

NOTES

THE CLEAN-HANDS DEFENSE IN PATENT INFRINGEMENT SUITS: AN EXPANDED CONCEPT*

Two factors have combined to make the patent field particularly fruitful of conflict between private claim and public interest. The first is the double aspect of the patent itself, as a sanction of exclusive privilege, purportedly¹ granted in furtherance of a broad social objective. The second, and the more specific, is the extensive overlap of the domains controlled by the frankly monopolistic patent system and by the anti-trust laws. A special and acute problem under the latter head arises with respect to the so-called "tying clauses", by means of which the patentee seeks to impose upon his licensee, as a condition of license, an obligation to purchase from the patentee or from his nominee other goods or materials, for use in connection with the invention.² Section 3 of the Clayton Act³ lays an interdiction upon such contracts where they result in lessening of competition or creation of monopoly.

Two separable questions are suggested by the tying-contracts practice, and are raised by the *Morton Salt* case.⁴ First, by whom and under what circumstances may the illegality or repugnance to public policy of the tying clause be raised? Secondly, how broad a conception of public policy is to govern the disposition of such a plea? Prior to the principal case, these questions had been set in a very different theoretical framework from that which must be constructed to accommodate the present holding.

* *Morton Salt Co. v. G. S. Suppiger Co.*, 62 Sup. Ct. 402 (U. S. 1942).

Plaintiff-petitioner brought suit for injunction and accounting against an alleged direct infringer of its patent on a machine for depositing salt. The alleged infringement consisted in manufacture and leasing of competing machines. The District Court granted summary judgment for the defendant, upon a showing that plaintiff required its licensees to use its own salt in the machines. 31 F. Supp. 876 (N. D. Ill., 1940). Defendant was not shown to have been injured by this practice, nor to have had any connection therewith. The Circuit Court of Appeals reversed, on the ground that violation of § 3 of the Clayton Act, 38 STAT. 731 (1914), 15 U. S. C. § 14 (1940), had not been shown. 117 F. (2d) 968 (C. C. A. 7th, 1941). In reversing that holding, a unanimous court, speaking through Mr. Chief Justice Stone, held that violation of the Clayton Act, a penal statute, was not decisive, as plaintiff's practice was in any case opposed to public policy. It was expressly assumed that defendant was not hurt by plaintiff's licensing policy, and the court refused to apply the theory that plaintiff's misconduct, to constitute matter for a clean-hands defense, must be integrated with the particular events raising the equity. An overriding public policy was believed to make inapplicable the stricter equity rule.

1. "The Congress shall have Power . . . to promote the Progress of Science and useful Arts, by securing for limited Times to Authors and Inventors the exclusive Right to their respective Writings and Discoveries;" U. S. CONST. ART. I, § 8 cl. 8.

2. See HAMILTON, TNEC REP., PATENTS AND FREE ENTERPRISE, Monograph 31 (1941) 62-70; Havighurst, *The Legal Status of Industrial Control by Patent* (1941) 35 ILL. L. REV. 495, 504.

3. 38 STAT. 731 (1914), 15 U. S. C. § 14 (1940).

4. *Morton Salt Co. v. G. S. Suppiger Co.*, 62 Sup. Ct. 402 (U. S. 1942).

From the time of the overruling of the *A. B. Dick* case,⁵ in *Motion Picture Patents Company v. Universal Film Manufacturing Company*,⁶ the federal courts have moved toward a strict attitude with respect to use of the patent as a means of securing monopoly in unpatented materials. The prohibition has been extended to a case in which the licensee was offered a choice between use of the patentee's materials and other terms considered so unreasonable as to be coercive.⁷ The patentee has been barred from relief against contributory infringers whose offense consisted in supplying to direct infringers the materials in which monopoly was sought.⁸ Where, though not formally licensing with condition annexed, the process patentee has sought to implement a monopoly in an unpatented material by selling the latter with an implied license to use the process, and by refusing to license on other terms, the courts have refused to be puzzled by the obvious.⁹ And even where the patentee has offered proof of another patent on the material tied to the patent in suit, it has been held that tying may not be used to avoid a full adjudication regarding such other patent.¹⁰

There have been many attempts at analysis of the theory or theories underlying these decisions.¹¹ A recent summary¹² suggests that two alternative concepts have been at work: a "claims construction" theory, limiting the protected domain of the patentee to the scope of the patent itself, and hence disabling him from bringing a suit aimed at the protection of an interest in a commodity outside the patent grant; and, on the other hand, a "use restriction" theory, relating not at all to the scope of the patent as a matter of construction, but rather to the permissible scope of its use in litigation.¹³

5. *Henry v. A. B. Dick & Co.*, 224 U. S. 1 (1912).

6. 243 U. S. 502 (1917).

7. *Barber Asphalt Corp. v. La Fera Grecco Contracting Co.*, 116 F. (2d) 211, 214 (C. C. A. 3d, 1940).

8. *Carbice Corp. v. American Patents Development Corp.*, 283 U. S. 27 (1931).

9. *Leitch Mfg. Co. v. Barber Co.*, 302 U. S. 458 (1938); *American Lecithin Co. v. Warfield Co.*, 105 F. (2d) 207 (C. C. A. 7th, 1939), *cert. denied*, 308 U. S. 699 (1939). Cases of this kind are the most numerous, owing to the difficulty of exploiting many process patents on any other basis. See Henry, *Limitations Inherent in the Grant of Letters Patent* (1942) 27 CORN. L. Q. 214, 229. But this difficulty seems to have been rejected as a ground for relaxation of the rule. See *B. B. Chemical Co. v. Ellis*, 62 Sup. Ct. 406, 408 (U. S. 1942).

10. *International Business Machines Corp. v. United States*, 298 U. S. 131, 137 (1936). The case was an antitrust action, and the direct holding is only that patent rights in the tied material do not justify tying under the Clayton Act. Under the theory of limitation inherent in the grant, such illegality might not be held to bar infringement suit, as plaintiff could plausibly argue that it was not attempting to extend its patent monopoly except into a domain equally its own. Under the broad equitable doctrine of the principal case, one making such a plea would at least have something new to answer.

11. See, e.g., HAMILTON, *loc. cit. supra* note 2; Feuer, *The Patent Monopoly and the Anti-Trust Laws* (1938) 38 COL. L. REV. 1145.

12. Henry, *Limitations Inherent in the Grant of Letters Patent* (1942) 27 CORN. L. Q. 214.

13. "The questions are, what restraint would be imposed by the granting of the prayer, and, is such a restraint lawful." *Id.* at 218 (italics supplied).

This permissible scope would be delimited by the law other than the patent law; apparently Section 3 of the Clayton Act, considered both as strict law and as a declaration of public policy, adequately accounts for the results in most of the decided cases.

The "claims construction" theory has been properly criticised.¹⁴ The "use restriction" theory, so called, appears more adequate to justify and explain past judicial action. But its latest and most articulate expositor¹⁵ does not appear to believe that transgression of the boundary of permissible use should work a general forfeiture of the patent *ipso facto*.¹⁶ It is needless to say that no case would support any such proposition. Hence it would appear that a defense upon the ground of such transgression would bear a close analogy to the defense of illegality in an action *ex contractu*¹⁷ — a defense which would of course be available either to the obligor or to one wrongfully inducing breach, the analogues, respectively, of the direct and contributory infringers. When a patentee "*seeks judicial sanction* for any condition so prohibited, relief must be denied him, for no court has power to countenance that which the law forbids."¹⁸ It is use in litigation that is restricted, and the weapon of restriction is dismissal upon a showing that the suit at bar is brought to implement an illegal course of dealing, or one obnoxious to public policy.

This concept is logically satisfying, but it must be observed that, in practice, it necessarily will result in confinement of the matters raised in defense. Conceivably, a patentee might impose any sort of illegal condition upon his licensee, and might, in consequence, be denied relief against an infringement consisting in violation of the condition, or against a contributory infringement consisting in abetting such violation. In practice, patentees will impose conditions commercially advantageous to themselves; this in turn means that they will seek to win from the licensee special commercial concessions withheld from others, and this will usually amount to some form of restraint of trade. Tying clauses, the exclusive use of licenses implied by material sales, and enforced retail price maintenance are typical devices. The foregoing may explain why monopoly or restraint of trade almost invariably constitute the subject-matter of the defense on grounds of the patentee's improper use, while this fact in turn explains the vogue of the "claims construction" theory. The latter concept would have been clearly inadequate and indeed irrelevant with respect to cases in which the patentee sought,

14. See *Id.* at 216.

15. See *id.* at 218.

16. There is, indeed, a hint of such a view in an addendum covering the principal and a companion case. See *id.* at 236. But the author may intend to suggest that the "legal existence" of the patent is merely suspended during the period of the patentee's misconduct. In point of doctrine, this does not seem to be what the Supreme Court is saying, but there may be little difference in practice.

17. The analogy lies only in the fact that in both cases it is, strictly speaking, the employment of the court's machinery to implement or enforce the illegal scheme itself that is forbidden.

18. Henry, *supra* note 12 at 218 (*italics supplied*).

not to "extend his monopoly" beyond the scope of the patent, but to impose some non-monopolistic but otherwise illegal condition.

It must be observed that this practical narrowing of the matters raised in defense is closely integrated with the limitation upon parties entitled to interpose such a defense; indeed, the two limitations are merely different aspects of the same rule. Hitherto, no one has been allowed to raise the defense of illegality or repugnance to public policy, unless the very suit in which the defense is raised implements or bears direct relation to that misconduct.¹⁹ But the only defendants are infringers, either direct or contributory. And, as suggested above, by far the commonest type of wrong-doing of which the patentee will have been guilty as against infringers, and in connection with his patent and with his infringement action, is the attempt at one of several rather restricted sorts of restraint of trade. He may have used his patent in a hundred ways either unlawful or antisocial, without ever having injured the particular infringer sued, and certainly without relation to the cause of action sued upon. As long, then, as conduct injurious to the defendant and linked with the plaintiff's action must be the foundation of this defense, the availability of the defense can have little deterrent effect on any abuses other than those usually implemented and directly aided by infringement litigation.

It is easy to see what may be the effect if, upon any theory whatever, another than the injured party may interpose, in an infringement suit, a defense of illegality or public policy, and if the conduct complained of need only be connected with the patent, and not necessarily with the particular infringement alleged. There would seem to be no reason at all for conceiving the public policy of Section 3 of the Clayton Act to be superior to any other formulation of public policy. It is true that the patent act itself is law, and hence declaratory of public policy;²⁰ but so, it may be remarked, is the constitutional language granting the patenting power.²¹ And if an admitted infringer of a valid patent may win a dismissal because the patentee-plaintiff (*ex hypothesi* without injury to the defendant)²² has utilized his patent in an attempt to secure a monopoly, or has violated either the letter or the policy of the Clayton Act,²³ it seems tenable to suppose that a patentee may in the future be barred from relief upon proof of his use of the patent for any purpose contravening a public policy of equal dignity with the one invoked in the principal case. The doctrine announced in the principal case might even lead to the eventual articulation of the policy declared in the patent clause of the Constitution.

19. *Keystone Driller Co. v. General Excavator Co.*, 290 U. S. 240 (1933), is not a real exception. The court, at 245, expressly denies it to be such, and plaintiff's misconduct, while perhaps not technically infecting its cause of action, had been made the basis for preparation of the suit. (The case was not concerned with tying contracts or monopoly).

20. See *License Tax Cases*, 5 Wall. 462, 469 (U. S. 1867).

21. U. S. CONST. Art. I, § 8, cl. 8, quoted note 1 *supra*.

22. *Morton Salt Co. v. G. S. Suppiger Co.*, 62 Sup. Ct. 402, 404 (U. S. 1942).

23. *Ibid.*

The principal case, therefore, while ostensibly a mere enlargement of the class of persons entitled to raise a defense based upon a given type of wrongdoing, may serve as a transition from a period in which patent rights were conceived as somehow not subject to be tempered to social ends, into one in which the patentee may find his effective remedy conditional upon his use of the patent in conformity to all the law and declared policy of the state. Such a condition, stated abstractly, would create a great deal of confusion as to the scope of permissible conduct,²⁴ but that confusion might be dispelled by progressive judicial definition.

The references in the principal case to the plaintiff's attempt at monopoly, and to the earlier cases dealing with monopolistic practices as a bar to patent suits,²⁵ are believed to be no more than a specification of plaintiff's misconduct, and certainly do not suggest that attempted monopoly has been arbitrarily selected as the only violation of public policy capable of supporting a clean-hands defense. Broad language elsewhere in the opinion weighs against such a view.²⁶ One limitation does, however, remain. It is clearly implied that denial of relief on grounds of public policy may be expected only where success in the infringement suit would indirectly assist the patentee in the consummation of the unsocial scheme.²⁷ In practice, it may be assumed that few cases will occur in which success in such a suit will not in some degree help the patentee in a course of action depending for its success upon the patent.²⁸

No attempt has been made to add to the literature dealing with the theoretical basis of past decisions in the tying-clause or contiguous fields. The analogy with the defense of illegality or public policy in contract actions,²⁹ an application (with a stricter rule regarding injury to the defendant)³⁰ of the clean-hands doctrine, or a concept of an inherent limitation upon the patent suit as a *sui generis* action,³¹ may separately or together explain the past cases. The important thing is that the "clean-hands" defense, under

24. Not because public policy external to the patent law is harder to define here than in any other field, but because it must be admitted that, even though not regarded as a grant of general immunity from all social requirements, the patent does unquestionably confer certain rights more or less opposed in tendency to public interests articulated in other law.

25. *Morton Salt Co. v. G. S. Suppiger Co.*, 62 Sup. Ct. 402, 404-05 (U. S. 1942).

26. *Id.* at 405.

27. *Ibid.*

28. The Court appears to be convinced that this causal relation will generally exist where patentee is using his patent "as a means of restraining competition." Attention is even given to the intangible but highly important factor of "persuading the public of the validity of the patent . . ." *Ibid.* It is submitted that, with this last quantity in the equation, there should in future be a strong presumption that every infringement suit practically aids whatever uses the patentee may be making of his patent.

29. See note 17 *supra*.

30. That is, with the more usual equity rule, from which the principal case represents a departure. See note 35 *infra*.

31. See, *e.g.*, the language in *Julius Kayser & Co. v. Rosedale Knitting Co.*, 18 F. Supp. 836, 838 (E. D. Pa. 1937), *aff'd*, 98 F. (2d) 839 (C. C. A. 3d, 1938), *cert. denied*, 305 U. S. 649 (1938).

whatever name, might previously have been thought limited by requirements of injury to the defendant and direct connection with the patentee's cause of action. The principal case has removed the suspicion of these limitations. The superficial result is to make the "tying-clause defense" available to more defendants than hitherto. By clear implication, the case seems to open up the whole field of public policy as material for the clean-hands defense, and to force upon the patentee a new circumspection.

To accomplish this result, the court has based the decision squarely upon the equitable doctrine of "clean-hands".³² Equity has long sought a resting-place between the obvious impracticability of requiring "blameless lives"³³ of its suitors, and a natural reluctance to become party to proceedings even on the periphery of an enterprise against the public interest.³⁴ The more orthodox formulation would require, for maintenance of the clean-hands defense, some wrong to the defendant himself.³⁵ But clearly where, as a practical matter, the granting of relief would abet anti-social conduct, the court must refuse to stultify itself, even though dismissal may come to the defendant as an undeserved good fortune.

An interesting question may arise with respect to the availability of the clean-hands doctrine of the principal case as a basis for declaratory relief in a suit by infringer against patentee. There is a dearth of authority on the standing of patentee's monopolistic use of the patent as a basis for declaratory relief under the relatively constricted doctrines of the older cases.³⁶ In addition, certain peculiar ways of talking about the clean-hands maxim might at first seem to make it inappropriate as a basis for affirmative action even on the part of one clearly entitled to rely on it as defendant.³⁷ Yet it

32. *Morton Salt Co. v. G. S. Suppiger*, 62 Sup. Ct. 402, 405 (U. S. 1942).

33. *Loughran v. Loughran*, 292 U. S. 216, 229 (1934), cited in the principal case, 62 Sup. Ct. 402, 405.

34. See, e.g., *Williams v. Dutton*, 184 Ill. 608, 56 N. E. 868 (1900). Cases involving misrepresentation to the public sometimes illustrate expansion of the usually constricted meaning given to the words, "subject matter of the suit." See *Fay v. Lam-bourne*, 124 App. Div. 245, 108 N. Y. Supp. 874 (1st Dep't 1908), *aff'd without opinion*, 196 N. Y. 575 (1909).

35. 2 POMEROY, EQUITY JURISPRUDENCE (Symons' ed. 1941) 99.

36. In *Steiner v. Schwartz*, 98 F. (2d) 999 (C. C. A. 10th, 1938), *cert. denied*, 305 U. S. 662 (1939), plaintiff sought a declaration that defendant's licensing agreements violated the Sherman and Clayton Acts. The claim was considered and rejected on the merits. But plaintiff's purpose in seeking the declaration is not clear. That a claim was made and rejected on a theory of flat illegality differentiates the facts of that case from those of the principal case. Violation of the Clayton Act need not be shown for the maintenance of the clean-hands defense. *Morton Salt Co. v. G. S. Suppiger Co.*, 62 Sup. Ct. 402, 404 (U. S. 1942).

37. "It [the clean-hands maxim] says that whenever a party, who, as *actor* [italics in original], seeks to set the judicial machinery in motion and obtain some remedy, has violated conscience, or good faith, or other equitable principle, in his prior conduct, then the doors of the court will be shut against him *in limine*; . . ." 2 POMEROY, *op. cit.* *supra* note 35, at 91. In *Sakon v. Santini*, 257 Mich. 91, 241 N. W. 160 (1932), the court refused to apply the maxim against one brought in by interpleader, saying, at p. 93: "Based on the maxim, a refusal of the court to act is as against one who seeks its active

is believed the objections to such use evanesce upon analysis. Any good potential defense ought to be allowed as a basis for declaratory relief, provided other essential conditions, including threat of suit by the patentee, are present.³⁸ It seems needless to dwell upon the enormous expansion of the strategic importance of the clean-hands defense, if it may be used not only to defeat suits for infringement, but also to force an issue on the patentee's threat, and, by way of counterclaim, to prevent dismissal of an infringement action once instituted.³⁹

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SEC INTERPRETATION OF "HOLDING COMPANY" AND "AFFILIATE" UNDER THE PUBLIC UTILITY HOLDING COMPANY ACT.

THE control exercised over the utility industry by holding companies dominated by outside financial interests brought dangers of excessive rates to consumers and dissipation of investors' holdings.¹ To remedy this situation, Congress provided for geographic integration of holding companies and for regulation of security issues and various intercorporate financial

interposition." In the most super-refined doctrine, it would seem that the court refuses its aid not precisely because the plaintiff has behaved inequitably, but because, having so behaved, he has the temerity to seek judicial assistance. It is to be hoped that the practical considerations which led to the introduction of the declaratory judgment will outweigh this impalpable concept.

38. "It is only in the clearest case . . . , where the prospective plaintiff's suit is imminent or where the issue would not be determined by the declaration, that a court should disregard the legal interest of a prospective defendant in averting trouble, in repelling an unjust claim, and in clearing his right or title . . ." BORCHARD, *DECLARATORY JUDGMENTS* (2d ed. 1941) 349.

39. The strategic gains to the alleged infringer would be, in general, the same as those acquired by the winning of the right to declaratory relief on the issues of validity and infringement. See BORCHARD, *op. cit. supra* note 38, at 802. Expansion of the infringer's use of the clean-hands defense naturally expands the inhibitory effect of the defense upon patentees, and so its scope as a safeguard for social interests.

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1. Comment (1936) 45 YALE L. J. 468, 472 *et seq.* Among the factors making for unparalleled use of the holding company in the utility field were relaxation of state incorporation laws governing holding of stock in one company by another, and lack of regulation of the securities markets. In addition, the unique, non-competitive nature of public utilities made combinations based on them less susceptible to regulation under the Sherman and Clayton Acts. And state utility commissions were unable to control effectively holding companies which fell outside the statutory definition of utilities and in any event usually transcended state boundaries. See BONBRIGHT AND MEANS, *THE HOLDING COMPANY* (1932) 55 *et seq.*; SEN. DOC. NO. 92, 70th Cong., 1st Sess. (1928) Pt. 72A, 13, 23 *et seq.*, Pt. 73A, 2 *et seq.*, 201-02 (hereinafter cited as *UTILITY CORPORATIONS*).

relations² in the Public Utility Holding Company Act.³ As criteria defining the firms to which these broad controls in the Act should apply, Congress framed definitions of "holding company"⁴ and "subsidiary".⁵ In addition, the concept of an "affiliate"⁶ of any holding company or subsidiary was set up to aid in regulating certain intercompany transactions such as service contracts between affiliates and any company covered by the Act.⁷

The definitions contained in the Act provide an opportunity for flexibility in administration by the Securities and Exchange Commission. Under Section 2(a)(7),⁸ any company holding ten percent of the voting stock of a public utility operating company, or of another holding company, becomes *prima facie* a holding company subject to the Act. But the Commission may grant exemptions under certain conditions, notably if the holding company does not exert such a controlling influence over its statutory subsidiary as to make regulation under the Act necessary "in the public interest". Moreover, the Commission may subject to regulation any person, regardless of stock ownership, if the person is found to be exercising such a controlling influence over a public utility or holding company that the public interest requires regulation under the Act. The definition of a "subsidiary" in Section 2(a)(8)⁹ is substantially the converse of that of a "holding com-

2. Comment (1936) 45 YALE L. J. 468, 482 *et seq.*

3. Public Utility Holding Company Act of 1935, 49 STAT. 803 (1935), 15 U. S. C. §79 (1940) (hereinafter cited by section number only).

4. Section 2(a)(7).

5. Section 2(a)(8).

6. Section 2(a)(11).

7. Sections 79l, 79m.

8. Section 2(a)(7). "Holding company" means (A) any company which directly or indirectly owns, controls, or holds with power to vote, 10 per centum or more of the outstanding voting securities of a public-utility company or of a company which is a holding company by virtue of this clause or clause (B), unless the Commission, as hereinafter provided, by order declares such person not to be a holding company; and

(B) any person which the Commission determines, after notice and opportunity for hearing, directly or indirectly to exercise (either alone or pursuant to an arrangement or understanding with one or more other persons) such a controlling influence over the management or policies of any public-utility or holding company as to make it necessary or appropriate in the public interest or for the protection of investors or consumers that such person be subject to the obligations, duties, and liabilities imposed in this title upon holding companies.

The Commission, upon application, shall by order declare that a company is not a holding company under clause (A) if the Commission finds that the applicant . . . (iii) does not, directly or indirectly, exercise (either alone or pursuant to an arrangement or understanding with one or more other persons) such a controlling influence . . . as to make it necessary or appropriate in the public interest . . . that the applicant be subject to the obligations . . . imposed in this title upon holding companies. . . .

9. Section 2(a)(8). "Subsidiary company" of a specified holding company means—(A) any company, 10 per centum or more of the outstanding securities of which are directly or indirectly owned, controlled, or held with power to vote, by such holding company (or by a company that is a subsidiary company of such holding company by virtue of this clause or clause (B) . . .

pany". Under Section 2(a)(11)¹⁰ the looser relation of an "affiliate" is automatically created by a five percent holding of voting stock. Moreover, in transactions between any person and a company subject to the Act, the Commission may find that the likelihood of an absence of arm's length bargaining makes it necessary that the person be declared an affiliate and thus regulated by the Act. Thus the standards defining the inclusiveness of the Act turn ultimately on requirements of the public interest, as determined by the Commission in the light of the Act's objectives. Similar statutory tests have been upheld on constitutional grounds.¹¹ And the experience of state regulatory commissions,¹² together with the hearings¹³ preceding

10. Section 2(a)(11). "Affiliate" of a specified company means—

(A) any person that directly or indirectly owns, controls, or holds with power to vote, 5 per centum or more of the outstanding voting securities of such specified company;

(B) any company 5 per centum or more of whose outstanding voting securities are owned, controlled, or held with power to vote, directly or indirectly, by such specified company;

(C) any individual who is an officer or director of such specified company, or any company which is an affiliate thereof under clause (A) of this paragraph; and

(D) any person or class of persons that the Commission determines, after appropriate notice and opportunity for hearing, to stand in such relation to such specified company that there is liable to be such an absence of arm's-length bargaining in transactions between them as to make it necessary or appropriate in the public interest or for the protection of investors or consumers that such person be subject to the obligations, duties, and liabilities imposed in this title upon affiliates of a company.

11. *Federal Radio Commission v. Nelson Brothers Bond and Mortgage Co.*, 289 U. S. 266, 285 (1933); *New York Central Securities Corp. v. United States*, 287 U. S. 12, 24 (1932).

Among the objectives listed in the Act are regulation of issuance of securities by holding companies and their subsidiaries, and furnishing investors with adequate information; regulation of transactions between subsidiaries and holding companies; facilitation of state regulation; elimination of uneconomical methods of raising capital; and integration and simplification of holding company systems. For the abuses resulting from the use of the holding company in the public utility field see *BONBRIGHT AND MEANS, THE HOLDING COMPANY* (1932) 153 *et seq.*; *UTILITY CORPORATIONS*, Pt. 73A, 61 *et seq.*

12. *MASS. SPECIAL COMMISSION REPORT ON CONTROL AND CONDUCT OF PUBLIC UTILITIES* (1930) 27 *et seq.*, 66, 248; *NEW YORK (STATE) COMMISSION REPORT ON REVISION OF THE PUBLIC SERVICE COMMISSION LAW* (1930) Vol. I, pp. 26, 141-42, 144; *MOSHER AND CRAWFORD, PUBLIC UTILITY REGULATION* (1933) 362 *et seq.*; *Marlett and Taylor, Public Utility Legislation in the Depression* (1935) 11 *J. LAND & P. U. ECON.* 173, 177; *Comment* (1933) 42 *YALE L. J.* 941, 945.

13. "The definition [of holding company] is made flexible enough to prevent evasion by simple alterations of form rather than substance (as has been the experience under other legislation where affiliation or holding companies were defined upon the basis of a specified stock ownership)." *Hearings before Committee on Interstate Commerce on S. 1725*, 74th Cong., 1st Sess. (1935) 51; *id.* at 211; *Hearings before Committee on Interstate and Foreign Commerce on H. R. 5423*, 74th Cong., 1st Sess. (1935) 76-77; *UTILITY CORPORATIONS*, Pt. 73A, p. 202 n. 35; *H. R. Doc. No. 137*, 74th Cong., 1st Sess. (1935) 9; *S. REP. No. 621*, 74th Cong., 1st Sess. (1935) 5. For problems of inclusion and exclusion in framing the definition see, *Comment* (1933) 42 *YALE L. J.* 941, 945; *BONBRIGHT AND MEANS, op. cit. supra* note 11, at 8 *et seq.* On techniques of control

the passage of the Act, indicated the need for such flexible criteria in defining the application of the Act.

The Commission has adopted a broad interpretation of "controlling influence" in refusing petitions for exemption from regulation.¹⁴ For example, in an early case¹⁵ H. M. Byllesby and Co. was denied exemption from the status of a prima facie holding company created by its stock ownership in Standard Gas and Electric Co. and its subsidiaries. Byllesby's dominant position in the Standard System dated from formation of Standard Gas in 1910 by Byllesby. This dominance was undermined in 1929 in a fight with an outside group for control of Standard's voting stock, and in a subsequent reorganization.¹⁶ However, this reduction of Byllesby's control was not sufficient to prove absence of a present "controlling influence" in view of the long history of control by Byllesby over Standard and in view of Byllesby's continued underwriting of Standard System securities. Transfer of Byllesby's holdings of Standard stock to a voting trust was held not to have terminated this long-continued influence;¹⁷ since some of the trustees of the voting trust had been associated with, and all were paid by, Byllesby,¹⁸ petitioner could

by a minority interest see, H. R. REP. NO. 827, 73d Cong., 2d Sess. (1934), Pt. 2, 84 *et seq.* (hereinafter cited as RELATION OF HOLDING COMPANIES TO OPERATING COMPANIES); UTILITY CORPORATIONS, Pt. 72A, 136 *et seq.*; BERLE AND MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (1932) 69 *et seq.*

14. The Commission has exercised several times its power under § 2(a)(8)(B) to declare on its own motion, after notice and opportunity for hearing, that the public interest required that certain non-registering companies be designated as subsidiaries. Shinn & Co., 7 S. E. C. 333 (1940); Associated General Utilities Co., 4 S. E. C. 526 (1939); Employees Welfare Ass'n, 4 S. E. C. 792 (1939); Utilities Employees Securities Co., 4 S. E. C. 806 (1939).

15. H. M. Byllesby & Co., 6 S. E. C. 639 (1940). Byllesby owned more than ten percent of the voting stock of Standard Gas and Electric Company.

16. By the terms of an agreement settling the fight Byllesby and the opposition group shared future underwriting of Standard System companies. In addition, Byllesby was to have the power of electing a majority of the directors of Standard Gas, but in a subsequent reorganization of Standard this power was reduced to that of electing, in combination with the opposition group, four out of nine Standard Gas directors. For a description of the control exercised by bankers in reorganization proceedings, see S. E. C. REPORT ON THE STUDY AND INVESTIGATION OF THE WORK, ACTIVITIES, PERSONNEL AND FUNCTIONS OF PROTECTIVE AND REORGANIZATION COMMITTEES (1938) Pt. I, p. 86S *et seq.* For a good description of the fight for control of the Standard System, see *Hearings before TNEC Pursuant to P. R. 113*, 75th Cong., 3d Sess. (1938) v. 10, 578 *et seq.*

17. Byllesby argued that after transfer of the stock to the voting trust it did not own or hold the stock *with power to vote* within the meaning of § 2(a)(7) and therefore was not even prima facie a holding company within the automatic part of the definition. The Commission overruled this contention and stated that beneficial ownership of the stock, alone, was enough to bring Byllesby within the definition. Compare Cities Service Company, Holding Company Act Release No. 2444, Dec. 23, 1940, at 7 *et seq.*; Clearfield Bituminous Coal Corp., 1 S. E. C. 374 (1936) (petitioner owned all voting stock in a public utility; exemption granted because had transferred to another party all voting rights under a proxy agreement).

18. Two new trustees were appointed just prior to the hearing. One had previously been elected a director of Standard Gas and had been connected with the investment

not meet the burden of proving¹⁹ that interpolation of the voting trust had freed Standard from the "controlling influence".

In the only judicial review of a Commission ruling under Section 2(a)(7) or (8), the Court of Appeals for the Sixth Circuit upheld the Commission's denial of Detroit Edison's petition for exemption,²⁰ and expressly stated that controlling influence was less than an absolute domination of the subsidiary by the holding company. "Controlling influence" means not necessarily that those exercising it "must be able to carry their point" but rather such influence as "may be effective without accomplishing its purpose fully."²¹ In addition, under a series of Commission rulings, if a holding company is capable of exerting a controlling influence over a subsidiary, the mere fact that it has not exercised its potential influence will not be sufficient to gain for it an exemption.²²

Other indicia of a holding company's controlling influence have been set forth in a series of Commission decisions. Interlocking officers or directors,²³ or the management of the operating utility by former officers of the holding company,²⁴ have been considered relevant. Reports or recommendations passing between a utility and a holding company are similarly

bankers, Ladenburg, Thalmann & Co., closely associated with Byllesby in erecting the Standard System. Both new trustees testified that they expected to receive compensation from Byllesby. All of the old trustees had been former Byllesby employees or directors.

19. The Commission had ruled previously that the burden of proof was on the applicant to bring itself within the exemption requirement. *SEC v. Sunbeam Gold Mines Co.*, 95 F. (2d) 699, 701 (C. C. A. 9th, 1938). See also, *Houston Natural Gas Corp.*, 3 S. E. C. 664, 669 (1938).

20. *Detroit Edison Co. v. SEC*, 119 F. (2d) 730 (C. C. A. 6th, 1941). Another important case, that of the Public Service Corporation of New Jersey, involving a Commission decision on § 2(a)(8), is presently before the courts. Holding Company Act Release No. 2998, Sept. 15, 1941. Appeal filed with Third Circuit Court of Appeals, N. Y. Times, Nov. 6, 1941, p. 34, col. 1.

The Commission denied the petition of Public Service, itself a holding company, to be declared not a subsidiary of United Gas Improvement Co., holding 28.4% of all voting securities of PSNJ, and United Corporation, holding 13.9%. UGI was admittedly a subsidiary of United, and their combined holdings totalled 42.3%. UGI organized PSNJ and transferred to it stock in some New Jersey properties held by UGI. From that time until 1938 the two companies had interlocking officers and directors. Records of voting at shareholders' meetings showed that the United-UGI block of votes represented in all cases save one a majority of the total votes cast. UGI and United actively participated in petitioner's negotiations with the Pennsylvania Railroad, lasting from 1927-30, for a contract to supply power to Pennsylvania's newly electrified lines. UGI and PSNJ merged their engineering service companies under circumstances indicating a domination of PSNJ by UGI. They retained their joint ownership at the time of the decision. These and other facts seemingly afford strong grounds for supporting the Commission's decision.

21. *Detroit Edison Co. v. SEC*, 119 F. (2d) 730, 739 (C. C. A. 6th, 1941).

22. *Manchester Gas Co.*, 7 S. E. C. 57, 62 (1940); *Detroit Edison Co.*, 7 S. E. C. 968, 969 (1940). See also *Rochester Telephone Corp. v. United States*, 307 U. S. 125, 145 (1939).

23. *Detroit Edison Co.*, 7 S. E. C. 968, 971 *et seq.* (1940).

24. *Pacific Gas and Electric Company, Holding Company Act Release No. 2988*, Sept. 11, 1941, at 12.

significant in showing close relations.²⁵ Officers of the holding company may carry on important negotiations with third parties on behalf of the operating company.²⁶ Sometimes the holding company retains control of the utility's proxy machinery.²⁷ Group purchasing contracts, or contracts by a holding company to supply service to an operating company, are likewise relevant.²⁸ If the holding company buys a major part of the operating company's output, the latter's economic dependence on the parent company makes it likely that the holding company will exercise a controlling influence.²⁹ The Commission's refusal to grant exemptions in such situations has proceeded from a recognition that corporate control for purposes of the Act may depend upon relations more subtle than mere stock ownership.

But if no controlling influence is shown, or if the public interest does not require regulation under the Act,³⁰ exemptions have been readily granted by the Commission. Companies no longer actively engaged in any corporate activity have presented the clearest case for exemptions.³¹ In other decisions, although a company owned more than ten percent of the stock of a public utility, a third company held a larger share and exercised dominant control.³² Where prima facie parent companies were in a process of reorganization which would eliminate their stock holdings in the utility, exemption has likewise been granted.³³ The Commission's control over holding companies has thus been limited to situations where regulation is necessary to effectuate the purposes of the Act.

In the interpretation of the "affiliate" definition, the Commission's most important ruling has come in the *Dayton Power and Light* case.³⁴ In this

25. Pacific Gas and Electric Company, Holding Company Act Release No. 2933, Sept. 11, 1941, at 15. But cf. The Bridgeport Gas Light Company, Holding Company Act Release No. 2440, Dec. 19, 1940, at 2.

26. Panhandle Eastern Pipe Line Co., Holding Company Act Release No. 2778, May 28, 1941, at 13.

27. American Gas and Electric Co., Holding Company Act Release No. 2749, May 13, 1941, at 17.

28. Paul Smith's Electric Light and Power and Railroad Company, Holding Company Act Release No. 2854, July 1, 1941, at 7; American Gas and Electric Company, Holding Company Act Release No. 2749, May 13, 1941.

29. Hartford Gas Co., Holding Company Act Release No. 2613, March 13, 1941, at 5. See also opinion on rehearing, Hartford Gas Company, Holding Company Act Release No. 3277, Jan. 21, 1942.

30. West Penn Railways Company, Holding Company Act Release No. 953, Jan. 3, 1938.

31. Reading Gas Co., 7 S. E. C. 755 (1940); Halsey, Stuart & Co., Inc., 1 S. E. C. 323 (1936).

32. Lehigh Power Securities Corp., 5 S. E. C. 143 (1939); Allied Chemical & Dye Corp., 5 S. E. C. 151 (1939). But the Commission has declared a company to be simultaneously a subsidiary of three different holding companies. Northern Natural Gas Co., 5 S. E. C. 228 (1939).

33. Genesee Valley Gas Co., Inc., 3 S. E. C. 672 (1938); Boise Gas Light & Coke Co., 2 S. E. C. 269 (1937).

34. Holding Company Act Release No. 2654, March 28, 1941. See also Consumers Power Company, 6 S. E. C. 444 (1939); West Penn Power Co., 5 S. E. C. 376 (1939); Halsey, Stuart & Co., Inc., 5 S. E. C. 865 (1939).

case are exemplified the subtle relationships which link the great investment bankers to public utilities.³⁵ By permission of the SEC, an issue of Dayton's bonds was floated with Morgan Stanley and Co. as managing underwriters, without prior Commission approval of the underwriting terms. In its subsequent decision, the Commission found that an absence of arm's length bargaining between Dayton and Morgan Stanley was likely, and thus forbade payment of any underwriting fees by Dayton to Morgan Stanley.³⁶ Although the rule under which this conclusion was reached has since been superseded by the requirement of competitive bidding,³⁷ this case is still valid as an illustration of the Commission's interpretation of the "affiliate" criterion.

The "affiliate" relation in this case centered around J. P. Morgan and Co. For, even after regulatory legislation had brought the divestment of more formal controls, J. P. Morgan retained influential connections with invest-

35. "Fundamentally, the holding company problem always has been, and still is, as much a problem of regulating investment bankers as a problem of regulating the power industry." H. R. Doc. No. 137, 74th Cong., 1st Sess. (1935) 6. See SEN. REP. NO. 1455, 73d Cong., 2d Sess. (1933) 333 *et seq.* H. R. REP. NO. 1593, 62d Cong., 3d Sess. (1913). *Hearings before TNEC Pursuant to P. R. 113*, 75th Cong., 3d Sess. (1938) v. 10, pp. 5, 33, 50, 256, 258, 481 *et seq.*; THE PROBLEM OF MAINTAINING ARM'S LENGTH BARGAINING AND COMPETITIVE CONDITIONS IN THE SALE AND DISTRIBUTION OF SECURITIES OF REGISTERED PUBLIC UTILITY HOLDING COMPANIES AND THEIR SUBSIDIARIES (SEC Pub. Util. Div. 1940).

See also Statement of the SEC upon the Promulgation of U-50, accompanying Holding Company Act Release No. 2676, April 7, 1941, at 17, 18, 25; DOUGLAS, DEMOCRACY AND FINANCE (1940) 6; Comment (1941) 50 YALE L. J. 1071, 1073 *et seq.*

36. Holding Company Act Release No. 2654, March 28, 1941, at 3, n. 4.

Rule U-12F-2 under which the action was taken provides:

(a) In connection with an issue, sale or acquisition of any security with respect to which an application or declaration is required by §§ 6, 7, 9, 10 or 12(d), (f), or (g) of the Act, no underwriter or finder's fee shall be paid to (1) any company in the same holding company system as the applicant or declarant, or (2) any affiliate of the applicant or declarant, or of a company of which the applicant or declarant is a subsidiary, or (3) any person who the Commission finds stands in such relation to the declarant or applicant, or to the person by whom the fee is to be paid, that there is liable to be or to have been an absence of arm's-length bargaining with respect to the transactions.

Strictly, the Commission in the instant case was interpreting not "affiliate" but Rule U-12F-2. However, as the Commission pointed out, the section of the Rule under which the finding was made is substantially the same as 2(a)(11)(D), the flexible clause in the "affiliate" definition. See *Consumers Power Company*, 6 S. E. C. 444, 456 (1939).

37. About a week after the Commission handed down its decision in the instant case, it announced the promulgation of Rule U-50 designed to supplant Rule U-12F-2. Holding Company Act Release No. 2676, April 7, 1941. U-50 requires competitive bidding in the issuance or sale of securities by registered public utility holding companies and their subsidiaries.

For an excellent discussion of the reasons for the Commission's action, see Statement of the SEC upon the Promulgation of U-50, accompanying Holding Company Act Release No. 2676, *supra*. See also Comment, *Competitive Bidding in the Sale of Public Utility Bonds* (1941) 50 YALE L. J. 1071.

ment bankers and public utility companies. The Banking Act of 1933³⁸ forced banks to choose between commercial and investment banking, and J. P. Morgan terminated its traditional underwriting business. However, several Morgan partners and numerous employees soon left the firm to establish Morgan Stanley & Co., with Harold Stanley as President. The voting common stock of Morgan Stanley was completely held by its own officers and directors, but several J. P. Morgan partners owned non-voting preferred stock which amounted to 35.8% of the total capital stock outstanding. Although from these facts the Commission found no controlling influence, it did find that members of the firm of J. P. Morgan had a strong pecuniary incentive for helping Morgan Stanley to get business.

In order to foster "closer relations among the great public utility systems in the East,"³⁹ in 1929 J. P. Morgan and Co. cooperated with Bonbright and Co. in organizing United Corporation, a super-holding-company formed to hold stock in several utility holding company systems.⁴⁰ United soon extended its holdings by acquiring 25 percent of the common stock of Columbia Gas and Electric, with the help of Harold Stanley, then a member of Columbia's board and executive committee.⁴¹ Columbia owned all the stock of the Dayton Company. At the time of Dayton's issue of bonds, United's slightly reduced holdings in Columbia made it prima facie a holding company over both Columbia and Dayton. But, at the end of 1939, just before the start of this proceeding, J. P. Morgan's holding of United stock had decreased to less than one-half of one percent. In deciding that J. P. Morgan still retained a controlling influence over United, the Commission emphasized Morgan's continued control over United's proxy machinery. Moreover, United's board of directors was friendly to Morgan,⁴² and on several occasions some of them had conferred with a leading Morgan partner who had been himself formerly a director of United. In addition, other factors indicated more directly an affiliation between United's utility subsidiaries and Morgan Stanley. Since its formation, Morgan Stanley had been the leading underwriter of public issues of bonds or debentures for all United

38. 48 STAT. 165 (1933), 12 U. S. C. § 355 (1940).

39. N. Y. Times, January 11, 1929, p. 1, col. 6.

40. For the history of United see Comment (1937) 37 COL. L. REV. 785, 930; RELATION OF HOLDING COMPANIES TO OPERATING COMPANIES, Pt. 5, 715 *et seq.*

41. Prior to 1934, Columbia's financing was handled by Guaranty Company, whose president, until he went over to J. P. Morgan, was Harold Stanley. Since Guaranty's termination of its investment banking business in 1934 as a result of the Banking Act, Morgan Stanley has led underwriting on Columbia subsidiary bond issues. For the importance of personal relationships in the investment banking field, see *Hearings before TNEC Pursuant to P. R. 113*, 75th Cong., 3d Sess. (1938) v. 10, pp. 5, 50, 258.

42. United's board included Howard, president of United almost since its inception, and two representatives of another holding company system who had participated with J. P. Morgan in formation of Niagara Hudson, a subsidiary of United. One of these, Carlisle, was made chairman of the board of Niagara at its formation and was elected a director of United in 1930. The two other members of the board were attorneys, one retained at the time by United and the other from a firm retained by Niagara Hudson.

utility companies except in three cases, explainable on other grounds.⁴³ Moreover, Morgan Stanley's financing of gas and electric utility companies had been limited to subsidiaries of United, Commonwealth and Southern which was an affiliate of United, and Consolidated Edison in which United also held a substantial stock interest. In view of these facts, the Commission held that such an absence of arm's length bargaining between Dayton and Morgan Stanley was likely, as made it necessary in the public interest⁴⁴ that Morgan Stanley be brought within Rule U-12F-2. Thus by this Rule no underwriting fees could be paid for Dayton's 1940 bond issue.⁴⁵ In making this finding, the Commission expressly stated that it interpreted the kind of relation connoted by "affiliate" as something less than "controlling influence".⁴⁶

On appeal, the Court of Appeals for the Second Circuit upheld the Commission's decisions as supported by substantial evidence.⁴⁷ The court pointed out that under the "affiliate" definition "there need not be an absence of arm's length, only a likelihood that there is." Moreover, the court indicated that, under recent decisions of the Supreme Court,⁴⁸ a great degree of finality must be accorded to the Commission's interpretations of statutory definitions such as "affiliate".

Thus the courts have approved the Commission's broad interpretations of the statutory definitions of "holding company" and "affiliate". In view of

43. In all three cases the issuer of the securities was the Connecticut Light and Power Company. The Commission felt that the floating of these issues by an underwriter located in Connecticut, rather than by Morgan Stanley, was explainable in view of the strong policy expressed in Connecticut statutes of promoting local control. The statute provides that no foreign holding company shall control or interfere with the operations of Connecticut utilities.

44. In discussing the requirements of the public interest the Commission pointed out several conflicts between the underwriter's interest and that of the public in securing cheap financing for public utilities. Thus, since underwriting profits can only be secured through floating security issues, it is to the interest of the investment banker to encourage multiple issues, which may not be to the best interests of the issuer. Likewise many investment houses have a predilection for debt financing, which tends to load the issuer with a burden of fixed charges. In approaching Morgan Stanley, which handles almost exclusively bonds and debentures, Dayton apparently had in mind an issue of either stock or bonds for new money amounting to approximately \$5,700,000. In the discussions Morgan Stanley suggested combining the acquisition of new money with refunding of about \$19,000,000 outstanding 3½% bonds due in 1960. This was done by floating the present issue of about \$25,000,000 in 3% bonds. The Commission questioned whether this transaction would have taken place without some sort of prodding. Holding Company Act Release No. 2654, March 28, 1941, at 20.

45. Compare United Gas Improvement Co., Holding Company Act Release No. 3053, Oct. 6, 1941.

46. Dayton Power and Light Company, Holding Company Act Release No. 2654, March 28, 1941, at 22.

47. *Morgan Stanley & Co., Inc. v. SEC*, Ct. of App. for the Second Circuit, Feb. 20, 1942.

48. See *Gray v. Powell*, 62 Sup. Ct. 326, 333 (U. S. 1941). Cf. *Helvering v. Tex-Penn Oil Co.*, 300 U. S. 481, 491 (1937).

the subtle and varied manifestations of modern corporate control, such a course seems the only one capable of effectuating the purposes of the Act.⁴⁹

PUBLIC UTILITY RATE REGULATION: THE END OF THE RULE OF SMYTH v. AMES*

FOR more than forty years one of the knottiest and most discussed problems in utility rate regulation has been that of rate base determination in the light of the judicial requirements laid down in *Smyth v. Ames*.¹ This leading case climaxed a series of decisions in which the Supreme Court, abandoning its refusal to take part in rate regulation, held that rate reasonableness and rate base determination were judicial questions.² Looking to the Fourteenth Amendment, the Court in *Smyth v. Ames* ruled that no state could establish confiscatory rates and that a rate would be deemed confiscatory if it did not allow the utility to earn "a fair return upon the fair value"³ of its property used and useful in the public service. Among the "matters for consideration"⁴ in determining the rate base, Mr. Justice Harlan listed original cost and

49. Compare Comment (1941) 40 MICH. L. REV. 274, 284, and the Supreme Court's emasculation of the commodities clause of the Hepburn Act, *United States v. Delaware & Hudson Co.*, 213 U. S. 366 (1909). The term "control" standing alone does not have a definite connotation, but must be interpreted in the light of the purposes to be achieved. Thus control is defined in certain parts of the income tax law for purposes of determining capital loss or gain as eighty percent of the total combined voting power of the voting stock of a company. INT. REV. CODE § 112(h) (1940). Nor is the Commission free to exercise an unfettered discretion. "However, this part of the present Act [§ 2(a) (8)] has its guide post, which prevents the Commission from exercising arbitrary power in enforcing it." *Detroit Edison Co. v. SEC.*, 119 F. (2d) 730, 739 (C. C. A. 6th, 1941).

* *Federal Power Commission v. Natural Gas Pipeline Co.*, 62 Sup. Ct. 730 (U. S. 1942).

1. 169 U. S. 466 (1898).

2. Although the Court held in *Munn v. Illinois*, 94 U. S. 113, 134 (1876), that "for protection against abuses by legislatures the people must resort to the polls, not to the courts," it declared fourteen years later that "the question of the reasonableness of a rate of charge . . . is eminently a question for judicial investigation, requiring due process of law for its determination." *Chicago, M. & St. P. Ry. v. Minnesota*, 134 U. S. 418, 458 (1890). For an historical survey of early regulation by franchise and commission, see JONES AND BIGHAM, *PRINCIPLES OF PUBLIC UTILITIES* (1931) 102, 157 *et seq.*

3. *Smyth v. Ames*, 169 U. S. 466, 546-47 (1898).

4. These "matters" are: original cost of construction, amount expended in permanent improvements, amount and market value of bonds and stock, present as compared with original cost of construction, probable earning capacity of the property under particular rates prescribed by statute, and the sum required to meet operating expenses. They are to be given "such weight as may be just and right in each case." *Ibid.*

reproduction cost,⁵ the latter of which has been held in nearly all subsequent decisions to be an essential valuation factor.⁶ These later holdings have been severely criticized,⁷ particularly by proponents of a modification of original cost—prudent investment value.⁸ Foreshadowing resolution of the long conflict between these competing methods of valuation, a recent Supreme Court case⁹ suggests the necessity of reappraising the validity and status of the *Smyth v. Ames* rule.¹⁰

As critics of the *Ames* decision were quick to point out, the fair-value concept itself involved a fundamental circularity in reasoning.¹¹ It postulated a fair return upon the fair value of a property for which there was no market, and whose value was largely determined by what it could earn. This circularity derived from the Court's misappropriation of the fair-value doctrine from the law of eminent domain,¹² which requires that compensation for condemned property leave the property owner in the same position pecuniarily that he was in prior to the condemnation.¹³ It is apparent that a concept of fair-value drawn from this field is completely inapplicable to rate-making, where the value of the property to the owners varies with every change in the utility rate.

Besides the inherent defects of the fair-value rule, use of reproduction-cost as a measure of fair-value is administratively burdensome. Since both tangibles and intangibles necessary to plant-replacement must be included

5. The reproduction cost method seeks to determine the cost of the identical properties, and not an equally efficient substitute, if they were to be replaced as of the time of the rate inquiry. See BAUER AND GOLD, *PUBLIC UTILITY VALUATION* (1934) 155-72.

6. See cases cited *infra* notes 25, 28.

7. BAUER AND GOLD, *op. cit. supra* note 5, 371-445; 2 BONBRIGHT, *VALUATION OF PROPERTY* (1937) 1154-56; Richberg, *A Permanent Basis for Rate Regulation* (1922) 31 *YALE L. J.* 263; Booth, *Prudent Investment, Fair Value, and Public Utility Regulation* (1938) 1 *NAT. LAWYERS' GUILD Q.* 229; Kauper, *Wanted: A New Definition of the Rate Base* (1939) 37 *MICH. L. REV.* 1209 and references cited therein.

8. Although it admits of many variations, the prudent investment method generally purports to ascertain the amount of capital judiciously invested originally in an enterprise plus increases for permanent plant additions. See 2 BONBRIGHT, *op. cit. supra* note 7, 1084-86.

9. *Federal Power Comm. v. Natural Gas Pipeline Co.*, 62 *Sup. Ct.* 736 (U. S. 1942).

10. As it has been popularly understood, the "rule of *Smyth v. Ames*" makes essential the consideration of reproduction cost in the rate base determination.

11. See Hale, *The "Fair-Value" Merry-Go-Round* (1939) 33 *ILL. L. REV.* 517. "Fair value" must be shelved among the great juristic myths of history, with the Law of Nature and the Social Contract. As a practical concept, from which practical conclusions can be drawn, it is valueless." Henderson, *Railway Valuation and the Courts* (1920) 33 *HARV. L. REV.* 1031, 1051.

12. See Hale, *The "Physical Value" Fallacy in Rate Cases* (1921) 30 *YALE L. J.* 710. See further, 2 BONBRIGHT, *VALUATION OF PROPERTY* (1937) 1094-98; Hale, *Conflicting Judicial Criteria of Utility Rates* (1938) 38 *COL. L. REV.* 959, 960-64.

13. *United States v. New River Collieries Co.*, 262 U. S. 341, 343 (1923); *cf. Monongahela Navig. Co. v. United States*, 148 U. S. 312, 328-29 (1893).

in an engineering inventory,¹⁴ conclusions reached by the reproduction-cost method are necessarily speculative and generally unreliable.¹⁵ As a result, the length and expense¹⁶ of rate litigation are notorious, and may be said, ironically, to feed upon themselves — since valuation by the reproduction-cost method becomes obsolete with any change in the price level as of the time of the inquiry.¹⁷ Although the method is strongly urged by the utilities during periods of high prices,¹⁸ it is temporarily neglected, sometimes

14. In evaluating property under the rule of *Smyth v. Ames*, the Court has held that the following items, *inter alia*, must be included in the rate base: (1) *Tangible*: land and structures [Denver v. Denver Union Water Co., 246 U. S. 178 (1918)]; labor [McCardle v. Indianapolis Water Co., 272 U. S. 400 (1926)]. (2) *Intangible*: depreciation and amortization [Knoxville v. Knoxville Water Co., 212 U. S. 1 (1909)]; going-concern value [McCardle v. Indianapolis Water Co., *supra* at 414]. But *cf.* note 33 *infra*. See 2 BONBRIGHT, VALUATION OF PROPERTY (1937) 1118-51. The following items, *inter alia*, have been excluded as evidence of fair-value: franchises and good will [Cedar Rapids Gas Light Co. v. Cedar Rapids, 223 U. S. 655, 659 (1912)]; past losses [Galveston Elect. Co. v. Galveston, 258 U. S. 388 (1922)]. Conversely, past exorbitant profits do not justify present or future rates that are confiscatory [Newton v. Consol. Gas Co., 258 U. S. 165 (1922)]. On the admission or exclusion of any of these elements, the party contesting a Commission order has the burden of proof [Railroad Comm. v. Cumberland Tel. Co., 212 U. S. 414 (1909)].

15. "A plant valuation which simply represents a hypothetical cost of reproduction at a particular time is obviously a purely theoretical valuation. It does not correspond with anything which has actual existence in the world of industry and business." *Re Springfield Consol. Ry.*, P. U. R. 1920E, 474, 480 (Ill.). See NEW YORK COMMISSION ON REVISION OF PUBLIC SERVICE COMMISSION LAW, MINORITY REPORT (1930) 250 *et seq.*

16. Perhaps the most outrageous example of the prodigious cost and length of fair-value litigation is the attempt made by the ICC to appraise Class I railroads under the Valuation Act of 1913. Expenditures: \$178,000,000; time spent: 18 years. Proceedings were suspended in 1931 when depression prices made earlier valuations useless. *Hearings before Committee on Interstate and Foreign Commerce on H. R. 7116, 7117*, 72d Cong., 1st Sess. (1932) 322.

17. "The most serious vice of the present rule [fair-value] for fixing the rate base is not the existing uncertainty; but that the method does not lead to certainty." Brandeis, J., dissenting in *Southwestern Bell Tel. Co. v. Pub. Serv. Comm.*, 262 U. S. 276, 306-08 (1923). A possible explanation of this perpetual lack of finality is that fair-value connotes a market value which does not exist; fair-value is "not exchange value" but "a special value for rate-making purposes." Brandeis, J., dissenting in the *Southwestern Bell Telephone* case, *supra* at 292, 310. Neither can fair-value be used as assessment value for taxation purposes; nor vice versa. 2 BONBRIGHT, VALUATION OF PROPERTY (1937) 1100-02.

18. After *McCardle v. Indianapolis Water Co.*, 272 U. S. 400 (1926), decided at the height of post-war prosperity, it seemed as if the Court had made reproduction cost not *an*, but *the*, essential element in determining fair-value. But *cf.* *Los Angeles Gas & Elect. Co. v. Railroad Comm.*, 289 U. S. 287, 311-12 (1933), decided during the depths of the depression, where the Court accepted original cost as a measure of value because reproduction cost estimates as of 1929-30 afforded "no secure foundation for prediction of future values".

completely condemned,¹⁹ by them when market value declines. Thus, besides providing a shifting rate base, reproduction-cost tends to place the burden of reckless investment and overcapitalization upon the consumer, thereby forcing him to pay the investor high profits during periods of high prices, while not guaranteeing to the consumer proportionate reductions during periods of falling prices.²⁰

Of the several compromise methods²¹ of fixing the rate base, prudent investment has received most support. Arguing that the Constitution requires a fair return on the utility's property investment, and not on the property's present fair-value,²² the proponents of prudent investment see their method as a means of (1) eliminating the logical objection of circularity; (2) avoiding periodic reappraisals of property with each change in the price level; (3) reducing the speculative character of utility investments by providing an objective standard of valuation, which in turn will remove the gamble on future property valuations, thereby allowing lower rates; and (4) easing the commission's regulatory task by making unnecessary the valuation of those intangibles included in the reproduction-cost appraisal.²³ On the other hand, reproduction cost adherents enter the caveat²⁴ that prudent investment will (1) result in a continued exaction of high rates from consumers on investments made during periods of high prices and inflated value, and

19. When *Smyth v. Ames* reached the Court in 1898, prices were at their lowest level since the Panic of 1893. GLAESER, *OUTLINES OF PUBLIC UTILITY ECONOMICS* (1931) 458 (chart). Accordingly, the railroads, which had been built during days of higher prices, urged the Court to adopt the original cost method of property valuation. The State of Nebraska, on the other hand, asked the Court to adopt the reproduction cost method as a protection against the railroads' claims, based on past inflated prices. But when, just before and during the first World War, the price level rose, the utilities and commissions reversed their arguments. See BAUER AND GOLD, *PUBLIC UTILITY VALUATION* (1934) 49-112.

20. Black, J., dissenting in *McCart v. Indianapolis Water Co.*, 302 U. S. 419, 431 (1938), pointed out that in *McCardle v. Indianapolis Water Co.*, 272 U. S. 400 (1926), the Company was held entitled to a rate based on a \$19,000,000 valuation although its total investment was \$9,000,000. Cf. BAUER, *EFFECTIVE REGULATION OF PUBLIC UTILITIES* (1925) 111-14, where the author maintains that "strict adherence to reproduction cost over a long period of falling prices would bring insolvency and financial collapse" to the utility. The inequalities of price movements among different elements of the rate base further complicates the problem. Re-determination of the rate base by index-numbers is therefore a highly impractical operation. See Lilienthal, *Regulation of Public Utilities During the Depression* (1933) 46 HARV. L. REV. 745, 748 (graph).

21. See, *inter alia*, the "split-inventory" and "index-number" methods discussed in 2 BONRIGHT, *VALUATION OF PROPERTY* (1937) 1089-92.

22. Brandeis, J., dissenting in *Southwestern Bell Tel. Co. v. Pub. Serv. Comm.*, 262 U. S. 276, 290 (1923). But see *contra*, Brown, *The Defects in Mr. Justice Brandeis' Theory of Prudent Investment as a Rate Base* (1924) 12 CALIF. L. REV. 283-96.

23. See note 14 *supra*.

24. See *Fed. Power Comm. v. Natural Gas Pipeline Co.*, 62 Sup. Ct. 736 (U. S. 1942), Reply Brief for Cross-Petitioner, pp. 93-96; Dorety, *The Function of Reproduction Cost in Public Utility Valuation and Rate-Making* (1923) 37 HARV. L. REV. 173.

(2) destroy management's incentive to reduce original cost. Used with great success by several state commissions,²⁵ urged for adoption by others,²⁶ the method of prudent investment received its greatest support in a memorable dissent of Mr. Justice Brandeis,²⁷ and has subsequently been impliedly approved by the Supreme Court at least four times.²⁸

In the instant case,²⁹ acting under the Natural Gas Act³⁰ on complaint of the Illinois Commerce Commission, the Federal Power Commission investigated rates for gas sold at wholesale by the Natural Gas Pipeline Company of America and the Texoma Natural Gas Company and found them excessive. For purposes of its interim order, the FPC "reluctantly" accepted the companies' estimates as to the reproduction cost new of the physical properties but refused to include in the rate base a separate allowance for going-concern value. Upon the rate base thus set, the FPC fixed a 6½% return, and thereupon ordered the companies to reduce rates sufficiently to bring their income rate down to this figure, a reduction of approximately thirty percent in operating revenues.³¹ On appeal to the Supreme Court from a decision in the companies' favor below,³² it was held that where the rate base is determined by the cost of reproduction new, a separate sum for going-concern value does not have to be included.³³ More important, however, than the specific holdings of the decision³⁴ is its total effect which, by

25. California, Massachusetts and Wisconsin took the lead in adopting the prudent investment principle. To the knowledge of the writer, no Massachusetts or Wisconsin case dealing with methods of rate-base determination has ever been reviewed by the United States Supreme Court; the California Commission's use of original cost was upheld in *Los Angeles Gas & Elect. Co. v. Railroad Comm.*, 289 U. S. 287 (1933) and in *Railroad Comm. v. Pac. Gas & Elect. Co.*, 302 U. S. 388 (1938). See BARRIS, *PUBLIC UTILITY CONTROL IN MASSACHUSETTS* (1930) *passim*; Goldberg, *The Massachusetts Proposals for Public Control* (1931) 11 B. U. L. REV. 54; *Milwaukee Elect. Ry. & Light Co. v. Milwaukee*, P. U. R. 1918E, 1, 23 (Wis.).

26. See NEW YORK COMMISSION ON REVISION OF PUBLIC SERVICE COMMISSION LAW, MINORITY REPORT (1930) *passim*.

27. *Southwestern Bell Tel. Co. v. Pub. Serv. Comm.*, 262 U. S. 276, 290 (1923).

28. See cases cited *supra* note 25; also, *Lindheimer v. Ill. Bell. Tel. Co.*, 292 U. S. 151 (1934) and *Dayton Power & Light Co. v. Pub. Util. Comm.*, 292 U. S. 290 (1934). Note that these four decisions were handed down at the nadir of the depression; in this connection, see notes 18-20 *supra*. See Hale, *The New Supreme Court Test of Confiscatory Rates* (1934) 10 J. LAND AND P. U. ECON. 307. But *cf.* *West v. Chesapeake & Pot. Tel. Co.*, 295 U. S. 662 (1935), which belied any expectations that the fair-value rule would be rejected.

29. *Fed. Power Comm. v. Natural Gas Pipeline Co.*, 62 Sup. Ct. 736 (U. S. 1942).

30. 52 STAT. 821 (1938), 15 U. S. C. § 717 (1940).

31. *Fed. Power Comm. v. Natural Gas Pipeline Co.*, 62 Sup. Ct. 736 (U. S. 1942), Brief for Petitioner, p. 41, n. 10.

32. *Natural Gas Pipeline Co. v. Fed. Power Comm.*, 120 F. (2d) 625 (C. C. A. 7th, 1941).

33. *Fed. Power Comm. v. Natural Gas Pipeline Co.*, 62 Sup. Ct. 736, 744-45 (U. S. 1942).

34. Natural Gas Act held constitutional; FPC's interim order directing companies to file decreased rate schedule held valid; period of amortization can be fixed as of the

narrowing the scope of judicial review, appears greatly to broaden the discretionary rate-making powers heretofore held by regulatory agencies.

Although the FPC's request that *Smyth v. Ames* be specifically overruled³⁵ was ignored by the Court, possibly for procedural reasons,³⁶ Chief Justice Stone declared that "the Constitution does not bind rate-making bodies to the service of any single formula or combination of formulas." The majority held that if the statutory requirements of a fair hearing had been met and no arbitrary result reached, the Court's "inquiry is at an end."³⁷ Black, Douglas, and Murphy, JJ., concurring with the Court's judgment, interpreted it as erasing "much which has been written in rate cases during the past half century"³⁸ and as freeing commissions from the compulsion of admitting evidence on reproduction cost or of giving weight to the element of fair-value. "The Commission may now adopt, if it chooses, prudent investment as a rate base."³⁹

The concurring justices, however, went even further. Whereas the Chief Justice, equating the Natural Gas Act standard of "reasonable" with the constitutional standard of "not confiscatory", maintained that the Court can here intervene when "the limits of due process have been overstepped",⁴⁰ Justices Black, Douglas, and Murphy advanced the conception of due process that would take from the Court the power to inquire into the substantive merits of a rate or rate base. "That judgment has been entrusted to the Commission. There it should rest."⁴¹

Underlying the concurring justices' opinion is the premise that rate-fixing is a species of price-fixing⁴² and that the substantive merits of the price set, under the *Nebbia* rule,⁴³ is not a question for judicial cognizance. If this reasoning were to be adopted by the Court, judicial review by federal courts in

entire life of the enterprise; amortization interest rate and rate of return held fair as "supported by substantial evidence." *Id.* at 741-49.

35. *Id.*, Brief for Petitioner, pp. 112-33.

36. According to a long-standing rule of appellate procedure, matter not raised in the trial courts—with few exceptions—will not be considered on appeal. See Note (1941) 50 YALE L. J. 1460. The request that *Smyth v. Ames* be overruled was not made in any of the proceedings below.

37. Fed. Power Comm. v. Natural Gas Pipeline Co., 62 Sup. Ct. 736, 743 (U. S. 1942).

38. *Id.* at 750.

39. *Id.* at 752.

40. *Id.* at 743. Cf. Brandeis, J., and Stone, J., concurring in *St. Joseph Stock Yards v. United States*, 298 U. S. 38, 73, 93 (1936).

41. Fed. Power Comm. v. Natural Gas Pipeline Co., at 753.

42. *Id.* at 749. Fixing maximum prices for an industry is probably on the constitutional side of the line between a "regulation" and a "taking of property." Comment (1942) 51 YALE L. J. 835-36, n. 76.

43. In *Nebbia v. New York*, 291 U. S. 502 (1934), the Court, in upholding a state statute authorizing a milk control board to fix minimum and maximum retail prices for milk, said, at 525, "The guaranty of due process . . . demands only that the law shall not be unreasonable, arbitrary or capricious, and that the means selected shall have a real and substantial relation to the object sought to be attained." See also Fed. Power Comm. v. Natural Gas Pipeline Co., at 749, n. 1.

state rate cases might well be limited to procedural due process. In the light of the Court's recent action in the *Rowan and Nichols* cases,⁴⁴ such an elimination of substantive due process from the Court's "special competence",⁴⁵ strongly urged by the concurring justices in the instant case,⁴⁶ may not be an unlikely development, and may possibly mean the Court's return to its position in *Munn v. Illinois*.⁴⁷ In view of the degree of finality accorded by the Court to administrative bodies in tax, tariff, and condemnation proceedings,⁴⁸ a return to judicial self-abnegation in rate proceedings would not be without precedent.

For the much criticized rule of *Smyth v. Ames*,⁴⁹ the *Natural Gas* case has substituted the doctrine that rate-making bodies "are free, within the ambit of their statutory authority", to choose any formula in ascertaining fair value or fair return, provided that a fair hearing is given and no arbitrary result is obtained.⁵⁰ If this means elimination of the problems inseparable from strict adherence to reproduction-cost, more effective and more economical regulation of utility rates should result.⁵¹

44. *Railroad Comm. of Texas v. Rowan & Nichols Co.*, 310 U. S. 573 (1940), amended, 311 U. S. 614 (1940); *id.*, 311 U. S. 570 (1941). Here Frankfurter, J., expressly disapproved the lower courts' inquiries into the reasonableness of state regulation of business. It appeared from these cases that the Supreme Court was limiting due process to its procedural aspects and that the Fourteenth Amendment was being abandoned as a check on the merits of state regulation of business. See Note, *Federal Court Review of State Regulation of Business* (1942) 51 YALE L. J. 680. In the instant case Frankfurter, J., concurring with the Chief Justice, stated that the constitutional question was not in issue. Presumably this was because the majority did not base its review directly on the Constitution but rather interpreted the statutory standard of "reasonable" in the light of past decisions holding that the lowest reasonable rate was one not confiscatory in the constitutional sense. In effect the majority then adopted the principle of stare decisis on the issue of the proper construction of "reasonable." The concurring justices, on the other hand, would reject these prior interpretations because they applied a concept of substantive "due process."

45. There is increasing evidence to the effect that substantive due process is being judicially exiled except in the fields of civil liberties and criminal procedure. See JACKSON, *THE STRUGGLE FOR JUDICIAL SUPREMACY* (1941) 283-85; Hamilton and Braden, *The Special Competence of the Supreme Court* (1941) 50 YALE L. J. 1319, 1349-57; *Fed. Power Comm. v. Natural Gas Pipeline Co.*, at 750, n. 4.

46. *Fed. Power Comm. v. Natural Gas Pipeline Co.*, at 749. But *cf.* p. 753, where the concurring justices enter the caveat that, in determining reasonable rates, "the consumer interest cannot be disregarded."

47. See note 2 *supra*. *Contra*: *Ohio Valley Water Co. v. Ben Avon Borough*, 253 U. S. 287 (1920); *Crowell v. Benson*, 285 U. S. 22 (1932). It seems likely that the force of the *Ben Avon* and *Crowell* decisions, limiting the freedom of administrative agencies, has been greatly weakened by the instant case. See Hardman, *Judicial Review as a Requirement of Due Process in Rate Regulation* (1921) 30 YALE L. J. 681.

48. Brandeis, J., concurring in *St. Joseph Stock Yards v. United States*, 293 U. S. 38, 78-80 (1936).

49. See notes 7 and 10 *supra*.

50. Stone, C. J., in *Fed. Power Comm. v. Natural Gas Pipeline Co.*, at 743.

51. See Comment, *Has Government Regulation of Utilities Proven a Failure?* (1930) 6 IND. L. J. 111.

FIDUCIARY OBLIGATION OF MAJORITY STOCKHOLDERS*

THE standards judicially imposed on directors and dominant stockholders in dealing with their corporations have traditionally been phrased in terms analogous to those which describe the duties of a trustee toward his cestui que trust.¹ This concept has not, however, noticeably influenced the course of decision. The courts have employed language which recognizes marked social benefits to be derived from the imposition of a strict fiduciary standard,² but the ideal of flexibility and a wise discretion in management has been an effective counterweight to the announced readiness to submit corporate action to judicial review.³

The recent decision of the New York Appellate Division in *Blaustein v. Pan American Petroleum and Transport Company*⁴ illustrates this reluctance on the part of the courts to substitute their business judgment for that of directors and dominant stockholders. In 1933 the Blausteins, owners of a retail organization for marketing oil products, were wholly dependent upon Pan American for their supply of gasoline. But Pan American's main sources of petroleum were located abroad, and in anticipation of a federal embargo on imported oil it planned the sale of its crude producing properties to the Standard Oil Company (N.J.). Faced with loss of their gasoline supply, the Blausteins purchased stock in Pan American and threatened to block the pending transaction. The dispute was terminated when Standard Oil of Indiana, which owned ninety-six percent of Pan American stock, and the Blausteins entered into a "definitive agreement", the express purpose of which was to make Pan American an integrated oil company. By its terms the Blausteins received approximately twenty percent of Pan American stock, with the option to resell it to Indiana at a stated price in the event of management disagreement, and the power to appoint three of nine directors. In addition, the agreement provided for the immediate allocation of Pan American funds to acquire crude oil producing properties and for the construction of a refinery of specified capacity.⁵

The failure of Indiana to comply with the agreement and its refusal to authorize establishment of a pipe line and a crude purchasing department essential to the integration of Pan American caused the Blausteins to insti-

* *Blaustein v. Pan American Petroleum & Transport Co.*, 263 App. Div. 97, 31 N. Y. S. (2d) 934 (1st Dep't 1941), *rev'g* 174 Misc. 601, 21 N. Y. S. (2d) 651 (Sup. Ct. 1940) (hereinafter cited as *Blaustein v. Pan American Co.*).

1. See, *e.g.*, *Southern Pacific Co. v. Bogert*, 250 U. S. 483 (1919); *Kavanaugh v. Kavanaugh Knitting Co.*, 226 N. Y. 185, 123 N. E. 148 (1919); *Bosworth v. Allen*, 168 N. Y. 157, 61 N. E. 163 (1901); 3 FLETCHER, *CYC. CORP.* (perm. ed. 1931) § 838; 13 *id.* § 5811; Uhlman, *The Legal Status of Corporate Directors* (1939) 19 B. U. L. Rev. 12.

2. See *Hymans v. Calumet & Hecla Mining Co.*, 221 Fed. 529, 537 (C. C. A. 6th, 1915); *Carr v. Kimball*, 153 App. Div. 825, 834, 139 N. Y. Supp. 253, 259 (1st Dep't 1912), *aff'd*, 215 N. Y. 634, 109 N. E. 1068 (1915).

3. See Rohrllich, *The New Deal in Corporation Law* (1935) 35 Col. L. Rev. 1167, 1178.

4. *Blaustein v. Pan American Co.*, 263 App. Div. 97, 31 N. Y. S. (2d) 934 (1st Dep't 1941).

5. *Id.* at 100 *et seq.*, 31 N. Y. S. (2d) at 940 *et seq.*

tute a derivative stockholder's suit charging Indiana with violation of its fiduciary duties. Uncertainty whether New York courts will enforce shareholder's contracts which substantially deprive directors of their independent business judgment,⁶ undoubtedly influenced the plaintiffs not to bring suit for breach of the "definitive agreement." But the contract was introduced in evidence to outline the obligations imposed upon Indiana by the contemplated reorganization of Pan American.⁷

In reversing the decision of the trial court for the plaintiffs, the Appellate Division held that nonfulfillment of the agreement was consonant with sound business policies and thus constituted no breach of the good faith and diligence required of a dominant stockholder. The delay in acquiring crude producing properties was found proper since the directors believed that the Texas antitrust laws made it illegal for Pan American to engage in Texas production when another wholly-owned Indiana subsidiary had already entered the field. Moreover, the court concluded that the directors properly relied upon the inaccurate⁸ opinion of Indiana's general counsel, concurred in by Pan American and Texas lawyers, in view of the confused state of Texas law and the attorney's good faith. The evidence also indicated that the Blausteins had been apprised of this difficulty before the reorganization of Pan American was undertaken. These factors, together with the severity of the penalties prescribed for violation of the Texas statutes, were said to have merited deferring the organization of a Pan American production subsidiary until the directors were convinced of its legality.⁹ The Appellate Division also decided that the action of the directors in purchasing crude oil and in leasing pipe lines from Indiana subsidiaries instead of establishing independent Pan American enterprises was justified by the uncertainty of economic conditions. The petroleum industry was harassed both by the general business depression and by vast overproduction which made expansion hazardous. Not only were the purchasing and pipe line contracts found to be reasonable in themselves; they were needed to guarantee to Pan American a dependable supply of crude oil. It was conceded that successful operation of a Pan American pipe line depended upon obtaining oil well connections in the East Texas field. But the court ruled that adequate connections could not have been procured since most of the wells were controlled by major companies unwilling to sell in view of an impending reduction of the legally allowable crude limit.¹⁰ The Appellate Division approved the finding of the trial court that technological and economic problems in the industry warranted construction of a smaller refinery. The appellate

6. See *McQuade v. Stoneham*, 263 N. Y. 323, 189 N. E. 234 (1934); *Manson v. Curtis*, 223 N. Y. 313, 119 N. E. 559 (1918). But *cf.* *Miller v. Vanderlip*, 235 N. Y. 116, 33 N. E. (2d) 51 (1941); *Clark v. Dodge*, 269 N. Y. 410, 199 N. E. 641 (1936).

7. *Blaustein v. Pan American Co.*, 174 Misc. 601, 621, 21 N. Y. S. (2d) 651, 674 (Sup. Ct. 1940).

8. On the basis of subsequent advice from Texas counsel, Pan American later organized a production subsidiary in Texas which has not fallen afoul of the antitrust laws.

9. *Blaustein v. Pan American Co.*, 263 App. Div. 97, 114 *et seq.*, 31 N. Y. S. (2d) 934, 952 *et seq.* (Sup. Ct. 1940).

10. *Id.* at 106 *et seq.*, 31 N. Y. S. (2d) 945 *et seq.*

court, however, stated that this justification of Indiana's conduct was unnecessary, since its position as majority stockholder and the existence of interlocking directorates did not evidence sufficient domination of the subsidiary to warrant the imposition of fiduciary obligations upon the parent corporation.¹¹

The trial court, on the other hand, ruled that Indiana had dominated Pan American and had prevented its integration for the purpose of diverting profits to other Indiana subsidiaries. Thus, delay in authorizing Pan American's acquisition of crude properties was held to have been designed primarily to expedite Indiana's purchasing program rather than to avoid violation of the Texas antitrust laws. This conclusion was based in part on a finding that the possibility of conflict with Texas law had been concealed from the Blausteins before the reorganization of Pan American was undertaken, and on a reversal of opinion by Indiana's general counsel after having been assured of the legality of the venture by a Texas lawyer. The court also found that the directors had failed to consider the opinion of Pan American's attorneys and to seek immediate advice from experts in Texas law. Furthermore, the supposed legal difficulties might have been circumvented by purchasing suitable property in Louisiana. The finding that a large part of the oil produced from the Indiana wells acquired during this period was later resold to Pan American at a profit was taken as further confirmation of an intent to divert profits to Indiana.¹²

Nor was the trial court persuaded that evidence concerning available oil well connections warranted the directors' decision not to construct a pipe line which would have saved Pan American a million dollars annually. The independent ownership of fifty percent of the East Texas wells supported the court's conclusion that adequate connections could have been procured. Moreover, numerous connections had become available because of the overproduction of oil, as shown by the fact that another company had successfully conducted a program similar to that contemplated by Pan American. Lacking facilities of its own, Pan American was compelled to negotiate contracts with Indiana subsidiaries, enabling the latter to renew expiring pipe line leases and to sell at posted prices crude oil which had been purchased on a "distress" market and stored. For these reasons, Indiana was ordered to account for the profits obtained by denying Pan American the opportunity to acquire such profits for itself.¹³

In addition to their disagreement on the facts, the two courts also differed in their application of the law. The Appellate Division determined the legality of Indiana's actions by the prevailing standards governing the conduct of dominant stockholders. A majority of courts have adopted the rule that transactions in which dominant stockholders have a personal interest

11. *Id.* at 119-25, 31 N. Y. S. (2d) at 956-62. See also *Gamble v. Queens County Water Co.*, 123 N. Y. 91, 25 N. E. 201 (1890); 13 FLETCHER, *op. cit. supra* note 1, § 5829; Rohrllich, *Suits in Equity by Minority Stockholders As a Means of Corporate Control* (1933) 81 U. OF PA. L. REV. 692.

12. *Blaustein v. Pan American Co.*, 174 Misc. 601, 630 *et seq.*, 21 N. Y. S. (2d) 651, 682 *et seq.*

13. *Id.* at 640 *et seq.*, 21 N. Y. S. (2d) at 690 *et seq.*

cannot be challenged unless clearly intended to divest the minority of their property rights.¹⁴ A market place standard of fairness and good faith rather than the receipt of personal gain from the fiduciary relationship is the criterion by which the validity of such transactions is judged.¹⁵ Normally courts will also permit directors to engage in a competing business or otherwise acquire interests adverse to those of their corporation;¹⁶ it is only when a director represents both the corporation and himself that the transactions are voidable at the option of the shareholders,¹⁷ without regard to fairness and good faith.¹⁸ Despite repeated admonitions that contracts in which directors are adversely interested will be set aside if the slightest irregularity appears,¹⁹ courts seldom interfere without clear evidence of undue prejudice to the corporation. Stressing these established principles, the Appellate Division disregarded the conflicting interests of the directors and emphasized the fact that Pan American prospered under Indiana's control.²⁰ And since the trial court had affirmed the fairness of the transactions and the good faith of the directors, the appellate court found no breach of fiduciary duties.

The decision below proceeded upon a direct application of the trust concepts to which the opinions have so frequently paid lip-service. The court relied heavily upon cases which state the rule of undivided loyalty governing the conduct of formal trustees,²¹ and the corollary that the fairness of a transaction is immaterial once a conflict between self-interest and fiduciary duty has been established.²² Reliance was also placed on cases applying these tests

14. *Jones v. Missouri-Edison Elect. Co.*, 144 Fed. 765 (C. C. A. 8th, 1906); *Ervin v. Oregon Ry. & Navig. Co.*, 27 Fed. 625 (C. C. S. D. N. Y. 1886); *Shaw v. Davis*, 73 Md. 308, 28 Atl. 619 (1894). *Contra*: *Wheeler v. Abilene Nat. Bank Bldg. Co.*, 159 Fed. 391 (C. C. A. 8th, 1908) (fairness of price immaterial); *Pearson v. Concord R. R.*, 62 N. H. 537 (1883) (fairness of contract immaterial).

15. See *International Radio Telegraph Co. v. Atlantic Communication Co.*, 290 Fed. 698, 702 (C. C. A. 2d, 1923); *Allied Chemical & Dye Corp. v. Steel & Tube Co.*, 14 Del. Ch. 1, 18, 120 Atl. 486, 493 (1923).

16. See *Twin-Lick Oil Co. v. Marbury*, 91 U. S. 587 (1875); *Barr v. Pittsburgh Plate-Glass Co.*, 57 Fed. 86 (C. C. A. 3d, 1893); *Carper v. Frost Oil Co.*, 72 Colo. 345, 211 Pac. 370 (1922); *Minnesota Loan & Trust Co. v. Peteler Car Co.*, 132 Minn. 277, 156 N. W. 255 (1916). See Comment (1939) 39 COL. L. REV. 219, 224.

17. The cases are collected in BALLANTINE, *MANUAL OF CORPORATION LAW AND PRACTICE* (1930) § 123.

18. See *Holcomb v. Forsyth*, 216 Ala. 486, 490, 113 So. 516, 520 (1927); *Tenison v. Patton*, 95 Tex. 284, 292, 67 S. W. 92, 94 (1902); 3 FLETCHER, *op. cit. supra* note 1, § 926.

19. See *Geddes v. Anaconda Mining Co.*, 254 U. S. 590, 599 (1920); *Twin-Lick Oil Co. v. Marbury*, 91 U. S. 587, 588 (1875).

20. Between 1933 and 1939 Pan American consolidated assets increased nearly \$25,000,000 and its earning schedule increased from a net loss of nearly \$1,500,000 to a net profit of more than \$5,000,000. *Blaustein v. Pan American Co.*, 263 App. Div. 97, 130, 31 N. Y. S. (2d) 934, 966 (1st Dep't 1941).

21. *Michoud v. Girod*, 4 How. 503 (1846); *Meinhard v. Salmon*, 249 N. Y. 458, 164 N. E. 545 (1928). See 3 BOGERT, *TRUSTS AND TRUSTEES* (1935) § 543.

22. *Jackson v. Smith*, 254 U. S. 586 (1921); *McGruder v. Drury*, 235 U. S. 106 (1914); *Wendt v. Fischer*, 243 N. Y. 439, 154 N. E. 303 (1926).

in disqualifying directors from entering into transactions in which they have a personal interest.²³ Thus, while the fairness and good faith of Indiana's actions were conceded, the court nevertheless held that the director's adverse interests had led to unwarranted diversion of profits from Pan American.

The respective positions of the courts are sharply contrasted in their decisions on the validity of Indiana's acquisition of crude properties to the exclusion of Pan American. The trial court imposed a constructive trust on the property in favor of Pan American, but this action was reversed by the appellate court. In deciding this issue, both courts spoke in terms of the corporate opportunity doctrine, which forbids a corporate fiduciary to preempt an opportunity in which his corporation has a precise and definite interest.²⁴ The Appellate Division, strictly construing the doctrine, held that Pan American's interest in the crude properties was too vague and indefinite to come within the rule. The court stated that it was never "proposed that Pan American purchase any of the properties" and that Indiana's action was merely "the negative one of postponing activity in crude production."²⁵ No weight was given to the conflict of interest implicit in the dual role of Indiana as dominant stockholder and as competitor. The lower court, on the other hand, stressed Indiana's profitable acquisition of crude properties to the detriment of Pan American rather than the latter's actual or expectant interest in the property. This position, which is concerned primarily with enforcing a duty of undivided loyalty on the part of corporate fiduciaries, is consistent with the recent judicial trend.²⁶

It cannot be hoped that the application of the ambiguous standards of "fairness" and "good faith" will lead to a satisfactory solution of the complex fact situations presented in modern corporate litigation. Particularly in view of the irresponsibility of controlling groups, a prophylactic rule which imposes liability without regard to the tests of "fairness" and "good faith" seems necessary. The recent case of *Overfield v. Pennroad Corporation*²⁷ suggests the potentialities of such a rule. In that case, the Pennsylvania Railroad organized and operated the Pennroad Corporation as an independent agency for the purpose of gaining control over certain railroads. As a result of this domination, secured by means of interlocking directorates and voting trusts, Pennroad's investments were used to further Pennsylvania's program of expansion rather than to benefit its own stockholders. Although

23. *U. S. Steel Corp v. Hodge*, 64 N. J. Eq. 807, 54 Atl. 1 (1903); *Munson v. Syracuse*, 103 N. Y. 59, 8 N. E. 355 (1886). See 3 FLETCHER, *op. cit. supra* note 1, § 930.

24. For an extensive discussion of the corporate opportunity doctrine see Fuller, *Restrictions Imposed by the Directorship Status on the Personal Business Activities of Directors* (1941) 26 WASH. U. L. Q. 189. See Note (1939) 39 COL. L. REV. 219.

25. *Blaustein v. Pan American Co.*, 263 App. Div. 97, 127, 31 N. Y. S. (2d) 934, 963 (1st Dep't 1941).

26. See *Irving Trust Co. v. Deutsch*, 73 Fed. (2d) 121 (C. C. A. 2d, 1934), (1935) 44 YALE L. J. 527; *Overfield v. Pennroad Corp.*, 42 F. Supp. 586 (E. D. Pa. 1941); *Singer v. Carlisle*, 26 N. Y. S. (2d) 172 (Sup. Ct. 1940), *aff'd*, 261 App. Div. 897, 26 N. Y. S. (2d) 320 (1st Dep't 1940); *Guth v. Loft*, 5 Atl. (2d) 503 (Sup. Ct. Del. 1939).

27. 42 F. Supp. 586 (E. D. Pa. 1941).

the directors offered evidence to prove their good faith and the fairness of their conduct, the court held that their conflicting interests prevented fulfillment of their fiduciary obligations.

The feasibility of effective application of the fiduciary concept to corporate management in favor of unknown shareholders is questionable.²⁸ The efficacy of the concept is further weakened by the grave deficiencies inherent in the derivative stockholder's suit as the only instrument of enforcement.²⁹ But, if minority interests are to be protected, courts must, until more adequate restraints can be devised, give full effect to available controls, however weak they may be.

JUDICIAL RESTRICTIONS ON PEACEFUL PICKETING BY "NON-LABOR" GROUPS

To protect activities of labor from excessive judicial interference, state¹ and federal² statutes curb the use of injunctions in "labor disputes". Narrow judicial construction³ of this limiting phrase in the statutes has subjected unions not only to prosecution under the antitrust laws but, as well, to injunctions which issue almost automatically⁴ when no labor dispute is found to exist. Consequently the question arises to what extent the constitutional immunity recently extended to peaceful picketing⁵ restores to unions the freedom of action they have lost by narrow judicial interpretation of the anti-injunction laws. On this point a recent New York Supreme Court case⁶ raises further questions whether the protection accorded activities of labor unions should be extended to the activities of groups of "independents" resembling labor unions.

In this case the parties to the dispute were seven New York newspaper publishers and a union of newsdealers which bought papers from the publishers and resold them to the public. Claiming that the terms of the sales contract were unjust, the union refused to continue selling the papers and picketed non-member newsdealers who would not join in the boycott. The State Attorney-General brought action for a temporary injunction, alleging

28. See Dodd, *Is Effective Enforcement of the Fiduciary Duties of Corporate Managers Practicable?* (1935) 2 U. OF CHI. L. REV. 194.

29. See Berlack, *Stockholders' Suits: A Possible Substitute* (1937) 35 MICH. L. REV. 597.

* *People v. Masiello*, 177 Misc. 608, 31 N. Y. S. (2d) 512 (Sup. Ct. 1941).

1. See Smith and De Lancey, *The State Legislatures and Unionism* (1940) 38 MICH. L. REV. 987, 1013 *et seq.*

2. Norris-La Guardia Act, 47 STAT. 70 (1932), 29 U. S. C. §§ 101-15 (1940). For a concise statement of the Act see 1 TELLER, *LABOR DISPUTES AND COLLECTIVE BARGAINING* (1940) § 200.

3. See Galenson and Spector, *The New York Labor-Injunction Statute and the Courts* (1942) 42 COL. L. REV. 51; Comment (1940) 49 YALE L. J. 537.

4. See Feinberg, *Picketing, Free Speech and Labor Disputes* (1940) 17 N. Y. U. L. Q. REV. 385, 388.

5. *Thornhill v. Alabama*, 310 U. S. 88 (1940).

6. *People v. Masiello*, 177 Misc. 608, 31 N. Y. S. (2d) 512 (Sup. Ct. 1941).

that the union was violating the antitrust laws and that no labor dispute existed within the statutory definition. The court, holding that the members of the union were independent contractors, granted the injunction.⁷ The corollary to the independent contractor holding was the further conclusion that the dispute did not concern "terms or conditions of employment" as required by Section 876(a) of the New York Civil Practice Act defining labor disputes.⁸ The court also found that the newsdealers association was not a union but a trade association and that, while it did not intend to eliminate competition, its campaign had that "inevitable tendency" and was a violation of the Donnelly Act,⁹ the state antitrust law.

This exclusion of an association of "entrepreneurs" from the protection of the anti-injunction laws follows a policy which the Supreme Court of the United States has, in a recent case, expressly approved.¹⁰ That Court held that the Norris-La Guardia Act gave no immunity from the antitrust laws to an association of "commodity sellers" which has conspired to monopolize the fish trade.¹¹ The Court argued that groups of "independent businessmen" masquerading as trade unionists have no legitimate claim to the privileges which legislation has extended to bona fide labor unions. Although this premise is undoubtedly sound, the criteria presently used are unsatisfactory for distinguishing between those groups within, and those without, the protection provided by the statutes.¹²

According to the law as it now stands, groups of independents are read out of the statutes through the use of a criterion borrowed from the law of agency and designed for tort, contract and workmen's compensation cases. Formal relations and doubtful analogy should not be brought in to control the decision of cases of this kind in the labor field. The essential inquiry

7. In this connection the degree of control exercised by the publishers over the newsdealers is relevant; see p. 1041 *infra*. The practices referred to have caused previous litigation. See *Lucomsky v. Palmer*, 141 Misc. 278, 252 N. Y. Supp. 529 (Sup. Ct. 1931); *Brown v. Metropolitan News Co.*, 149 Misc. 536, 267 N. Y. Supp. 623 (Sup. Ct. 1933).

8. See N. Y. CIV. PRAC. ACT § 876(a)(10)(c), N. Y. Laws 1935, c. 477, § 10(c). The same words occur in the Norris-La Guardia Act, 47 STAT. 70, § 13(c) (1932), 29 U. S. C. § 113(c) (1940).

9. N. Y. GEN. BUSINESS LAW Art. 22 § 340, N. Y. Laws 1918, c. 490. Cases reaching the result of the principal case are *People v. Distributor's Division*, 169 Misc. 255, 7 N. Y. S. (2d) 185 (Sup. Ct. 1938); *Fertel v. Rosenzeig*, 28 N. Y. S. (2d) 6 (Sup. Ct. 1941).

10. *Columbia River Packers Ass'n v. Hinton*, 62 Sup. Ct. 520 (U. S. 1942) (unanimous opinion).

11. In the *Hinton* case, cited *supra* note 10, the fishermen's union boycotted a packer because he would not purchase fish exclusively from its members. Since his supply of fish was thereby cut off he sought an injunction against the boycott. The Supreme Court refused to extend labor immunities to a dispute between businessmen over the terms of a contract of sale. It was held that to obtain protection under the Norris-La Guardia Act a dispute must have some bearing on the employer-employee relationship. See cases cited note 9 *supra*.

12. See 2 TELLER, *op. cit. supra* note 2, § 422. The small body of law on this matter is collected in Galenson and Spector, *The New York Labor-Injunction Statute and the Courts* (1942) 42 COL. L. REV. 51, 55.

is rather the nature of the demands made and the circumstances surrounding the relationship between "independents" and those with whom they are negotiating. Thus the independent contractor classification of itself should not be enough to support the automatic¹³ issuance of an injunction¹⁴ when the character of the demands pressed by the independents is equivalent to the demands customarily presented to employers by bona fide employees. The same is true when the relationship resembles the employer-employee status — *e.g.*, if the independents had at one time been employees, or if financial aid is extended by the company to the independents to allow them to secure equipment. In the principal case the publishers prescribe the place where the newsdealer is to set up his stand, the number of papers he can sell, how the papers are to be arranged on the stand, and the price at which the papers are to be sold. These practices are characteristic of the employer-employee relationship, and to deny the newsdealers the benefits of anti-injunction legislation may deprive them of the only economic weapons appropriate to their status.

Even if such restrictions are read into the anti-injunction laws, the constitutional right to picket¹⁵ peacefully should be extended to include groups other than ordinary labor unions. The United States Supreme Court has declared that peaceful picketing, even in the absence of an immediate employer-employee relationship, is an exercise of the right of free speech.¹⁶ Furthermore, a recent decision of that Court makes it plain that a state cannot defeat the constitutional guarantee by limiting its application to a labor dispute as narrowly defined by state law.¹⁷ In that case the New York Court of Appeals had ruled that no "labor dispute" existed and therefore the doctrine of *Thornhill v. Alabama* did not apply, where a bona fide union was picketing customers of "independent vendors" in an effort to make the vendors join the union and hire assistants.¹⁸ By this reversal of the New York decision, the Supreme Court has made the application of the *Thornhill* doctrine a federal question. The Supreme Court has not as yet had occasion to decide whether this protection is to extend to groups other than labor unions.¹⁹ Since many non-labor groups have found picketing to be

13. See note 4 *supra*.

14. There is at least a hint that the United States Supreme Court will employ such an approach. Mr. Justice Black in the first *Milk Drivers* case found it significant "that the 'vendors' were actually regarded as employees" notwithstanding their independent status. *Milk Wagon Drivers' Union v. Lake Valley Farm Products, Inc.*, 311 U. S. 91, 98 (1940). See *Suchodolski v. American Federation of Labor*, 127 N. J. Eq. 511, 14 A. (2d) 51 (Ch. 1940).

15. *Thornhill v. Alabama*, 310 U. S. 88 (1940) (striking down a state anti-picketing statute); *Carlson v. California*, 310 U. S. 106 (1940) (voiding a county ordinance of the same nature). It should be noticed that the failure of a state to enact an anti-injunction statute defining labor disputes has no bearing on the extent to which picketing as a free speech right will be permitted. *Alabama in the Thornhill case, supra*, had no such statute.

16. *American Federation of Labor v. Swing*, 312 U. S. 321 (1941).

17. *Bakery Drivers' Union v. Wohl*, 62 Sup. Ct. 816 (U. S. 1942).

18. *Wohl v. Bakery Drivers' Union*, 285 N. Y. 843, 35 N. E. (2d) 506 (1941).

19. But see *New Negro Alliance v. Sanitary Grocery Co.*, 303 U. S. 552 (1938), where a negro "betterment association" was permitted to picket a store refusing to employ

a useful device for publicizing their economic grievances, the question is an urgent one. The Court has been willing to extend a broad protection to various types of civil liberties.²⁰ Moreover, on principle it may be argued that constitutional protection should be extended wherever the demands of a group are not attended by violence or unnecessary hardship to strangers to the issue.²¹ To limit the *Thornhill* doctrine to "labor unions" would deprive similar groups from making known their legitimate grievances to the public whose continued patronage may perpetuate existing injustices.

When in the *Masiello* case the effect of the *Thornhill* case was raised, the court held that the doctrine of that decision does not apply where the picketing is in restraint of trade. This "lawful objective" test²² had previously been applied where the applicability of the New York anti-injunction law was being considered. Particularly in the field of "labor activity" the courts should not be permitted to read into the legislative or constitutional declaration their own concepts of the legitimate end.²³ To allow state courts thus to limit the *Thornhill* doctrine would similarly emasculate the constitutional right and leave its application completely dependent on interpretation by the state courts.

Exercise by state courts of such extensive interpretive powers contains many possibilities for abuse. This is indicated by the *Meadowmoor*²⁴ decision which permits state courts to grant injunctions even against peaceful picketing when violence of a serious nature has occurred.²⁵ In drawing the line

colored workers. This case preceded the *Thornhill* decision so that non-union picketing was upheld without assistance from the First Amendment. See also Comment (1941) 41 COL. L. REV. 89.

20. *Cantwell v. Connecticut*, 310 U. S. 296 (1940) (free religious communication); see *Bridges v. California*, 62 Sup. Ct. 190 (U. S. 1941). But cf. *Minersville School Dist. v. Gobitis*, 310 U. S. 586 (1940).

21. See opinion of Mr. Justice Frankfurter in *Carpenters' and Joiners' Union v. Ritter's Cafe*, 62 Sup. Ct. 807 (U. S. 1942).

22. *Opera-on-Tour, Inc. v. Weber*, 285 N. Y. 348, 34 N. E. (2d) 349 (1941), 51 YALE L. J. 144. See *Schwab v. Moving Picture Machine Operators*, 165 Ore. 602, 109 P. (2d) 600 (1941). This doctrine deprives anti-injunction laws of their effectiveness. They define lawfulness, yet this test allows courts to reenter the field from which these statutes sought to remove them.

23. Cf. *American Furniture Co. v. Chauffeurs', Teamsters' and Helpers' Local*, 222 Wis. 338, 364, 268 N. W. 250, 262 (1936). See 1 TELLER, *op. cit. supra* note 2, 59 (Supp. 1941). The judicial vicissitudes of Section 6 of the Clayton Act, 38 STAT. 731, § 6 (1913), 29 U. S. C. § 51 (1940), offer a familiar horrible example. See, *cf.*, *Duplex Printing Press Co. v. Deering*, 254 U. S. 443 (1921); *Bedford Cut Stone Co. v. Journeymen Stone Cutters' Ass'n.*, 274 U. S. 37 (1927).

24. *Milk Wagon Drivers' Union v. Meadowmoor Dairies*, 312 U. S. 287 (1941).

25. See *Borden Co. v. Brotherhood of Teamsters*, 152 S. W. (2d) 828 (Tex. Civ. App. 1941); *Chrisman v. Culinary Workers' Union*, 115 P. (2d) 553 (Cal. App. 1941) (noise is sufficient to justify injunction against picketing). Cf. *Wisconsin Employment Relations Board v. Milk & Ice Cream Drivers' Union*, 238 Wis. 379, 299 N. W. 31 (1941). Extreme examples which suppress peaceful picketing are *Busch Jewelry Company v. United Retail Employees' Union*, 281 N. Y. 150, 22 N. E. (2d) 320 (1939) and *Gevas v. Greek Restaurant Workers' Club*, 99 N. J. Eq. 770, 134 Atl. 309 (Ch. 1926) (menacing silence is coercion).

between the constitutional right and exercise of the state's power to preserve order, the majority in the *Mcadownmoor* case ruled that peaceful picketing may continue unless the "momentum of fear"²⁶ induced by the violence makes impossible the preservation of peace.²⁷ Only when the peaceful picketing is so enmeshed with contemporaneously violent conduct as to be a part of a coercive thrust is an injunction justified. In theory this is a reasonable compromise between the preservation of the Bill of Rights and the functions of the state police power, but the result is not compatible with the freedom of communication desirable for full airing of labor grievances. State court decisions since the *Mcadownmoor* case have amply demonstrated the danger of granting local courts power to nullify a constitutional right.²⁸ If a single judge is convinced that future picketing will be violent, the union's attempts to enlist public support will be enjoined, even though violence induced by the employer will not curtail the latter's freedom of speech.²⁹ The Supreme Court in the *Mcadownmoor* case suggested criteria for testing the peaceful character of picketing. These criteria, inevitably inexact, have in part made possible the inequitable result just referred to.

The requirements of the Bill of Rights are to a degree in conflict with the need for orderly settlement of disputes. As the scope of the *Thornhill* doctrine becomes clear, the Supreme Court will undoubtedly delimit the discretion which the states may exercise in resolving these opposing demands. The states' discretion in resolving these opposing demands should be narrowly limited by criteria laid down by the Supreme Court to define the scope of the *Thornhill* doctrine. Standards such as the lawfulness of the objective, mentioned in the principal case, are vague and unsatisfactory.³⁰ And where demands are made for public sympathy to remedy an economic or social grievance, no distinction should be drawn between "labor" and "non-labor" groups.³¹

26. 312 U. S. 287, 294 (1941).

27. *May's Furs and Ready-to-Wear, Inc. v. Bauer*, 282 N. Y. 331, 26 N. E. (2d) 279 (1940); *Nann v. Raimist*, 255 N. Y. 307, 174 N. E. 690 (1931). Cf. Mr. Justice Black, dissenting in the *Mcadownmoor* case, 312 U. S. 287, 299 (1941). The restrictive possibilities of the *Mcadownmoor* case have been well resisted in *Ellingsen v. Milk Wagon Drivers' Union*, 377 Ill. 76, 35 N. E. (2d) 349 (1941), and *Isolantite v. United Electrical Radio Workers*, 22 A. (2d) 796 (N. J. Ch. 1941). Only "clear and present danger" justifies the abridgment of a constitutional right. *Schenck v. United States*, 249 U. S. 47, 52 (1919). "The substantive evil must be extremely serious and the degree of imminence extremely high." *Bridges v. California*, 62 Sup. Ct. 190, 194 (1941).

28. See note 24 *supra*. Mere suggestions of violence may lead to an injunction in some courts. Such a result distorts the intent of the court in the *Mcadownmoor* case. ". . . It is of prime importance that no constitutional freedom, least of all the guarantees of the Bill of Rights, be defeated by insubstantial findings of fact screening reality," 312 U. S. 287, 293 (1941).

29. *N. L. R. B. v. Ford Motor Co.*, 114 F. (2d) 905 (C. C. A. 6th, 1940), *cert. denied*, 312 U. S. 689 (1941).

30. And see *Carpenters' and Joiners' Union v. Ritter's Cafe*, 62 Sup. Ct. 807 (U. S. 1942).

31. Compare *Valentine v. Chrestensen*, 10 U. S. L. WEEK 4335 (U. S. 1942).