hats.

40. It should be noted that not only were the Guild’s membership and registration privileges open to all, but no attempt was made by the Guild either to control prices or to lessen competition between members.


45. Although the Supreme Court has consistently invalidated the few group boycott cases that have come before it [Eastern States Retail Lumber Dealers’ Ass’n v. United States, 234 U. S. 600 (1914); Paramount Famous Lasky Corp. v. United States, 282 U. S. 30 (1930); United States v. First Nat’l Pictures, Inc., 282 U. S. 44 (1930)], it does
Yet, although these analogous restraints have generally been stricken down, unique factors warn against hasty condemnation of the Guild's restraint. The women's apparel industries are distinctive for the irrational buying habits of their consumers. In the more prosaic pursuits, the consumer interest in lower costs and mass output may justify a tolerant judicial and legislative attitude towards unhampered copying of unpatentable ideas. That tolerance may likewise extend to producers for the mass consumer in the women's apparel market. The role of copying in the luxury brackets of the women's apparel industries, however, is circumscribed by an offsetting consumer interest in exclusiveness. The effects of the Hat Guild's plan must be analyzed with this anomaly in mind. It may be conceded that the plan acted as a substantial restraint upon the activities of the high-grade copyist. But it must be remembered that formulation of the plan was occasioned by the conduct of the high grade copyist whose buccaneering placed the originator at a direct competitive disadvantage and undermined his goodwill. The advantage secured by the copyist enabled him to lure consumers who otherwise might be disposed to purchase the exclusive product. The Guild's restraint may therefore be regarded as an attempt by the caterers to exclusiveness to recapture a strayed clientele. Policy considerations governing a decision as to the reasonableness of such a restraint are entirely different from those with which the Second Circuit Court felt itself confronted. Absent is the broad consideration of the social desirability of furnishing style to the masses. In its place is substituted the possibility that it might be desirable to accord limited protection to the exclusive design creator at the expense of a copyist whose objectives serve no broad social function but only his own pecuniary ends.

RECAPITALIZATION UNDER SECTION 11(e) OF THE PUBLIC UTILITY HOLDING COMPANY ACT*

Under the rule of Keller v. Wilson, corporations in many states find it difficult to amend their charters to provide for the elimination of accrued and unpaid dividends on cumulative preferred stock, even when such action is not follow that the Sherman Act bans all such boycotts. See United States v. American Livestock Commission Co., 279 U. S. 435, 438 (1929).

46. Consider, however, that much leeway remains to the high-grade copyist. There is no restriction upon sales of originals to cooperating retailers even though the manufacturer is a copyist. And the creation of originals is facilitated by the narrow definition of a new design. See note 9 supra.

47. The court might have discerned more readily the limited protection sought had the declaration of cooperation been framed to boycott only copied hats above a price high enough to exclude low-price copies. See note 39 supra.

appropriate or necessary for the financial rehabilitation of the corporation.2

A recent decision of the Securities and Exchange Commission, approving
a plan of recapitalization without reference to state court decisions, offers
a possible release from the rigid requirements generally imposed on such
plans by state courts.3 Whether the SEC was justified in its action requires
a determination of its statutory and constitutional power under Section 11(e)
of the Public Utility Holding Company Act of 1935.4

Possibly to escape the apparent restrictions of the Keller case upon cor-
porate amendments in Delaware, Community Power and Light Company
sought to effect a recapitalization under Section 11(e). This section allows
a registered holding company to submit a plan to the Commission for the
purpose of enabling it to comply with the provisions of 11(b) before the
Commission itself takes action under that subsection. By the terms of the

2. The opinion of the court in the Keller case proceeded on the theory that the
preferred stockholders’ claim for dividend arrearages was a “vested right,” having the
“nature and quality of a debt.” The court concluded that a statute was unconsti-
tutional if it allowed the destruction of this “vested” right upon the vote of specified
majorities of the stockholders against the protest of even a single dissenter. Although
the decision is not clear as to whether the court would countenance the cancellation of
accrued dividends if such action were necessary to meet corporate exigencies and if
corresponding sacrifices were made by the holders of common stock, many corporations
felt compelled to abandon plans of recapitalization after the Keller decision was announced.
SEC REPORT, Pt. VII (1938) 188, n. 138. Although usually stated as the prevailing
view, the constitutional doctrine of the Keller case has been severely criticized. See Notes
(1937) 4 U. OF CHI. L. REV. 645. Attempts have been made to circumvent the Keller
decision by the issuance of prior preferred stock, or by the device of merger or sale
of assets. See Yoakam v. Providence Biltmore Hotel Co., 34 F. (2d) 533 (D. R. I.
1929); Johnson v. Lamprecht, 133 Ohio St. 567, 15 N. E. (2d) 127 (1938); Federal
United Corp. v. Havender, 11 A. (2d) 331 (Del. Sup. Ct. 1940); Comment (1937)
46 YALE L. J. 985, 988; SEC REPORT, Pt. VII (1938) 112, n. 10, 122, 133, 496. On the
general power of corporations to change the rights of preferred stock by corporate
amendment, see SEC REPORT, Pt. VII (1938) 464–525; Dodd, Dissenting Shareholders

3. Community Power and Light Co., Holding Company Act Release Nos. 1803,
1804, Nov. 27, 1939.

4. “... Any registered holding company ... may ... submit a plan to the
Commission for the divestment of control, securities, or other assets, or for other action
by such company ... for the purpose of enabling such company ... to comply with
the provisions of subsection (b). If, after notice and opportunity for hearing, the
Commission shall find such plan ... necessary to effectuate the provisions of sub-
section (b) and fair and equitable to the persons affected by such plan, the Commission
shall make an order approving such plan; and the Commission, at the request of the
company, may apply to a court ... to enforce and carry out the terms and provisions
of such plan. If, upon any such application, the court, after notice and opportunity for
hearing, shall approve such plan as fair and equitable and as appropriate to effectuate
the provisions of section 11, the court as a court of equity may, to such extent as it deems
necessary for the purpose of carrying out the ... plan, take exclusive jurisdiction and
possession of the company or companies and the assets thereof, wherever located. ...”
statute, a plan to be approved under 11(e) must be "necessary to effectuate the provisions of subsection (b)." Whether or not the Commission has power to approve of a plan of recapitalization providing for the elimination of accrued dividends on preferred stock will depend, therefore, on the steps which the Commission must take under Section 11(b)(2) in the absence of voluntary action by the corporation under 11(e). Section 11(b)(2) makes it the Commission's duty:

"To require by order, after notice and opportunity for hearing, that each registered holding company, and each subsidiary company thereof, shall take such steps as the Commission shall find necessary to ensure that the corporate structure or continued existence of any company in the holding-company system does not unduly or unnecessarily complicate the structure, or unfairly or inequitably distribute voting power among security holders, of such holding-company system. . . ."

It is evident that a hopeless financial burden upon a holding company's structure, which is the direct cause of a bad financial condition of the system, "unduly complicates the structure" of its entire system. The Commission was apparently correct, then, in making the finding mandatory for its approval under 11(e) that the plan in the Community case was "necessary to effectuate the provisions of subsection (b)." If Community had not anticipated its action, the Commission would have been obligated under 11(b) to come forward with a plan for the elimination of the accrued preferred dividends. If a holding company's credit is bad and it cannot secure refinancing because of large arrearages, its capital structure "unduly complicates" the structure of its entire system, contrary to the standards of Section 11(b). The Commission's power to reorganize holding companies in the same difficulty as Community may also be predicated on the theory that their recapitalization is necessary to lay the groundwork for carrying forward the task of economic and geographical integration of holding company systems, as required by the "death sentence" provisions of Section 11.

5. Paragraph (1) of subsection (b) is the "death sentence" provision, making it the Commission's duty to confine the operations of holding companies to "integrated public-utility systems." Paragraph (2) requires the simplification of the corporate structure of registered holding companies and the equitable distribution of voting power among security holders.


7. The SEC has declared that one of the major financial problems confronting a large part of the utility industry arises from arrearages on outstanding issues of preferred stock. "There are at least 20 holding companies with consolidated assets aggregating about $6,500,000,000 which must be recapitalized." Holding Company Act Release No. 1798, Nov. 21, 1939, p. 1. If the SEC is able to effectuate recapitalizations eliminating these arrearages under the Public Utility Holding Company Act, many corporations will be in a better position to refinance and thus to avoid actual or threatened insolvency.

According to the requirement of Section 11(e), the Commission may give its approval only if it finds the submitted plan "fair and equitable to the persons affected by such plan." The vagueness of this provision may give rise to many questions of statutory and constitutional construction for court determination. The heart of the controversy is whether the Commission is bound to respect the letter of "vested" preferential rights, or whether it may find a plan to be "fair and equitable" which, although not in strict compliance with the preferred contract, seems to distribute the brunt of the loss fairly among the security holders.

In the instant case, the Commission indicated its answer by approving a plan that provided for conversion of the preferred stock into new common stock, cancellation of accrued dividends and distribution, in return for these concessions, of 95% of the new common stock (and consequently the voting control of the reorganized company) to the present holders of preferred as a class. In discussing the fairness of the plan as between the holders of preferred and the holders of the present common stock, the Commission admitted that there was no book value attributable to the common stock, since the company's net worth, after certain proposed revaluations, was less than the stated value of the preferred stock even without the accrued and unpaid dividends. The Commission, however, did not deem book values to be conclusive of the right of the common stock to participation in the reorganized company. It appeared at the time of the plan that the corporation's earnings exceeded the dividend requirements of the preferred stock, and the forecasts of future earnings pointed to a still further improvement. Although the common stock could not hope, in view of the crippling effect of the present capital structure, to receive dividends for many years, the Commission felt that there was "an eventual prospect which must be regarded as having a present value."

9. Since the SEC, at the request of Community, has filed an application in the United States District Court for the Southern District of New York, requesting the Court to enforce and carry out the Company's plan of corporate simplification, the Court must also find the plan to be "fair and equitable." See note 4 supra. The application to the Court, in behalf of Community, was the first application of its kind, under § 11(e). See Holding Company Act Release No. 1803, Nov. 27, 1939, p. 3.

10. By its terms, if the plan is approved by the Federal Court, it is to be consummated either (a) by amending the charter of the existing corporation, or (b) by organization of a new corporation which will take over all of the assets and assume the liabilities and obligations of the existing corporation. Holding Company Act Release No. 1803, Nov. 27, 1939, p. 6.

11. Holding Company Act Release No. 1803, Nov. 27, 1939, p. 6. Allowing for the proposed adjustments, the book equity available for the stockholders was $6,712,774, or $3,355,678 less than prior claims of the preferred stockholders.

12. Community's annual preferred dividend requirement is $413,772. In the years ending December, 1937, December, 1938, and June, 1939, the company's earnings, excluding one of its subsidiaries, exceeded this amount, thus leaving a balance available for common, of $207,523, $135,286, and $159,553. Holding Company Act Release No. 1803, Nov. 27, 1939, p. 7.

13. Holding Company Act Release No. 1803, Nov. 27, 1939, p. 10. The decision is especially important in that the same issue is likely to come before it for determination
The proposed allocation of securities in the principal case seems eminently reasonable and consistent with the preferred stockholders' equity in the company.\textsuperscript{14} It is to be regretted, however, that the Commission made no attempt in its decision to define carefully the requirement that every plan it approves be "fair and equitable" to those affected. In determining what standards to apply to Section 11(e), two possible analogies are the criterion of a "fair and equitable" plan of reorganization under the Bankruptcy Act\textsuperscript{15} and the standards of a court of equity in passing upon the fairness of a charter amendment under state corporation laws.\textsuperscript{10}

In the \textit{Los Angeles Lumber} case, the Supreme Court rejected the "composition theory" of reorganization proceedings and extended the "strict priority" rule of the \textit{Boyd} case to plans formulated under Section 77B of the Bankruptcy Act, and inferentially to Chapter X. The court decided that a dissenting creditor was not bound by a plan which allowed stockholder participation when creditors had not received priority to the extent of their

four times in the near future. Since the plans to be submitted to the Commission under § 11(e) will be formulated by management groups, which usually represent the interests of the common stockholders, it is unlikely that any plan presented will not include some participation for the common stock. However, the Commission can be expected to show proper solicitude for the rights of holders of cumulative preferred stock. See Comment (1939) \textit{52 Harv. L. Rev.} 1331.

14. Under the present corporate set-up, there was small possibility of eliminating the dividend arrears within ten years, and a thoroughgoing recapitalization was necessary to re-establish the corporation's credit. The preferred stockholders of Community will now have the voting control of the reorganized company and will be able to require the payment of dividends as the financial condition of the company permits. The common stockholders are benefited, in turn, by the early prospect of dividend payments. Any plan calling for a greater sacrifice on the part of the common stockholders would be unfair, in view of the fact that annual earnings have been exceeding the dividend requirements of the preferred stock. See note 12 \textit{supra}.

Under the Delaware Corporation Law, there is no right of appraisal to holders of securities affected by charter amendment, but it is at least doubtful that the present plan could not be enjoined by the holders of preferred stock. See note 2 \textit{supra}. Without reference to state law, however, the plan approved by the Commission cannot be called unfair simply because no provision is made for dissenters. The company's cash position and lack of credit would obviously have made a cash payment impracticable. In the company's present financial situation, the only possible alternative to the proposed plan of reorganization would be the creation of a new preferred stock, but such a proposal would not in this case have been financially sound. The existence of new preferred stock might well lead to further dividend arrears with a consequent necessity for subsequent recapitalization. See note 23 \textit{infra}.

15. For a discussion of the test of a "fair and equitable" plan of reorganization under the Bankruptcy Act, see citations in note 17 \textit{infra}.

16. See note 2 \textit{supra}.


debts, even though a great majority of each class of security holders had voted in its favor. It is not improbable that the court will decide in the future that preferred stockholders who have fixed rights on liquidation and claims for arrearages of dividends are entitled to the same precedence over common stockholders as creditors.19 Insistence, however, on an automatic application of the "strict priority" rule of the Los Angeles case to corporations availing themselves of the machinery of Section 11(e) must be unsatisfactory, since such corporations are usually not insolvent either in the equity or in the bankruptcy sense. The strategic position of the common stockholders of a solvent company cannot be ignored. The court in the Los Angeles case refused to recognize the "nuisance" value of the common stock as a basis for participation, although the company might have been able to defer foreclosure proceedings on its bonded indebtedness until several years after its petition under 77B. The court pointed out that the company could not withdraw from the jurisdiction of the court after submitting to it, and therefore had voluntarily surrendered its strategic position.20 The same is not true, however, of a proceeding under Section 11(e). The corporation cannot be forced to declare dividends, and an impasse might easily result to the detriment of both classes of securities if a recapitalization were not effected.

Even in reorganization proceedings under Chapter X, moreover, the plan must make some provision for the common stockholders if it appears that future earnings will be sufficient to permit their participation.21 It has frequently been recognized that, for reorganization purposes, capitalized earning power rather than book value of assets is the best test of value.22 The Community case is in accord with these decisions in taking into account the excess of earnings over current preferred dividend requirements which eventually would become available for the common stock. Nor can it be said that the Commission failed to meet the tests applied in Chapter X reorganizations by approving the distribution of one class of security in the reorganized company to both common and preferred stockholders, thus placing both classes on a parity for the future. The interest of the present common stockholders in the new securities is too small to merit the serious contention that the preferred stockholders should have received securities senior in rank to those issued to the holders of common stock.23 On no account, therefore, can the

19. Comment (1940) 34 Ill. L. Rev. 589, 590.
22. The SEC itself has always been of this opinion. Genesee Valley Gas Co., 3 S.E.C. 104 (1938); United Telephone & Electric Co., Holding Company Act Release No. 1187, Aug. 5, 1938; see discussion in Comment (1940) 34 Ill. L. Rev. 589, 592, 593; Note 49 Yale L. J. 1099, 1104, 1105.
23. See Kansas City Term. Ry. v. Central Union Trust Co., 271 U. S. 445 (1936). For a discussion of both the courts' and the SEC's views on this point, see Note (1940) 49 Yale L. J. 1099, 1103; Comment 34 Ill. L. Rev. 589, 595. It may often be detrimental to the new corporation to set up a complex capital structure in order to preserve creditor priority by "graded" securities. Moreover, under § 7(c) of the Public Utility
instant decision be condemned by reference to the standards of a "fair and equitable" plan under Section X of the Bankruptcy Act, although those standards are not necessarily determinative of the meaning of Section 11(e).

It is possible, however, that a state court would, at the instance of dissenters, enjoin a plan such as that proposed in the principal case. The rule generally stated is that all corporate amendments are subject to the equitable power of the court and may be enjoining if they appear unfair and unduly oppressive to a minority, or if they have not been adopted in good faith to meet the exigencies of the corporate enterprise. The plan proposed in the Community case seems to meet this test, as it distributes equitably the sacrifices required in the interest of the corporation. Despite the severe criticism levied at the Keller case, however, the decisions have made it clear that most state courts, even apart from constitutional considerations, would condemn an amendment to a certificate of incorporation which interfered with the "vested right" to accrued and unpaid dividends.

It may be argued, of course, that Section 11(e) cannot be construed to allow the Commission to approve a rearrangement of stockholders' rights that conflicts with the law of the state of incorporation. The Public Utility Holding Company Act, however, makes no reference to the standards set by state courts in requiring the simplification of corporate structures and allowing the Commission to approve plans for such simplification. A court would, of course, avoid interpreting the Act to mean that the Commission can approve as "fair and equitable" a plan which impairs what the state courts consider "vested rights," if it felt that such an interpretation would necessarily render the Act unconstitutional. But such a decision would only delay the determination of the constitutionality of the Act until a case arose in which the Commission itself had taken steps under Section 11(b)(2) to order the simplification of corporate structures. Just as serious a constitutional question would then be raised if the courts insisted that preferential rights could not be destroyed and thereby forced the Commission to achieve simplification by depriving the holders of common stock of their equity in a going concern. The courts have not yet passed upon the important question of the constitutionality of the Public Utility Holding Company Act as a whole, but if the other provisions of the Act are upheld, there is no reason

Holding Company Act, there is a "heavy presumption" against the issuance of preferred stock. See Note (1939) 87 U. of Pa. L. Rev. 744, n. 1.


25. See note 2 supra.

26. In situations where compliance with state law is deemed essential, the Act contains specific directions to that effect. For example, see § 7(g).

27. After a long delay, the SEC began to institute proceedings under this section on February 28, 1940. Holding Company Act Release No. 1943.

28. In Electric Bond & Share Co. v. SEC, 303 U. S. 419 (1938) the Supreme Court decided that § 5 of the Act requiring registration of public utility holding companies, as defined, was a valid, severable provision, but did not go into the question of the constitutionality of the Act as a whole. Congressional authority for setting up the drastic system of controls provided by the Act, must, of course, be postulated on the basis of
to decide that Section 11(e) is constitutional only if interpreted to mean that the Commission is bound to respect what the state courts consider “vested rights.” If Congress may, in the exercise of its interstate commerce power, impair the contract rights of stockholders, the “supremacy clause” of the Constitution makes it unnecessary to consider the protection which would have been given to these rights under state law.  

Every procedural safeguard was provided by the Commission in its approval of the plan. It would be to the disadvantage of all concerned if the courts required that, as a matter of statutory construction, a plan engineered under Section 11(e) must meet the requirements of state decisions as to “vested rights.” The Commission should not be restricted by the decisions of either the bankruptcy or state courts in determining what is fair and equitable. The SEC is competent to insist that the exchanges proposed by plans of recapitalization under 11(e) represent in a real sense the financial values of each class of security. The preferred and the common stockholders are aided equally by a plan such as that in the principal case. If a plan may be upset by a lone dissenter, as a charter amendment of this character might be in a state court, the financial rehabilitation of holding-company systems may be seriously impeded.


29. U. S. Const. Art. VI.

30. In some cases, however, the Supreme Court has tended to regard the “reserved powers” of the states under the tenth amendment as constituting an independent limitation on Congressional power. See Corwin, The Commerce Power versus States Rights (1936) c. V; Comment, “The Tenth Amendment as a Limitation on the Powers of Congress” (1939) 52 Harv. L. Rev. 1342.

31. By its terms the plan was not to become effective until it was ratified by holders of at least two-thirds in amount of the outstanding preferred stock, and a majority in amount of the outstanding common stock. Moreover, the plan is not to become operative until a court approves of it as “fair and equitable.”

32. Even the holders of preferred stock, whom the Keller case is designed to protect, will suffer less by yielding certain preferential rights than they will by an inevitable decline in the value of their holdings, if the corporation gets into financial difficulties through its inability to secure needed financing because of a complex capital structure. See note 14 supra.

33. See note 7 supra.
IRREVOCABLE TRUSTS AND THE FEDERAL INCOME TAX*

In their efforts to reduce income surtaxes, taxpayers have made effective use of the separate taxable entity of a short term trust. By expressly limiting the duration of the trust, the grantor not only secured the return of the property to himself, but also avoided tax liability because a reversion to the settlor was not within the legislative classification of a power to re vest. Furthermore, a temporary reallocation of income by a transfer in trust was not analogized to an assignment of future income (which is taxable to the assignor) because of the theory that title to the corpus from which the income was derived had passed to the trustee. But the price of utilizing the trust device for tax avoidance has been some loss of control over the corpus and its proceeds. If the taxpayer, unwilling to pay this price, retained substantial ownership of the trust, the income was taxable to him as grantor. A finding that no true trust existed was not necessary to establish the requirement of substantial ownership in these circumstances. If the substance of the transaction dictated that technical refinements of trust doctrine be disregarded for purposes of tax allocation, the requirement was satisfied.

This trend toward disregarding the formalities of trust theory for taxation purposes forecast the recent decision of Helvering v. Clifford, in which the Supreme Court sanctioned taxation to the grantor of the income of a five year trust. The taxpayer, in declaring himself trustee of securities, had

* Helvering v. Clifford, 60 Sup. Ct. 554 (U. S. 1940).
8. 60 Sup. Ct. 554 (U. S. 1940).
in no way restricted himself with respect to the sale, exchange, mortgage, pledge or loan of the trust corpus. He could exercise or appoint proxies to exercise all voting powers of the trust in the trust estate. As trustee, he retained broad powers to pay his wife only such part of the income as he in his absolute discretion might determine, with the sole restriction that on termination of the trust all accrued or undistributed income was to be treated as property of the wife. Neither the principal nor income was chargeable for the wife's debts, nor did she have power to sell, transfer, encumber or in any manner anticipate or dispose of any income from the trust property prior to its actual payment and delivery to her. The ruling of the Board of Tax Appeals that the grantor was taxable was reversed by the Eighth Circuit Court of Appeals. Certiorari was granted "because of the importance to the revenue of the use of such short term trusts in the reduction of surtaxes." In reversing the circuit court, the Court held that the income of the trust was properly chargeable to the taxpayer under Section 22(a) of the Revenue Act of 1934, which defines gross income. Emphasis was placed upon three factors: the short duration of the trust; the control reserved by the grantor which little altered his dominion over the property; and, through the intimate familial relationship, the substantial enjoyment of the property flowing indirectly to the grantor.

The decision made it clear that all short term trusts will not be taxable to the grantor if the elements of control and indirect benefits are lacking. But the Court left an opening for taxing the settlor under Section 22(a) when control and benefits are retained, even though there is no short term trust. The short term provision of the trust agreement was perhaps the most significant right reserved by the grantor in this case. But because the determination of whether the trust agreement comes within the broad definition of gross income in Section 22(a) is now left to the triers of the facts, it is impossible to ascertain what the duration of the trust must be in order to fall within the classification of a short term trust taxable to the grantor. Whether or

10. "'Gross income' includes gains, profits, and income derived from salaries, wages, or compensation for personal service, . . . of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. . . ." Inr. Rev. Code § 22(a) (1939).
11. If the trust term were extremely short, as for a year and a day, it is possible that this factor alone would be sufficient grounds for taxing the grantor. Although § 22(a) had been advanced previously by the Commissioner of Internal Revenue as ground for taxing the settlor who, through his control, retains the substantial ownership of an irrevocable trust [see, e.g., Ellsworth B. Buck, 41 B. T. A. No. 15 (Jan. 18, 1940)], the Clifford case is the first squarely to confirm the applicability of this section. Such confirmation, however, was forecast by Douglas v. Willcuts, 296 U. S. 1, 9, 10 (1935).
not the trust was created for purposes other than tax avoidance\textsuperscript{12} will probably be a relevant consideration. When the reversion to the grantor is not limited to a definite period but is conditional upon the happening of uncertain events, the approach of \textit{Helvering v. Clifford} indicates that the controlling factor will be the likelihood that the stated contingency may occur.\textsuperscript{14} If the probable duration of the contingency is equivalent to the period for a short term trust, the transaction is apparently within the scope of the opinion. In view of \textit{Helvering v. Hallock},\textsuperscript{35} which has eliminated technical differences between vested and contingent remainders in fee for purposes of estate taxation, no distinction between vested and contingent reversions is likely to be made.

The multiple varieties of control adopted to satisfy demands of particular situations likewise preclude prediction of the degree of control remaining in the grantor which will be fatal to the separate entity of a trust. It appears from the \textit{Clifford} case, however, that if the grantor may direct the disposition of the trust proceeds in a manner that "will not effect any substantial change in his economic position,"\textsuperscript{16} the trust income will be taxable to the grantor. The broad language of the opinion seems to overcome technical obstacles to holding that a trust of which the settlor remains the substantial owner is, in effect, an assignment of future income.\textsuperscript{17} Inasmuch as the control retained is the basis for taxability in both situations,\textsuperscript{18} this seems a desirable result.

\textbf{NOTES}


\textsuperscript{14} A similar problem arises under §§166 and 167(a)(1) providing that trust income is taxable to the grantor when he has power to vest the corpus or when the trust income is or may be held or accumulated for future distribution to the grantor. When the trust provides for a "mere possibility of reverter" to the grantor, however, it is not within these provisions of the statute. William E. Boeing, 37 B. T. A. 178 (1938), rev'd on other grounds, 106 F. (2d) 305 (C. C. A. 9th, 1939); cert. denied, 303 U. S. 619 (1939); Genevieve F. Moore, 39 B. T. A. 803 (1939); Paul W. Litchfield, 39 B. T. A. 1017 (1939). Reliance was placed on decisions in the estate tax field. Helvering v. St. Louis Union Trust Co., 296 U. S. 39 (1935); Becker v. St. Louis Union Trust Co., 296 U. S. 48 (1935). These decisions have been overruled by Helvering v. Hallock, 60 Sup. Ct. 444 (U. S. 1940) and the latter case has been applied to the situation of a "possibility of reverter" in the income tax field. First Nat. Bank of Chicago v. Comm'r, 4 Prentice-Hall 1940 Fed. Tax Serv. ¶62,305 (C. C. H. 7th, 1940) (alternative holding).

\textsuperscript{15} 60 Sup. Ct. 444 (1940), 49 YALE L. J. 1118; see note 14 supra.

\textsuperscript{16} Helvering v. Clifford, 60 Sup. Ct. 554, 557 (U. S. 1940).

\textsuperscript{17} In argument before the Supreme Court, the Commissioner of Internal Revenue stressed the similarity between the transaction in the \textit{Clifford} case and an assignment of future income. Brief for Petitioners, pp. 17-20. Once the assignment label is attached, the consequences attributable thereto can be carried over to the taxation of trusts. The Supreme Court has never squarely held that an assignment of income from property by means of the trust was ineffective to relieve the assignor of the tax burden. But the Court has held that an assignment of stock to a controlled corporation did not relieve the assignor from the capital gains tax. Griffiths v. Comm'r, 308 U. S. 355 (1939).

\textsuperscript{18} See Note (1935) 35 Col. L. Rev. 461.

\textsuperscript{19} As to the assignment of future income, see Lucas v. Earl, 281 U. S. 111 (1930); Burnet v. Leininger, 285 U. S. 136 (1932).
Whenever trust income was held taxable to the grantor prior to Helvering v. Clifford (except decisions under the specific sections providing therefor), the powers reserved by the grantor so strongly invaded the duties of the trustee that the relationship between grantor and trustee was practically that of principal and agent. But since these decisions were rendered without the aid of the broad provisions in Section 22(a), a showing of considerably less control in the grantor will probably satisfy the requirements set by the Clifford case.

Closely allied to the settlor’s control over corpus and income are the benefits derived from its exercise. The Supreme Court’s recognition of the family unit as a basis by which benefits to the grantor are measured foreshadows a broad extension of the present concept of taxable income. It is well-established that the settlor is taxable upon trust income that satisfies his legal obligations. The Supreme Court, in Burnet v. Wells, upheld the constitutionality of a tax on the grantor of an irrevocable trust, the income of which was to be used for payment of his insurance premiums, on the ground that such expenditures were considered by normal men a “pressing social duty.” Decision was expressly reserved in the Wells opinion on the question of whether Congress could likewise tax the grantor for income which “may be expended by the beneficiaries without restraint.” At present, even if the income from a trust is used for the education and support of the grantor’s minor children, he is not taxed so long as the terms of the trust do not require the income to be so expended. Likewise, if the settlor provides that the trust proceeds shall be used for the “welfare” or “use and benefit” of his dependents, he has successfully divided his income, for these terms are considered not to be confined to the discharge of legal duties. And when premiums for insurance on the life of the grantor are paid with the trust income by one who is a beneficiary of both trust and policy, such sums may not be included in the grantor’s income if the terms of the trust do not require any part of the income to be applied to policies owned by the beneficiary on the life of the settlor. The reasoning upon which these holdings are based is that since the income is the property of the beneficiary, voluntary expenditures are not within the statute.

Yet to require that, before the settlor is taxable, the terms of the trust state that income of the trust must be applied to strictly legal obligations of the settlor or to payment of premiums on insurance policies owned by the grantor

21. 289 U. S. 670 (1933); see 4 Paul and Mertens, op. cit. supra note 20, § 34.164.
is to ignore the probability of tax avoidance through "bed-chamber" agreements. The grantor in these cases receives identical benefits from the income used to discharge his obligations whether or not such application was required in the trust agreement; in the ordinary course of social conduct, such unrestricted expenditures by immediate members of a taxpayer's family provide him with no less a "flow of satisfaction" than that derived from disbursements which are legally or morally required. Nonetheless, these prior decisions appear to be accurate interpretations of the present Revenue Act. Consequently, notwithstanding the absence of restrictions—except for the immaterial spendthrift provisions—upon use of the trust income by the wife-beneficiary in Helvering v. Clifford, these cases may not be within the immediate holding of the Clifford decision. The broad language used in the opinion, however, may be a bid to Congress for direct legislative action.

An additional loophole in the Revenue Act which may be closed by the repercussions of Helvering v. Clifford is avoidance by the grantor of an irrevocable trust with power reserved to change beneficiaries of both income and gift taxes on distributions of income. In Rasquin v. Humphreys, the Supreme Court held that so long as this power was retained the gift of the corpus was incomplete; but it expressly reserved decision on whether the income from the trust was taxable to the grantor. By a strict interpretation of the statute, however, lower courts and the Board of Tax Appeals have held that such income was not taxable to the grantor because, by providing that he could not alter distribution of the income in favor of himself, he retained no power to revest the corpus. Yet a settlor who may change beneficiaries has an essential attribute of ownership: power to direct distribution of income to whomsoever he may select. Although the settlor may provide

26. See Helvering v. Fuller, 8 U.S. L. Week 673, 674 (U.S. 1940); 5 Paul and Mertens, op. cit. supra note 20, § 853.36.
27. For an opposing view see Altman, New Trends in Taxing Trust Benefits (1935) 14 Tax Mag. 199.
28. Serious constitutional questions are involved, of course, if the duty test is abandoned. These questions merge into the broader issue of whether the Supreme Court will now permit compulsory joint returns for husband and wife under a federal statute similar to the Wisconsin statute held unconstitutional in Hooper v. Tax Comm., 284 U.S. 205 (1931). Helvering v. Clifford points to a new view upon these questions. The Supreme Court has recently stated, citing the Clifford case, that although the settlor of an alimony trust may have no further legal obligation to support his divorced wife, the income from the trust may be taxable to the grantor if he retains substantial ownership thereof. See Helvering v. Fuller, 8 U.S. L. Week 673, 674 (U.S. 1940). For a discussion of these issues see Comment (1940) 49 Yale L. J. 1279.
31. Helvering v. Clifford, 60 Sup. Ct. 554, 557 (U.S. 1940). This power leaves the discretion of the grantor uncontrolled because beneficiaries who are subject to ouster at the caprice of the grantor will not resort to equity for protection against mismanagement. Rollins v. Helvering, 92 F. (2d) 390 (C. C. A. 8th, 1937), cert. denied, 302 U. S. 763 (1938). Grantors frequently remove equity's "jurisdiction" through exculpatory clauses in the terms of the trust. See, e.g., Commissioner v. Grosvenor, 85 F. (2d) 2 (C. C. A. 2d, 1936).
that the trust shall not be amended in a manner directly beneficial to himself, Helvering v. Clifford indicates that this consideration is not determinative, because power to allocate income within a family unit is considered a ground for taxing the grantor. If income from trusts of this character were held taxable to the grantor, the income would appear to be a gift to the beneficiaries.\textsuperscript{32} The income should be a taxable gift, however, even if it is not taxable income to the grantor. The beneficiaries have no greater right to receive the trust income than they have to retain the trust corpus.\textsuperscript{33} Since gift of the corpus is incomplete when power to amend still remains in the grantor, it would appear that the same principle should apply to income which is actually appropriated by the beneficiaries and thus placed beyond the amendatory powers of the grantor.

The application of Section 22(a) in Helvering v. Clifford indicates that the Supreme Court may require a complete factual analysis of the circumstances surrounding the creation of a trust which the grantor, in conjunction with an immediate member of his family, has power to revoke.\textsuperscript{34} At present, if the latter's interest in the proceeds of the trust is substantial, it is sufficiently adverse to prevent taxing the grantor on the income of the trust.\textsuperscript{35} Retention of the principle that members of a family unit have adverse interests appears inconsonant with language in the Clifford opinion, which emphasized the familial relationship in permitting taxation to the husband of the distributed income of the trust technically the property of the wife-beneficiary.\textsuperscript{36} A similar situation exists when members of a family create reciprocal trusts and make each trust revocable with the consent of the beneficiary.\textsuperscript{37} But since the Revenue Act specifically states that the grantor is not taxable on trust income when his powers can be exercised only in conjunction with substantial adverse interests,\textsuperscript{38} and since a substantial pecuniary interest in trust proceeds establishes technical adversity among relatives,\textsuperscript{39} it would be difficult to bring

\begin{itemize}
\item \textsuperscript{32} In the only decision holding that the income is not a gift to the beneficiaries, it was stressed that ownership of the income was in the beneficiaries and not the grantor. Estate of Giles W. Mead, 41 B. T. A. No. 63 (Feb. 20, 1940).
\item \textsuperscript{33} See Magill, Taxable Income (1936) 266.
\item \textsuperscript{34} But see Montgomery, Federal Taxes on Estates and Trusts (1938-39) 100.
\item \textsuperscript{35} The relationship between husband and wife was not considered, however, when the settlor had power to revoke with a spouse beneficiary. The test for adversity seems one solely of pecuniary interests. Margaret A. Holmes, 27 B. T. A. 660 (1933); accord, Savage v. Comm'r, 82 F. (2d) 92 (C. C. A. 3d, 1936); Paul W. Litchfield, 39 B. T. A. 1017 (1939); Jane B. Shiverick, 37 B. T. A. 454 (1938); W. L. Honnold, 30 B. T. A. 774 (1934), aff'd per curiam, 77 F. (2d) 995 (C. C. A. 2d, 1935); cf. Reinecke v. Northwestern Trust Co., 278 U. S. 339 (1929).
\item \textsuperscript{36} See Magill, Taxable Income (1936) 266.
\item \textsuperscript{37} Margaret A. Holmes, 27 B. T. A. 660 (1933); see Paul, The Background of the Revenue Act of 1937 (1937) 5 U. of Chi. L. Rev. 41, 72.
\end{itemize}
this problem within the scope of Section 22(a). The more practical solution would be elimination from the statute of the substantial adverse interest concept and adoption of the estate tax provision that powers to be exercised in conjunction with any person constitute a trust taxable to the grantor. The need for this amendment is sharpened by the fact that taxpayers may attempt to escape the holding of the Clifford opinion—and still retain control over the trust—by substituting for the short term trust provision a power to revoke with the consent of an amenable beneficiary.

Helvering v. Clifford fails to answer the question of whether a grantor who retains substantial ownership of the trust is to be treated as a beneficiary of the trust, or whether the gross income of the trust shall be amalgamated into the income of the grantor—an issue important in finding taxable income in connection with such problems as the proper taxation of capital gains and losses and allowances for depreciation and depletion. Although the Supreme Court did not deny the existence of a true trust, the Clifford decision may indicate that the trust entity will not be recognized at all for income tax purposes. This is the position of the Treasury Department and the holding of the majority of opinions upon this question. Consistency with the decision of Helvering v. Clifford requires that the taxpayer should not be permitted to minimize his burden by regarding the trust as a separate entity in any respect for tax purposes.

The Clifford opinion has doubtless introduced much uncertainty into an already amorphous portion of taxation law. No definite standards are available to the taxpayer seeking to pursue his legitimate privilege of paying no more taxes than necessary. The decision is thus likely to cause an increase in litigation during the period in which the triers of the facts are learning to draw fine distinctions between trusts coming within Section 22(a) and

41. It seems clear that there would be no constitutional objections to such an amendment. See Helvering v. City Bank Farmers Trust Co., 296 U.S. 85 (1935), rehearing denied, 296 U.S. 664 (1935).
42. A further problem arises if trust property is sold to a member of the settlor's family who is not a beneficiary of the trust and sustains a loss. In this situation would this loss be non-deductible on the ground that the transaction was actually between the settlor and his kin? See Int. Rev. Code § 24(b)(1) (1939).
45. This conclusion, however, requires relinquishment of settled principles concerning the taxation of income from trusts. See Paul and Mertens, op. cit. supra note 29, at § 34.168, p. 1721.
46. See 4 Paul and Mertens, op. cit. supra note 20, § 34.169.
47. Paul, Studies in Federal Taxation (1937) 104 et seq.
those remaining a taxable entity. One possible solution is the enactment of specific provisions to cover the Clifford situation. But an attempt to provide by specific statutory language for the taxation of “short term” trusts in which the settlor retains “substantial control” and keeps the “benefits in the family” would probably engender as much, if not more, controversy. By creating fixed lines for taxability of trusts, the legislature would invite numerous attempts to avoid the strict letter of the law. It seems desirable, therefore, to leave the problem in the hands of a judiciary well equipped to handle such variable concepts as “ownership” and “property” in a manner that will assure the government of the revenue to which it is entitled under the statute.

APPLICATION OF THE ANTI-TRUST LAWS TO EXTRA-TERRITORIAL CONSPIRACIES*

The ever-increasing cartelization of European business enterprise, with its concomitant elimination of competition, division of world markets and limitations upon total productive output, has an important effect on American industry. Competition tends to vanish when an American producer who dominates the domestic market openly adopts or covertly abides by the market controls utilized by cartel members. In such a case, reduction of tariff barriers is of little value in restoring competition because world selling prices are predetermined irrespective of import duties or quotas. The anti-trust laws, however, may offer a weapon by which to attack price uniformity secured by international combination. A recent ruling in United States v. Aluminum Co. of America, now being tried, illustrates this possibility of application of the Sherman Act to a world cartel entered into outside the United States.

49. The statement in the text has, of course, no application to the desirability of amending §§ 166 and 167 to eliminate the substantial adverse interest concept. See pp. 1310, 1311 supra.

50. “One can read in the revisions of the Revenue Acts the record of the government’s endeavor to keep pace with the fertility of invention whereby taxpayers had contrived to keep the larger benefits of ownership and be relieved of the attendant burdens.” Mr. Justice Cardozo in Burnet v. Wells, 289 U. S. 670, 675 (1933).


1. See Domeratzky, The International Cartel Movement (U. S. Dep’t Comm. 1928); Lieffmann, Cartels, Concerns and Trusts (1932); Plummer, International Combines in Modern Industry (1938); Kirsch and Shapiro, Trade Associations in Law and Business (1938) 321-374; Wolf, Business Monopolies: Three European Systems in their Bearing on American Law (1935) 9 Tulane L. Rev. 325.


The petition of the United States, answers of the defendants, briefs and trial record will be cited throughout this Note by title, without further identification.

In 1937 the Department of Justice, induced by a constant stream of complaints from small domestic rivals against the industrial practices of the Aluminum Co. of America (generally referred to as Alcoa), brought the present anti-trust suit in equity for the dissolution of Alcoa. This draconian measure was deemed necessary to introduce competition into an important field of industrial activity in which one domestic company has maintained a complete monopoly of the production of the virgin metal. The Government contends that this monopoly has been protected in part through almost continuous cartel agreements with foreign competitors.

The most ambitious of these agreements was formulated in 1931 when all the leading world producers of aluminum, with the apparent exception of Alcoa, met in Paris to establish an international price, production and distribution cartel. Impelled by rising inventories and a demand shrunken by the world depression, the members of the cartel, who controlled over 89% of annual non-domestic production, set up Alliance Aluminium Compagnie with power to stabilize the market through the purchase of all available metal at a fixed price. To reduce over-production, quotas were assigned to each member with power reserved to the cartel to confiscate all metal refined in excess of the agreed amounts. In 1936, a second agreement provided for the levying of a royalty on all extra-quota metal in place of the confiscation requirement.

The Government, seeking to show a conspiracy to restrain trade, maintains that Alcoa was in reality a party to the cartel through the instrumentality of one of the other defendants in the suit, Aluminium Co., Ltd. of Canada, created in 1928 by Alcoa to take over all of the former's foreign holdings. Aluminium, the Government charges, was formed largely to free Alcoa from the operation of our anti-trust laws in so far as agreements with foreign cartels are concerned. Color is lent to this claim by the refusal of Aluminium to sell in the United States, the largest and most profitable market in the

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6. The foundation agreement setting up Alliance appears in the Trial Record as Exhibit 744, together with a contemporary explanatory memorandum, Exhibit 784.

7. Effectiveness of the power to stabilize the market is perhaps demonstrated by the fact that within one year of operation the price rose from approximately 12.1 cents per pound to approximately 13.4 cents.

8. The largest production quota, 28.58% of the total controlled by the cartel, was allotted to Aluminium. Trial Record pp. 15,310-6, 15,323-9.

9. Trial Record pp. 15,303-4, 15,704; Exhibit 744.

world.\textsuperscript{11} Aluminium has also supplied Alcoa with its most secret business data, access to which, of course, has been denied to competitors.\textsuperscript{12} Furthermore, although Aluminium is not a corporate subsidiary of Alcoa, the latter has made very favorable loans to the Canadian company.\textsuperscript{18} In addition, the stock control of both companies has always been vested in less than a dozen persons,\textsuperscript{14} with the management of both closely interlocked.\textsuperscript{16}

Aluminium, a leading member of the cartel,\textsuperscript{16} included the American market within the agreement of 1931 and strongly urged the European producers to do likewise. The European members, however, refused to follow Aluminium's lead and continued, over the Canadian company's protests, to ship metal to the United States in excess of quota allotments.\textsuperscript{17} But from 1936, when the second agreement was entered into, until the final abandonment of the cartel in 1938, the American market was covered by means of the royalty levied on all extra-quota metal produced for shipment to any part of the world including the United States.\textsuperscript{18} Aluminium, however, contends that the American market was included within the scope of the cartel's operations only because non-quota shipments of aluminum to the United States had been re-exported to compete with Alliance controlled metal.\textsuperscript{19}

The district court has not finally passed upon the exact legal relations existing among Alcoa, Aluminium and the cartel. At the close of the Government's case, however, the court ruled as a matter of law that, standing unrebutted, the evidence adduced would justify an ultimate finding that a conspiracy existed between any two or more of the four foreign producers and the two principal defendants, Alcoa and Aluminium.\textsuperscript{20} Solely through the utilization of this procedural device of a preliminary finding of conspiracy, some 170 exhibits, otherwise inadmissible, were introduced into evidence by the Government.

Inasmuch as the preliminary finding does not consider the question of the court's jurisdiction over the extraterritorial conspiracy, the precise legal effect of an ultimate finding of conspiracy remains as yet undetermined.

\textsuperscript{11} This view of the United States market is that of Aluminium's president, E. K. Davis. Trial Record p. 14,410. Since 1928, Aluminium has made but three sales in the United States to customers other than Alcoa. Trial Record pp. 13,994, 14,437.
\textsuperscript{12} Trial Record pp. 13,909-13, 13,916-7. 
\textsuperscript{13} Exhibit 775, Aluminium interrogatory No. 210; Trial Record pp. 14,545, 14,547. 
\textsuperscript{14} Trial Record pp. 13,781-5; Exhibits 402, 421, 774. 
\textsuperscript{15} The directing heads of the two companies are brothers; and the personnel of Aluminium has always been largely drawn from Alcoa. Both defendant companies have also utilized the same banking facilities, employed the same accountants and retained the same legal counsel. 
\textsuperscript{16} The foundation agreement was drafted in part at least by Aluminium's attorneys, and former employees of the Canadian company were given key posts in Alliance. Trial Record pp. 13,782, 13,860, 14,655, 14,676-9, 15,032. 
\textsuperscript{17} Trial Record pp. 15,334-7, 16,210-11, 16,506-98. 
\textsuperscript{18} Trial Record pp. 15,701, 15,747, 15,756, 16,345-7. 
\textsuperscript{19} Brief of Alcoa in Reply to the Brief of the United States Concerning a Preliminary Finding of Conspiracy pp. 20-21; testimony of E. K. Davis, president of Aluminium, Trial Record p. 15,303. 
\textsuperscript{20} United States v. Aluminum Co. of America, (S. D. N. Y. 1939).
In any conspiracy to violate a federal law, three elements are necessary to ground jurisdiction:21 (1) a common plan or understanding between two or more persons; (2) an overt act;22 and (3) personal jurisdiction over the parties charged.23 The most important element in the determination of whether an extraterritorial conspiracy comes within the Sherman Act is the nature of the overt act necessary for jurisdiction. So far as domestic violations are concerned, an overt act can best be expressed as any effect on interstate or foreign commerce. But, for extraterritorial conspiracies, the debatable issue has been whether effect on American commerce is sufficient to bring them within the scope of the Anti-Trust Law.

The first Supreme Court anti-trust case involving an extraterritorial conspiracy, American Banana Co. v. United Fruit Co.,24 appeared to require more than an effect on our commerce. Although the Court recognized the power of Congress to make acts committed abroad or on the high seas actionable in the United States, no intent on the part of Congress so to apply the Sherman Act extraterritorially could be found.25 It was held, therefore, that the Sherman Act had no application if the acts in furtherance of a conspiracy to restrain our foreign trade were done in a country in which they were lawful, whether the common plan was entered into abroad or in the United States.26

21. Under the modern federal doctrine of conspiracy, venue may be laid in any judicial district in which the common understanding was formed or an overt act committed. Hyde v. United States, 225 U. S. 347 (1912); Brown v. Elliott, 225 U. S. 392 (1912).

22. This is particularly true of civil suits charging conspiracy such as the principal case because: "Whatever may be the rule in criminal conspiracies, it is well settled that the civil liability does not depend upon the confederation . . . but upon the acts committed in realization of the common purpose." Lewis Invisible Stitch Mach. Co. v. Columbia Blindstitch Mach. Mfg. Co., 89 F. (2d) 862, 864 (C. C. A. 2d, 1936); Nalle v. Oyster, 230 U. S. 165, 182-3 (1913); Northern Ky. Tel. Co. v. Southern Bell T. & T. Co., 1 F. Supp. 576 (E. D. Ky. 1932).

23. When foreign corporations are involved, the element of personal jurisdiction may prove especially troublesome. See United States v. Aluminum Co. of America, 20 F. Supp. 13 (S. D. N. Y. 1937). This problem is currently presented in the efforts of the Government to obtain jurisdiction over certain Canadian newsprint manufacturers who exercise an important effect on the west coast market. See Brief of the United States in Answer to Motion to Quash Citation on Indictment, filed February, 1940, esp. pp. 45-51, United States v. Crown Zellerbach Corp., No. 26,650 S. (N. D. Cal. 1940).


26. The complaint in the Banana case clearly charged an effect upon the American market but these allegations were completely ignored in the Supreme Court. See the enlightening criticisms in Hunting, Extra-Territorial Effect of the Sherman Act (1911) 6 Ill. L. Rev. 34. For the main allegations in the complaint see American Banana Co. v. United Fruit Co., 160 Fed. 184, 185-6 (C. C. S. D. N. Y. 1903), 166 Fed. 261 (C. C. A. 2d, 1908).
Soon after the *Banana* case, however, the Supreme Court began to direct its attention to the factor of effect on American commerce. It was first held that a conspiracy was unlawful under the Sherman Act if it affected the foreign commerce of this country even though the conspiracy was entered into abroad. 27 Shortly afterwards, the Court further held that the lawful character of the acts committed in the foreign country was immaterial if the conspiracy was "entered into by parties within the United States and made effective by acts done therein." 28 These modifications of the *Banana* case were reflected in subsequent consent decrees entered into by foreign producers holding monopoly positions in quinine, potash and Norwegian sardines, who agreed to forego the employment of exclusive agencies and other devices aimed at price maintenance in this country. 29 The parties, however, apparently felt that the *Banana* case limited federal power to the territorial limits of the United States because the decrees all contained provisions that no act by, or agreement among, these foreign monopolists was to be forbidden which was "entirely completed outside the United States and [did] not require any act or thing to be done within" 30 this country. The advisability of excepting activity not related to American commerce was borne out recently by a circuit court of appeals decision holding that no remedy exists under the Sherman Act for acts done in this country in furtherance of a conspiracy entered into outside the United States, when those acts relate only to restraints on the commerce of other countries. 31

As a result of these decisions clarifying the broad statements of the *Banana* case, 32 the law of extraterritorial conspiracies is fairly settled. As with domestic conspiracies, the essential element necessary to turn a common plan or understanding into a conspiracy subject to the Sherman Act is activity which

31. This is the only rational meaning that can be ascribed to the majority's refusal to apply the Sherman Act to "whatever has been shown to have been done in this country in aid of any combination abroad." Eastern States Petroleum Co. v. Asiatic Petroleum Corp., 103 F. (2d) 315, 319 (C. C. A. 2d, 1939). As in the *Banana* case, the vital question of whether those acts committed here or abroad actually affect our commerce is not discussed. Yet until the possibility of such effect has been canvassed, it is literally impossible to determine whether the acts were "done wholly abroad." The intra-territorial operation of those foreign acts is the vital question. See note 35 infra.
32. Commentators looking only to general propositions have on occasion mistaken the *Banana* case for an accurate exposition of present day law. See, for example, Thornton, *A Treatise on Combinations in Restraint of Trade* (2d ed. 1928) § 447.
has an effect on American commerce, foreign or interstate.\textsuperscript{33} If such effect is present, it is immaterial whether the common understanding was entered into in the United States\textsuperscript{34} or abroad.\textsuperscript{35} In the absence of an effect on our commerce, the Sherman Act does not apply to acts committed here\textsuperscript{36} or abroad\textsuperscript{37} in furtherance of a common understanding entered into at home or in foreign countries. But once jurisdiction has attached, all activities, foreign\textsuperscript{38} as well as domestic, are covered by the anti-trust laws.\textsuperscript{39}

In any case involving an extraterritorial conspiracy, the nature of the effect on American commerce will depend on the factual situation involved. Some insight into what constitutes such an effect on our trade can be gained from

\textsuperscript{33} The cases holding that a court has jurisdiction over all conspiracies entered into within the judicial district, despite the fact that the overt act was committed outside that district or in no specified place, involved fact situations where the conspiracy actually was of operative effect in the United States. Therefore they are not in conflict with the elements essential to a conspiracy under the Sherman Act. Hyde v. Shine, 199 U. S. 62 (1905) (land fraud in California); Hyde v. United States, 235 U. S. 347 (1912) (same); Brown v. Elliott, 225 U. S. 392 (1912) (use of the mails to defraud in Nebraska and California). The same is true of Ford v. United States, 10 F. (2d) 339 (C. A. 9th, 1926), aff'd, 273 U. S. 593 (1927); Baker v. United States, 21 F. (2d) 903 (C. A. 4th, 1927).


38. Slight should not be lost of the fact that our anti-trust laws apply to the activities in this country of corporations wholly or partially owned by foreign governments as well as to those privately owned. United States v. Deutsches Kalisyndikat Gesellschaft, 31 F. (2d) 199 (S. D. N. Y. 1929). Although prices may have been fixed, markets allocated and production quotas set in accordance with foreign laws especially enacted for the purpose, or joint sales agencies selected in this country to handle the output of government mines, such acts, even if sanctioned by foreign statute or carried out by governmental agencies, do not exempt their activities from the Sherman Act. 31 Opn. Att'y Gen. (1910) 545. The only case where the employment of an exclusive sales agent in this country has been sanctioned was where the article sold was patented. Becton, Dickinson & Co. v. Eisele & Co., 86 F. (2d) 267 (C. C. A. 6th, 1936), cert. den'd, 300 U. S. 667 (1937).

a consideration of the facts of the principal case. Testimony of the defendants shows that, from the very beginning of the cartel's operations, Aluminium based price quotations in its sales to Alcoa on the buying price of the cartel. In all price quotations to other American purchasers, Aluminium used the cartel buying price plus a differential favoring Alcoa. Thus, the price of aluminum in the United States was directly affected by the buying policy of the cartel. After 1936, when the method of operation of the cartel changed, the effect was even more clearly shown by the fact that any aluminum sold in the United States was subject to the royalty payments exacted by Alliance. The result was not only a direct effect on the price, but a probable restriction on the available supply from abroad as well.

In view of the preceding facts showing an effect on American commerce, it seems unquestioned that if Alcoa should ultimately be found to have been a member of Alliance by and through the instrumentality of Aluminium, the Sherman Act would apply from 1936 to 1938 — the period that the American market was embraced within the terms of the agreement. During this period, the elements essential to a violation of the anti-trust laws — a common plan followed by an effect upon the American market — were present. Whether participation by Alcoa in the agreement before 1936 would subject its activities to the Sherman Act depends on whether Alcoa intended the foundation agreement to apply to our domestic market. If it was the purpose of Alcoa that the cartel should apply, then a conspiracy with Aluminium (which also wanted to affect the American market) existed, and the anti-trust laws would be applicable to both. If, however, Alcoa did not intend the agreement to apply to this country, then it would seem that, prior to 1936, membership of Alcoa in Alliance would not be actionable because there was no common plan to affect the American market. Since there is no direct evidence revealing intent, a conspiracy between Alcoa and Aluminium can be found only if a consideration of all the facts shows constructive intent.

On the other hand, if only Aluminium is held on the conspiracy charge, its activities together with those of the other foreign producers scarcely constituted a violation of our anti-trust laws for the years 1931–1936. During this period American commerce was affected, but no common plan existed among the members of Alliance to include the United States within the terms of the agreement. Aluminium considered the cartel arrangement operative in this country, but inasmuch as a conspiracy cannot be entered into with

41. In addition to the effect on price, Aluminium always included shipments to the United States within the production quotas allotted to it under the cartel agreement. Trial Record pp. 15,334–5.
42. Trial Record pp. 15,701–5, 16,345–7.
43. Aluminium paid royalties to Alliance on extra-quota production "quite irrespective of what became of the production or even whether or not it was sold." Trial Record p. 15,747.
44. Alcoa's membership in a cartel which specifically excluded the American market from the scope of its operations was considered unobjectionable by the Department of Justice in 1912. Exhibits 141–144; Trial Record pp. 4,283–5.
no violation of the Sherman Act by means of conspiracy follows. After 1936, however, all members of Alliance agreed on including the American market, and the Sherman Act became applicable because the effect on the American market, which continued under the new arrangement, was the direct and proximate result of the common understanding.\(^4\)

Although the ultimate disposition of the *Aluminium* case is not dependent solely upon the illegality of the world cartel, effective efforts to insure a competitive market in virgin aluminum and its derivative products will depend on inclusion of the cartel's activity in consideration of the problem. Careful collation of the decisions limiting the *Banana* case clearly establishes a legal basis for including the cartel. Inasmuch as the uncontroverted facts established in the trial to date warrant such inclusion, a splendid opportunity exists for a forthright statement of the economic interrelationship between cartels and American commerce, and of the necessity for preventing the use of cartels in aid of local restraints.

ROBERT T. MOLLOY\(^†\)

**REVALUATION OF ASSETS UNDER QUASI-REORGANIZATIONS**

In recent months the Securities and Exchange Commission\(^1\) has focused attention upon a corporate procedure, labeled a "quasi-reorganization,"\(^2\) whereby a company may eliminate deficits from its balance sheet and embark upon the accumulation of earned surplus "on substantially the same basis as a new enterprise."\(^3\) This metamorphosis is accomplished by absorbing the deficit into an existing capital surplus, or into one created at the time of

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1. Hereinafter referred to as "Commission" or "SEC."


the quasi-reorganization by reducing the stated value of capital stock. The ease with which such capital surplus may be created under lax state laws by an original segregation or later reduction of a portion of the capital contribution of stockholders furnishes a ready means to this end.

Corporations are motivated to effect quasi-reorganizations by a desire to present to prospective and existing investors a balance-sheet picture of prosperity. Such a portrayal may laudably seek to facilitate financing or, in those states where distributions out of other than earned surplus are restricted, the declaration of dividends. In other instances, the objective of the deficit elimination may be nothing more than an attempt to maintain management prestige. Such deficits sometimes arise from write-offs of inflated asset valuations — inflations revealed by segregations of original cost required by various regulatory agencies. Whatever the objective, unwitting investors are apt to be misled by surface appearances. Discrimination between earned surplus and capital surplus is necessary to enable investors to distinguish between contributed capital and the undistributed balance of earnings, and to permit them to estimate accurately the earnings history of an enterprise.

It was therefore only natural that Congress, seeking investor protection by the disclosure principle in the Securities Act of 1933 and the Securities Exchange Act of 1934, should require that earned surplus be distinguished from capital surplus, and that the historical content of the asset and surplus

4. A few fundamental definitions of terminology are necessary for the discussion to follow. The term “capital” will be used to describe the entire amount of the stockholder contribution. This sum may appear on the balance sheet either in one account, “Capital Stock,” or divided into two accounts, “Capital Stock” and “Capital Surplus.” A third account, “Earned Surplus,” reflects the fortunes of the business; it may, at any given time, show either a surplus or a deficit as the result of past operations. This note emphasizes the distinction between “capital” (“Capital Stock” plus “Capital Surplus”) and “Earned Surplus,” rather than the traditional state law distinction between “Capital Stock” and “surplus” (“Capital Surplus” plus “Earned Surplus”). For the importance of these distinctions, see Sanders, Accounting Aspects of the Securities Act (1937) 4 LAW & CONTEMP. PROB. 191; Comment (1940) 49 YALE L. J. 492, 494-504.

5. For a discussion of state regulation of the creation of capital surplus, see Comment (1940) 49 YALE L. J. 492, 497.

6. Sometimes the management may employ the subtler device of reporting more favorable operating results by using the capital surplus account to relieve the earned surplus account of normal expenses or losses. Thus downward revaluations of assets, necessitated by past insufficient depreciation or obsolescence allowances, may be subtracted from capital surplus, to that extent overstating the earned surplus account. The chief accountant of the SEC has specifically condemned this practice. SEC Accounting Release No. 1, Apr. 1, 1937, 135 C. C. H. Stock Exch. Reg. Serv. ¶ 8545. Another objectionable device is the excessive write-down of asset values to minimize future depreciation charges, thus increasing reported net earnings.

accounts be unfolded. The necessity to disclose, however, served merely to heighten the incentive to consummate quasi-reorganizations, and thus to wipe the slate clean of embarrassing deficit accounts. How to afford adequate disclosure to investors in these cases became a serious problem for the Securities and Exchange Commission.

A start towards a solution has been worked out for the Commission in two recent, alternative opinions of its chief accountant. One opinion applies to those cases in which the corporation seeks stockholder approval of a deficit elimination. Where such approval is sought, proxy regulations require that the stockholder must be informed of the reasons for the restatement of the capital accounts, and of the extent to which the "creation of additional surplus or elimination of charges against income" will make available for distribution to stockholders funds which could not otherwise be used for such purpose. In addition, the chief accountant's opinion indicates that full disclosure of the procedure should be made in the financial statements for the year involved, that all subsequent surplus statements should designate "the point of time from which the new earned surplus dates," and that for at least three years, the company should indicate "the total amount of the deficit and any charges that were made to capital surplus in the course of the quasi-reorganization which would otherwise have been made against income or earned surplus."

Although the chief accountant declared that sound accounting practice would ordinarily require formal stockholder consent to quasi-reorganizations, it is unlikely, in view of the expense entailed, that corporations will seek approval in the absence of charter or statutory requirements. Since statutory mandate for stockholder approval is generally to be found where the corporation seeks to create capital surplus by a reduction of the capital stock account, and not where the restatement is restricted to absorption of a deficit into capital surplus, corporations will forego the stockholder vote unless the elimination of the deficit is accompanied by a reduction of capital stock.


9. The SEC has periodically released opinions of its chief accountant dealing with various accounting principles. The opinions generally refer to the problems of a particular company, but are published by the Commission because of the widespread application of the principle in question. They do not have the status of Commission rules or orders, but are indicative of Commission requirements.


A second opinion of the chief accountant, however, embraces quasi-reorganizations accomplished by director authorization without stockholder ratification. In those instances, the corporation must make "a complete disclosure of all the attendant facts and circumstances and their effect on the company's financial position in each balance sheet and surplus statement filed with the Commission thereafter." In addition, the accountant required that "in the registration statement or other filing containing financial statements first reflecting such action by the directors there be included an explanation of the action taken and an indication of its possible effect on the character of future dividends." Either set of requirements, obviously, will warn alert investors of significant corporate history worth investigation. To such disclosure, however, the Commission is apparently adding a substantive requirement that the quasi-reorganization must be "sufficiently thoroughgoing." The Commission has, in effect, taken the position that to consummate a quasi-reorganization, a corporation must restate its accounts in terms of present conditions, just as if it were a new corporate entity emerging from a bankruptcy reorganization. As a consequence, deficits and such intangible asset accounts as "Organization Expense," "Capital Stock Discount and Expense," and perhaps "Unamortized Debt Discount and Expense" have no place in the new balance sheet. Even more important is the requirement that assets be revalued upon a more current and realistic basis. Thus current assets must be restated to reflect reduced realization value; fixed property accounts must be altered to recognize "relatively permanent reductions in asset values, as

14. Id. at 2.
16. Werntz, supra note 2, at 122.
20. The asset need not be written down at the time of the quasi-reorganization, if an adequate reserve is established at that time for its eventual write-down. Associated Gas & Elec. Corp., Holding Company Act Release No. 1873, Jan. 10, 1940, p. 16.
21. Werntz, supra note 2, at 119.
for example complete or partial obsolescence, over-capacity, lessened utility value, [and] undue costliness in operation," and to wipe out original overstatements due to intercompany profits. Valuation of holding company investments in stock of subsidiaries, it follows, should be based upon the assumption that the subsidiaries have revamped their balance sheets as though they, too, had emerged from reorganization. And lastly, these downward revaluations are first to be applied to exhaust any existent earned surplus.

Thus far, thoroughness has been required by the Commission only in its jurisdiction over holding company dividend policies under Section 12(c) of the Public Utility Holding Company Act of 1935. The distinction between capital and unearned surplus gains added significance under that section for it provides, inter alia, that payment of dividends out of unearned or capital surplus in contravention of Commission rules or orders is illegal. The most striking application of the "sufficiently thoroughgoing" standard was made in the Associated Gas case, where the company sought permission to pay a dividend on its common stock or, in the alternative, to pay interest on certain notes outstanding, contending that earned surplus was available for

22. Ibid. See also Associated Gas & Elec. Corp., Holding Company Act Release No. 1873, Jan. 10, 1940, pp. 9, 16.


24. Werntz, supra note 2, at 122. In Philadelphia Co., Holding Company Act Release No. 1905, Jan. 30, 1940, the registrant had two investments in subsidiaries, one carried at a book value of $29,000,000, the other at $60,000,000. The former investment was probably worthless but the latter was admittedly worth about $169,000,000.

25. Werntz, supra note 2, at 120.


28. Such an application would ordinarily be made under Rule U-12C-2, 17 C.F.R. 250.12c-2 (1939) which provides that:

"Except upon application to, and approval by order of, the Commission, no registered holding company nor subsidiary company thereof shall declare or pay any dividend on any security of such company out of capital or unearned surplus . . . ."

29. Subsequent to the passage of the Act, but prior to its effective date, Associated paid a dividend to its parent out of capital surplus in the form of two notes, a long-term 5% cumulative income note of $80,000,000 and the other, a non-interest bearing note of $10,000,000. Thereafter, Associated was able to transfer its earnings to the parent holding company by interest payments without running afoul of Rule U-12C-2, supra note 28.
either payment. To support this contention the corporation claimed that, prior to its registration under the Act, a quasi-reorganization had eliminated any impairment of capital and that subsequent earnings were sufficient to cover the proposed payment. The Commission, however, attributed no such efficacy to the adjustment of accounts because the company had failed to make the proper disclosure and the indicated revaluations.

Simultaneously, the Commission indicated that even a thoroughgoing quasi-reorganization has its limitations as a means to facilitate dividend declarations under Section 12(c) of the Public Utility Holding Company Act. One such limitation stems from the additional statutory standards of “financial integrity” and adequate working capital to which the applicant must conform. Interpreting these standards, the Commission said in the Associated Gas case that "if protection of . . . financial integrity . . . necessitated prevention of the proposed dividend, we would be under a statutory duty to enter an order preventing the . . . payment . . . without regard to the source (capital or earned surplus) . . ." 30 On the other hand, the Commission has permitted dividends out of capital or unearned surplus where financial structures were adequate to protect security holders and creditors and where sufficiency of working capital would not be threatened. 31

The usefulness of a quasi-reorganization to free dividend payments under Section 12(c) apparently may also be circumscribed by equitable considerations. In the Associated Gas case, security holders of the applicant's parent had exercised an option to convert to securities of the applicant in the belief they might secure claims closer to the underlying assets of the holding company system. 32 This reliance, the Commission felt, warranted disapproval of an accounting reorganization which might enable diversion of underlying assets to the parent.

The limitations upon quasi-reorganizations blocked out in the Associated Gas case protect investors in companies within the jurisdiction of the Holding Company Act against use of the device to facilitate injudicious or inequitable dividend distributions. To investors in companies registered under the Security Act Serv. ¶ 8400B. 30. Associated Gas & Elec. Corp., Holding Company Act Release No. 1873, Jan. 10, 1940, p. 18.
32. For details of the conversion plan available to the parent's bondholders at the time of the quasi-reorganization, see Associated Gas & Elec. Corp., Holding Company Act Release No. 1873, Jan. 10, 1940, p. 5 et seq.
ties Act of 1933 or the Securities and Exchange Act of 1934, however, major interest in the Associated Gas case must lie in the possibility that the revaluation requirement there stressed might be carried over to implement the rudimentary disclosures now required. Revaluation of assets to more current values would offer important information to investors ordinarily dependent upon financial statements based on the accountant’s unrealistic historical accounting costs.3 It is not clear whether the revaluation procedure required under the Holding Company Act embraces a careful reappraisal34 of all the assets or whether the Commission’s requirements would be satisfied by bona fide revisions of obvious overvaluations. Naturally, the worth to investors of the revaluation—if transplanted to the 1933 and 1934 Acts—depends upon its extent. Whatever may be the scope of the revaluation, however, the Commission probably has power to require companies seeking a quasi-reorganization to disclose, without actual revaluation,35 the effect upon surplus accounts of a more realistic restatement of assets.30

PARTIAL ASSIGNMENTS FOR THE BENEFIT OF CREDITORS*

General assignments for the benefit of creditors are frequently used, especially by credit bureaus and other commercial agencies, as a method of liquidating the affairs of insolvent individuals and relatively small business units.1 On the other hand, the less common partial assignment—insofar as it is permissible at all—is not a liquidation device but a mode of making payment in the course of a continuing business.2 Thus, debtors may make partial assignments of frozen assets or unliquidated accounts to reduce the

34. An exact engineer’s appraisal is probably unnecessary. The Commission’s attitude is reflected in Genesee Valley Gas Co., Inc., 1 S. E. C. 104 (1938), where a capitalized-earnings valuation was sufficiently accurate for the more exacting bankruptcy reorganization purposes.

2. The general assignment is defined as the transfer by a debtor of all or substantially all of his property, in trust, to be used in paying his creditors. The partial assignment is a similar transfer by a debtor of a portion of his property. Missouri-American Elect. Co. v. Hamilton-Brown Shoe Co., 165 Fed. 233 (C. C. A. 8th, 1908); BISHILL, VOLUNTARY ASSIGNMENTS (6th ed. 1894) §119.
pressure of creditors. Similarly, debtors pursuing a policy of retrenchment may find the partial assignment a convenient way to get rid of assets no longer used in business and to settle with creditors in one operation. Although the different functions of partial and general assignments have given rise to varying patterns of legislation and opinions, many decisions have considered them in terms of the same doctrines. A large number of these cases have confused partial with general assignments, greatly diminishing the utility of the former. Two recent cases demonstrating such confusion point anew the need for clarifying the position of the partial assignment. Analysis of the doctrinal development of assignments for benefit of creditors will explain the present anomalous position of the partial assignment and suggest working rules within which it can safely be given its proper role in commercial affairs.

Early judges received the general assignment favorably, their sympathy won by the wholesome motives attributed to debtors who assigned all of their property to payment of their debts. At common law the assignor had to hurdle the Statute of 13 Elizabeth, which regulated fraudulent conveyances. The seemingly gratuitous conveyance of property to a third party in a general assignment was allowed because the courts apparently found consideration for the debtor's voluntary transfer in the subsequent proportionate reduction of his obligations. Once the validity of the general assignment was established, partial assignments were also usually upheld, without regard to their function, against charges based on the Statute of Elizabeth and its successors. The argument that the debtor retained a portion of his property

3. The cases suggest a variety of situations in which the partial assignment might be so used. Chicago Title & Trust Co. v. Smith, 158 Ill. 417, 41 N. E. 1076 (1895) (assignment of accounts receivable); Gelfman v. Hamershlag & Potash, 11 N. Y. S. (2d) 739 (Sup. Ct. 1939) (right of action on fire insurance policy under which loss has occurred); see Comment (1939) 48 YALE L. J. 1222.

4. Thus, in Hahn v. Kroll, 176 Wash. 302, 29 P. (2d) 392 (1934), a debtor desiring to liquidate one of his enterprises made an assignment of a lumber business for the benefit of the creditors of that business.

5. Friedmeyer v. Lynch, 284 N. W. 160 (Iowa, 1939); Gelfman v. Hamershlag & Potash, 11 N. Y. S. (2d) 739 (Sup. Ct. 1939). Conveyances by insolvent debtors were attacked as general assignments, invalid because of fraud or preferences, without regard to the proportion of the debtor's property which they affected.


The common law status of the partial assignment has not been changed by the Uniform Fraudulent Conveyance Act, which has replaced the American prototypes of 13 Elizabeth in seventeen states. The scope of the Act's definition of fraudulent conveyances is not broader with respect to assignments than the standard set up in the old English statute.


in the partial assignment (usually fatal to a general assignment)\textsuperscript{10} was summarily dismissed with the observation that creditors were not prejudiced so long as the debtor's unassigned property was still available for their claims.\textsuperscript{11} But when the property assigned was greater in value than the amount reasonably necessary to satisfy the debts provided for, the assignment was held fraudulent on the ground that the consideration for the property assigned was inadequate.\textsuperscript{12} Since the partial assignment seems to be a method of payment in the course of a continuing business, the assigned property should not be greater in value than the debts to be satisfied. To secure the special protection accorded to general assignments, however, the debtor must assign all of his property, except that exempt from creditor process under state statutes.\textsuperscript{13}

A second limitation imposed upon assignments by the courts stems from the doctrine that the debtor may not condition a creditor's participation in assigned property upon a full release of the debtor, when the creditor's claims have not been fully paid.\textsuperscript{14} General and partial assignments have been treated differently with respect to this doctrine, and implicit in such dissimilar treatment is a recognition of the distinct function of each. Although many courts have held that general assignments exacting releases fall within the prohibition of the statute against fraudulent conveyances,\textsuperscript{15} others have allowed such transfers, declaring that debtors who devote all of their property to the satisfaction of creditors should be free of their claims in the future.\textsuperscript{16} Some states


\textsuperscript{11} See Canal Bank v. Cox, 6 Me. 395, 400 (1830); Henry v. Root, 38 Mich. 371, 372 (1878).

\textsuperscript{12} See Beck v. Burdett, 1 Paige Ch. 305, 309 (N. Y. 1829); Minshall v. Sanders, 175 Okla. 1, 3, 51 P. (2d) 940, 942 (1936). Although the surplus is returned to the debtor upon payment of the designated creditors, nevertheless the effect of the conveyance is to tie up the debtor's property in the hands of the trustee and temporarily place it beyond the reach of his creditors. Knapp v. McGowan, 96 N. Y. 75 (1884).

\textsuperscript{13} Baldwin v. Peet, 22 Tex. 705 (1859); Glenn, Liquidation (1935) \S 122. Similarly, \S 6 of the Bankruptcy Act allows bankrupts the exemptions prescribed by the laws of the United States and the states.

\textsuperscript{14} The stipulation for a release is introduced in some cases as a condition of receiving any benefit under the assignment; in others, as a condition of preference over other creditors. For general discussion of this limitation, see Burt, Fraudulent Conveyances (3d ed. 1882) \S 15; Burhill, Voluntary Assignments (6th ed. 1894) \S\S 142-166; Comment (1932) 41 Yale L. J. 603.

\textsuperscript{15} Nelson v. Harper, 122 Ark. 39, 182 S. W. 519 (1916); MacLaren v. Kramer, 26 N. D. 244, 144 N. W. 85 (1913), 50 L. R. A. (N.S.) 714 (1914).

The courts are more inclined to uphold the stipulation for release where it is a condition of preference over other creditors than in the case where non-releasing creditors are completely barred from participating in the assigned property and the residue, if any, reserved for the assignor. Compare West, Oliver & Co. v. Snodgrass, 17 Ala. 549 (1859) with Ashurst v. Martin, 9 Port. 566 (Ala. 1840). See King v. Hargadine-McKittrick Dry Goods Co., 60 Ark. 1, 28, S. W. 514 (1894); Note (1914) 14 Col. L. Rev. 528.

\textsuperscript{16} Brashear v. West, 7 Pet. 608 (U. S. 1833); Fugate v. Allen, 153 Va. 143, 149 S. E. 501 (1929); Skipworth v. Cunningham, 8 Leigh 271 (Va. 1837).
have even provided for such releases by legislation.\textsuperscript{17} Partial assignments, however, have uniformly been held bad when participation was conditioned upon the creditor's execution of a full release;\textsuperscript{18} such assignments were branded oppressive, fraudulent and without color of justice.\textsuperscript{19} Although there are some equitable considerations justifying the exaction of releases by debtors who devote all of their property to creditors,\textsuperscript{20} such coercion with respect to partial assignments is incompatible with the function of the partial assignment as a mode of payment in the course of a continuing business.

Aside from the obstacles presented by fraudulent conveyance statutes and the judicial limitation of releases, assignments were practically unrestricted at common law. A debtor was allowed to prefer one creditor to the exclusion of another without regard to his own insolvency,\textsuperscript{21} and there was practically no control of the trust estates generally created by assignments for the benefit of creditors. The exercise of this unfettered assignment privilege resulted in various abuses.\textsuperscript{22} Debtors often chose sympathetic assignees willing to subordinate the interests of creditors to those of the debtor in the administration of the assigned property.\textsuperscript{23} Frequently no efforts were made by the debtor to inform creditors of the amount of property assigned, with the costly result that some creditors failed to press their claims.\textsuperscript{24} Furthermore, the freely exercised privilege of preferring one creditor to the exclusion of another did not in practice support the theoretical justification of the general assignment: payment to the 'most deserving creditors.'\textsuperscript{25}

\begin{itemize}
\item \textsuperscript{17} COLO. STAT. ANN. (Michie, 1935) c. 12, § 44; TEX. REV. CIV. STAT. (1925) art. 263 (making an exception if a creditor received less than one-third of the amount due him).
\item \textsuperscript{18} Maughlin v. Tyler, 47 Md. 545 (1877); Thomas v. Jenks, 5 Rawle 221 (Pa. 1835); Hurst & Co. v. Leckie, 97 Va. 550 (1899); McCord-Brady Co. v. Mills, 8 Wyo. 258, 56 Pac. 1003 (1899). But cf. Halsey v. Fairbanks, 11 Fed. Cas. No. 5,964 (C. C. Mass. 1826); Canal Bank v. Cox, 6 Me. 395 (1830). See BURRILL, VOLUNTARY ASSIGNMENTS (6th ed. 1894) § 120.
\item \textsuperscript{19} Seaving v. Brinkerhoff, 5 Johns Ch. 329 (N. Y. 1821); In re Wilson, 4 Pa. 430 (1846); Skipworth v. Cunningham, 8 Leigh 271 (Va. 1837).
\item \textsuperscript{20} “Humanity and policy, however, both plead so strongly in favour of leaving the product of his future labour to the debtor, who has surrendered all his property, that, in every commercial country known to us, except our own, the principle is established by law.” Marshall, C. J., in Brashear v. West, 7 Pet. 608, 614 (U. S. 1833).
\item \textsuperscript{21} Reed v. McIntyre, 98 U. S. 507 (1878); Campbell v. Colo. Coal & Iron Co., 9 Colo. 60, 10 Pac. 248 (1886); Gover v. Wakeman, 11 Wend. 187 (N. Y. 1833); Smith v. Allen, 144 Ore. 261, 24 P. (2d) 1043 (1933).
\item \textsuperscript{22} In Boardman v. Halliday, 10 Paige 223, 229 (N. Y. 1843), the assignment privilege is referred to as “that most iniquitous principle of the common law.” See Passumpsic Bank v. Strong, 42 Vt. 295, 298 (1869).
\item \textsuperscript{23} See Passumpsic Bank v. Strong, 42 Vt. 295, 298 (1869) (“The assignee was but the assignor in masque”).
\item \textsuperscript{24} See Wilt v. Franklin, 1 Binn. 502, 516 (Pa. 1809).
\item \textsuperscript{25} See Shapleigh v. Baird, 26 Mo. 322, 326 (1858); Riggs v. Murray, 2 Johns Ch. 565, 577 (N. Y. 1817).
\item \textsuperscript{26} See Grover v. Wakeman, 11 Wend. 187, 218 (N. Y. 1833).
\end{itemize}
To eliminate these evils, a number of statutes were enacted in the pre-Civil War era, many of which remain substantially unchanged today.\textsuperscript{27} The earliest state legislation was limited largely to the regulation of the general assignment, the partial assignment escaping control as a relatively rare phenomenon.\textsuperscript{28} Legislators probably found fewer precedents and less necessity for the regulation of conveyances made by a debtor in the normal course of business. Where federal statutes have referred to assignments for benefit of creditors, the courts have decided that such statutes include only general assignments, even though they are not specifically so limited. As a result, partial assignments — in contrast with general assignments — are not acts of bankruptcy,\textsuperscript{29} nor do they invoke the operation of the federal act giving the United States a prior claim against its debtors.\textsuperscript{30}

But with respect to the preference provisions in the state general assignment statutes\textsuperscript{31} the partial assignment has not fared so well: confused and uncertain judicial interpretation has destroyed its usefulness. These preference provisions, adopted as a result of opposition to unequal distribution of an insolvent debtor's estate,\textsuperscript{32} were apparently included in the general assignment statutes because the general assignment was the usual method used by debtors for voluntary liquidation, and consequently the usual method for effecting preferences on liquidation. When debtors, disregarding the spirit of the acts, tried to evade their provisions by using seriatim partial assignments,\textsuperscript{33} mortgages,\textsuperscript{34} deeds of trust\textsuperscript{35} or other types of conveyance,\textsuperscript{36} the courts were astute in disregarding such variations in form and labelling all these devices general assignments. Thus, in order to effectuate the legislative policy against liquidation preferences, unfortunately expressed in terms of a particular liquidation device rather than in functional concepts, the courts expanded the scope of

\textsuperscript{27} For a recent comparative study of the various state statutes, see Legis. (1933) 20 Va. L. R. 222.

\textsuperscript{28} These regulations are principally concerned with the execution of the assignment, notice to creditors of the provisions of the assignment, the conduct of the assignee, and his management of the trust. See \textit{Burwell, Voluntary Assignments} (6th ed. 1941) § 14, app. 1.


\textsuperscript{31} "All states, save one, in attempting to regulate assignments, forbid preferences." Legis. (1933) 20 Va. L. Rev. 222, 228.

\textsuperscript{32} See note 25 \textit{supra}. See also Hakrader v. Leiby, 4 Ohio St. 602, 610 (1855).

\textsuperscript{33} See Inman, Smith & Co. v. Schloss, 122 Ala. 461, 467, 25 So. 739, 741 (1899).

\textsuperscript{34} Dadeville Oil Mill v. Hicks, 184 Ala. 307, 63 So. 970 (1913); First Carolina Jt. Stock Land Bank of Columbia v. Knotts, 1 S. E. (2d) 797 (S. C. 1899).

\textsuperscript{35} Hopfan v. Knauth, 156 Misc. 545, 282 N. Y. S. 219 (Munici. Ct. 1935); see Pollock v. Sykes, 71 Miss. 700, 710, 21 So. 780 (1897).

\textsuperscript{36} Britton v. Lorenz, 45 N. Y. 51 (1871) (sale); Putney v. Friesleben, 32 S. C. 492 (1889) (confession of judgment).
the designated form — the general assignment\textsuperscript{37} — so that other types of conveyance could be fitted into it at will. Only the unusual court made it clear that it was the existence of a preference at dissolution, and not the type of conveyance used, which brought an attempted transfer within the purview of the statute.\textsuperscript{38} Although such judicial distortion of partial assignments and other forms of conveyance may have been justified when used to suppress preferences, it blurred the distinctions between them and rendered uncertain their application to other situations. The partial assignment, similar in form to the general assignment, was peculiarly susceptible to this confusion, and fell into disuse as a result.

Hence the future utility of the partial assignment depends on definition of the circumstances in which it will not be held invalid. Insofar as any general proposition can be drawn from a great variety of statutes, it seems clear that all preferential conveyances either are void\textsuperscript{39} or inure to the benefit of all creditors\textsuperscript{40} when made in general assignments or in contemplation of general assignments or in insolvency.\textsuperscript{41} Although the existence of a preference depends on the vague standard of whether the debtor intended a preference,\textsuperscript{42} analysis of decisions on a variety of forms of conveyance suggests certain practical guide-posts for such intent. Thus money payment of maturing debts is regarded with but little distrust,\textsuperscript{43} whereas payment by conveyance of merchandise is more questionable.\textsuperscript{44} Mortgages, unless made to secure a current loan,\textsuperscript{45} are examined closely to determine whether they effect absolute con-

\textsuperscript{37}. See, for example, the cases cited in note 5 supra. A number of statutes prohibit preferences in contemplation of insolvency as well as preferences in general assignments or in contemplation of general assignments. These statutes would seem to avoid the difficulties of evasion present in the case where the preference prohibition is phrased only in terms of the general assignment. But the fact that such provisions are frequently included in “general assignment” statutes has, of itself, confused matters, for the courts have continued to speak in terms of preferential assignments and not preferences in contemplation of insolvency.

\textsuperscript{38}. See Straw v. Jenks, 6 Dak. 414, 421, 43 N. W. 941, 943 (1889); Hakrader v. Leiby, 4 Ohio St. 602, 613 (1855).

\textsuperscript{39}. See Legis. (1933) 20 VA. L. Rev. 222, 228, n. 50. Where a preferential conveyance is held void, the assigned property reverts to the debtor, and a race for priorities ensues.

\textsuperscript{40}. See Legis. (1933) 20 VA. L. Rev. 222, 228, n. 49. The creditors benefit in proportion to their claims, except insofar as they have previously acquired valid lien on the debtor’s property. This type of statutory provision, which is the most common, seems preferable to that referred to in note 39 supra, which makes the debtor’s property a prize in a race of diligence — a race in which the most deserving are frequently not the winners.

\textsuperscript{41}. See note 37 supra.

\textsuperscript{42}. Any conveyance in which all creditors did not participate equally in proportion to their claims is, by definition, a preference in the time of payment, but it is not a preference in the statutory sense of giving one creditor more than his fellows.

\textsuperscript{43}. Little Wolf Imp. Co. v. Hanscom, 66 Wis. 42, 27 N. W. 625 (1886); Cecil v. Citizens Nat. Bank, 145 Ky. 842, 141 S. W. 416 (1911).

\textsuperscript{44}. See Killian v. Trigg, Dobbs & Co., 209 Ala. 352, 96 So. 409 (1923). The distrust with which such conveyances are regarded is clearly evidenced by the development and wide adoption of “Bulk Sales” acts. See N. Y. Pers. Prop. Law § 44.

\textsuperscript{45}. Hicks v. Dadeville Oil Mill, 177 Ala. 661, 59 So. 57 (1912); Comm’r of Banks v. Turnage, 202 N. C. 485, 163 S. E. 451 (1932).
veyances or merely give security—particularly where a large part of the debtor's property is involved. It seems clear that the fundamental distinction, implicit in the decisions of the courts, is between conveyances made in the ordinary course of a continuing business and those made as a step in a financial liquidation. The former should be held valid and the latter invalid. In like manner, the partial assignment should be held valid when used as a mode of payment rather than as a liquidation device. The use of this test, in conjunction with the more precise rules relating to releases and the amount of property assigned, should go a long way toward clarifying the position of the partial assignment and thus enable it to serve a useful commercial function.

Bruce H. Greenfield

JURISDICTION TO DISCHARGE INDIVIDUAL DEBTORS IN JOINT STOCK COMPANY REORGANIZATION

Jurisdiction under Section 77B and its successor, Chapter X, does not extend to the reorganization of individuals and general partnerships. It does include joint stock companies, similar to partnerships in that the stockholders are subject to unlimited individual liability. But the statute leaves unanswered the problem of whether the reorganization plan of a joint stock company can include the property of the stockholders and provide for their

46. For cases in which the mortgage was held a security device, see Wylly-Gabbett Co. v. Williams, 53 Fla. 872, 42 So. 910 (1907); Smith v. Allen, 144 Ore. 261, 24 P. (2d) 1043 (1933). For cases in which the mortgage was held to effect an absolute conveyance, thereby falling within the purview of the assignment statutes, see note 34 supra.


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1. A corporation formed to take over individual property for purposes of reorganization does not qualify as a corporation entitled to the benefits of Section 77B. Milwaukee Postal Bldg. Corp. v. McCann, 95 F. (2d) 948 (C. C. A. 8th, 1938). See Finletter, The Law of Bankruptcy Reorganization (1939) 99; Tondel, Corporations Eligible For Relief Under Section 77B (1937) 21 Minn. L. Rev. 144.


3. See Frey, Cases and Statutes on Business Associations (1935) 1, 3.
discharge from company debts in the reorganization of the debtor. This uncertainty must be resolved before any satisfactory reorganization can be achieved.

Although commentators have indicated that stockholders will not in any way be affected by reorganization of the company, this question has recently received renewed consideration from the Second Circuit Court of Appeals. The debtor was a cooperative country store organized as a partnership but operating as a company with shares of stock, officers and directors. No certificate for business organization of any kind had been filed. The petition under 77B had been approved on a prior appeal on the ground that the debtor was more of a joint stock company than a partnership. The plan offered for confirmation was intended to include not only company property but also funds of the stockholders sufficient to dispose of their disputed liability as individuals for the debts of the company. The creditors were offered cash, notes and stock in a successor company to the full amount of their claims. The cash was to be advanced by the stockholders, who were to receive in return new shares and a perpetual injunction against creditors, amounting to a discharge from any further liability as individuals for company debts. The court refused to confirm the plan. It was not satisfied that the stockholders’ contribution was sufficient to justify their extensive participation in the new company, when, in view of the likelihood of individual liability, the creditors might have been able to assert a claim against their personal assets as a matter of right. Although the court consented to analogize the shareholders to partners, thus warranting administration of their individual property, it denied jurisdiction to discharge the stockholders from their disputed liability for debts of the company.

As a result of this decision the stockholder is united with the company undergoing reorganization for purposes of jurisdiction over property but not for purposes of discharge. The disputed claim of the creditors against the stockholders is not, of course, property of the debtor company over which the bankruptcy court can exercise exclusive authority. The court is, never-


5. See Finletter, The Law of Bankruptcy Reorganization (1939) 102. Thus it has been maintained that a company coming within the bankruptcy definition should nevertheless be treated as a partnership if stockholders are individually liable, in order to assure the administration of individual property for the benefit of company creditors. See Burkhart v. German-American Bank, 137 Fed. 958, 960 (S. D. Ohio 1904).


theless, compelled to consider the claim to individual property in order to
determine properly the fairness of the reorganization plan, unless it is willing
to maintain that the company fund and the individual fund available to com-
pany creditors are entirely separate and distinct, necessitating separate actions
against each by company creditors. If the two are considered a single fund
to be devoted to the claims of company creditors, then ascertainment of the
liability of the stockholders and of the consequent size of the fund amounts
to the valuation of the company assets which is essential to a determination
of classes to be excluded in the cause of full priority. If the two are considered a single fund
to be devoted to the claims of company creditors, then ascertainment of the
liability of the stockholders and of the consequent size of the fund amounts
to the valuation of the company assets which is essential to a determination
classes to be excluded in the cause of full priority. Since the court followed
this latter approach, and in addition decided that individual liability probably
existed, a stockholder participation that might well have been a reasonable
equivalent to the contribution made if the company were treated as an entity became instead an illegal diversion of assets belonging to creditors in derogation
of their right to full priority.

If the entity is to be discarded in defining the property within the juris-
diction of the court, there can be little logic behind preservation of the entity
in defining the debtor which the court is authorized to discharge. But this
distinction, however illogical, has become the law of partnership bankruptcy,
and having adopted one part of the rule for purposes of analogy the court
apparently felt compelled to adopt the other. Under the law of partnership
bankruptcy as applied to joint stock companies, although the assets of the
stockholders above the amount necessary to satisfy individual debts are
included in the calculation of company insolvency and administered for the
benefit of company creditors, liens against these individual assets cannot be
set aside to protect this surplus; nor can the stockholders be discharged from
liability for company debts without individual adjudication. The adjudication
of the company permits administration of the stockholders’ property, but it
does not justify the stockholders’ discharge from company debts after the
property has been administered. Thus company creditors are spared the
expense and annoyance of a separate proceeding against the stockholders, but
the stockholders cannot escape the necessity of a second proceeding to secure
a discharge from company debts.

No analogy to this double standard has appeared outside the field of part-
nership bankruptcy. Whereas upon firm adjudication the union of part-
nership and individual property does not permit the discharge of liens against
the individual property or the discharge of the individual from debts of the

9. Unless the value of the property exceeds the amount of prior claims, credit-
or and stockholders have no interest to preserve in the reorganization. In the Matter of
620 Church Street Bldg. Corp., 299 U. S. 24 (1936); Sophian v. Congress Realty Co., 165
F. (2d) 499 (C. C. A. 8th, 1938); Price v. Spokane Silver & Lead Co., 177 F. (2d) 237
(C. C. A. 8th, 1938). Classes without equity may in certain circumstances be allowed
to contribute to the new company and receive in return a participation reasonably equiva-
lent to their contribution. See Case v. Los Angeles Lumber Prod. Co., Ltd., 303 U. S.
106, 121 (1939), (1940) 49 YALE L. J. 1099.

10. In holding the contribution insufficient, the court emphasized that it was intended
to satisfy a disputed individual liability. First Nat. Bank of Herkimer v. Poland Union,
109 F. (2d) 54, 56 (C. C. A. 2d, 1940).

11. For a recent discussion of these principles of partnership bankruptcy, see Comment (1940) 49 YALE L. J. 908, 910-911, 915, 921 et seq.
firm, the same results are derived elsewhere from the fact that the separate entities in property are recognized and preserved. Thus when property is not preserved for the creditors, it is because the particular assets concerned are not property of the debtor within the jurisdiction of the reorganization court.\textsuperscript{12} The property of a debtor's subsidiary can be attached or sold with impunity, because the debtor's ownership of stock does not make it the owner of the assets, which remain separate and distinct.\textsuperscript{13} However, when the circumstances indicate that in fact no separate entity exists, the bankruptcy court has been authorized to extend its protection to both as component parts of a single fund.\textsuperscript{14} Similarly, when third parties are refused discharges, it is not as a consequence of the administration of their property in the reorganization of the debtor, but it is based upon the fact that their property is not property of the debtor subject to the jurisdiction of the reorganization court. Consequently, the obligations of a guarantor cannot be modified in the reorganization of its principal.\textsuperscript{15} The guarantor is a distinct and separate personality whose assets are neither considered in the determination of the debtor's insolvency for purposes of a petition under Section 77B or Chapter X, nor administered by the reorganization court. The proceeding against the principal in no way establishes that the guarantor is an insolvent debtor entitled to relief. The same is true of an indenture trustee against whom creditors of the debtor in reorganization prefer a claim for misrepresentation in the sale of the debtor's obligations.\textsuperscript{16} Such a claim is not against the debtor or the property of the debtor, but against a distinct individual, and there could consequently be no release of the claims in a plan for the reorganization of the debtor. However, a claim against the same trustee for mismanagement of the res was held sufficiently related to the property of the debtor to permit the compromise of the claim in the debtor's reorganization.\textsuperscript{17}

There is, therefore, at least this much oblique authority, in addition to the persuasion of logic and good sense, for the proposition that a repudiation of the entity in the treatment of property justifies a discharge of the stockholders' individual liability for company debts. The stockholders, to be sure, remain separate entities insofar as they retain sufficient assets to satisfy their

\begin{footnotes}
\item[14] See Steelman v. All Continent Corp., 301 U. S. 278 (1937) (bankrupt and personal holding company).
\item[16] In re 1775 Broadway Corp., 79 F. (2d) 108 (C. C. A. 2d, 1935); cf. McCandless v. Furlaud, 293 U. S. 67 (1934), wherein an equity receiver was permitted to assert a similar claim on behalf of creditors.
\item[17] In re 1775 Broadway Corp., 79 F. (2d) 108 (C. C. A. 2d, 1935).
\end{footnotes}
individual creditors. But the joint administration of all property available for company debts should constitute an aggregate not only for the benefit of corporate creditors but also for the discharge of their debtors, both company and individual. If “property of the debtor” subject to the reorganization can be construed to include property of the individual, it might be possible to include the individual in a similar construction of “the debtor” entitled to a discharge. If this construction be precluded by the explicit statutory requirement of individual adjudication for the discharge of a partner from debts of the firm, qualification or removal of the requirement will then be necessary.

18. § 216(2), quoted supra note 4.
19. § 228(1), quoted supra note 4.