

NOTES

EFFECT OF COURT DECREE OF SPECIFIC PERFORMANCE UPON POWER OF NLRB TO INVALIDATE CONTRACT*

AFTER conducting a lengthy organization campaign in the face of brisk Company resistance, the United Electrical and Radio Workers, a CIO affiliate, succeeded in forming a local union among the employees of the National Electric Products Corporation. Though the United claimed to represent a majority of the employees, its requests for a conference were ignored by the Company. Instead, the Company suddenly recognized an A. F. of L. affiliate, the International Brotherhood of Electrical Workers, as sole bargaining agent; actively assisted the subsequently formed local in enrolling employees; and signed an agreement providing, in effect, for a closed shop.¹ The United immediately filed charges with the NLRB and, by calling a strike, effected a complete shutdown of the plant. When the Company capitulated by agreeing to re-employ all the workers without discrimination, the Brotherhood filed a bill in a federal district court for specific enforcement of its agreement with the Company. The Company did not deny the validity of the contract; instead, it answered that the plant could not possibly have been re-opened without making concessions amounting to a breach of the contract. The court ruled the answer insufficient, and decreed specific performance.² A few days after the Brotherhood had filed its bill in the federal court, the NLRB issued a complaint, but hearings were not held until after the court had handed down its decree. Nevertheless the Board invalidated the "closed shop" contract and ordered an election of representatives on the ground that the contract itself was a discriminatory device prohibited by the Wagner Act³ and that it was consummated through the unfair labor practices of the Company.⁴

*In the Matter of National Electric Products Corp., C-219 and R-241, 3 NLRB No. 47 (Aug. 30, 1937).

1. The company agreed to employ only members of the Brotherhood or else to check off union dues from those employees who did not join the Brotherhood.

2. International Brotherhood of Electrical Workers, Local Union B. 1073 *et al.* v. National Electric Products Corp., 1 PRENTICE-HALL LAB. SERV. footnote ¶15642 (W. D. Pa. July 29, 1937).

3. 49 STAT. 449 (1935), 29 U. S. C. §151 (Supp. 1937). Section 8(3) provides that it shall be an unfair labor practice for an employer "by discrimination in regard to hire or tenure of employment or any term or condition of employment to encourage or discourage membership in any labor organization."

4. In the Matter of National Electric Products Corp., C-219 and R-241, 3 NLRB No. 47 (Aug. 30, 1937), (1937) 32 ILL. L. REV. 353, (1937) 5 UNIV. OF CHI. L. REV. 148, (1937) 6 I. J. A. BULL. 52. The Brotherhood won the election by a vote of 780 to 675. In the Matter of National Electric Products Corp., R-241, 3 NLRB No. 47(b) (Oct. 18, 1937). The United challenged 155 ballots, but later abandoned the contest, at the same time reiterating its charges that the company had actively electioneered on behalf of the Brotherhood. N. Y. Times, Sept. 28, 1937, p. 8, col. 5. The company

Contrary to the impression created by the attendant barrage of untempered criticism,⁵ exercise of the Board's power to invalidate a contract⁶ under these circumstances conforms clearly to accepted principles.⁷ The Board's action did not violate any canon of the doctrine of *res judicata*.⁸ Since the validity of the contract was not considered in the case before the district court, and since neither the CIO union nor the Board was a party to that proceeding, the court decree could hardly foreclose Board action. Apart from these technical considerations, the Board's assumption of jurisdiction was undoubtedly also justified on broader grounds. An unfairly executed labor contract acquires no aura of sanctity merely because a court has decreed its specific performance. Ordinarily, the court would not even consider whether the contract was consummated as a result of unfair labor practices, particularly when the parties are anxious to conceal the circumstances of its creation. Even if it were interested in this phase, a court is ill-equipped to make the investigation necessary to ascertain these facts. And in any case a court would seem to be precluded from making an initial determination of the propriety of a labor contract, since the Board is vested with exclusive jurisdiction over unfair labor practices.⁹ Nevertheless, should a court presume to examine the validity of the contract, the Board would still be bound to assert its exclusive jurisdiction. Otherwise, an employer could conveniently thwart the purposes of the National Labor Relations Act by securing

appealed from the District Court decree and petitioned for a review of the NLRB order invalidating the contract. Both proceedings were pending before the Court of Appeals for the Third Circuit, but no further action has been taken. Apparently the election has rendered the issues moot. Communication to YALE LAW JOURNAL from Defendant's attorney, March 7, 1938.

5. See, e.g., N. Y. Times, Sept. 2, 1937, p. 1, col. 6; N. Y. Herald-Tribune, Sept. 2, 1937, p. 8, col. 2.

6. It is assumed throughout this note that the Board has power to void contracts in proper cases. This power has frequently been exercised when agreements have not been made with the freely chosen representative of a majority of the employees. See, e.g., In the Matter of Stone Knitting Mills Co., R-200, R-201 and R-202, 3 NLRB No. 22 (1937); In the Matter of Consolidated Edison Co. of N. Y., Inc., C-245, 4 NLRB No. 10 (1937); In the Matter of Lenox Shoe Co., Inc., C-255 and R-209, 4 NLRB No. 54 (1937). This note will consider whether in circumstances otherwise appropriate a prior court decree of specific performance deprives the Board of its power to invalidate contracts.

7. In an earlier case [In the Matter of Hill Bus Company, C-141, 2 NLRB 781 (1937)], the Board invalidated a closed-shop contract previously enforced by a state equity court [Unreported chancery case affirmed in *Hudson Bus Transportation Drivers' Ass'n v. Hill Bus Co.*, 121 N. J. Eq. 582, 191 Atl. 763 (1937)].

8. For a statement of the principles of *res judicata*, see Von Moschzisker, *Res Judicata* (1929) 38 YALE L. J. 299.

9. Section 10(a) of the National Labor Relations Act declares that the Board's power to prevent any unfair labor practice is "exclusive, and shall not be affected by any other means of adjustment or prevention that has been or may be established by agreement, code, law or otherwise." As indicative of the disapproval with which the Supreme Court views interference by a District Court with the NLRB, see *Myers v. Bethlehem Shipbuilding Corp., Ltd.*, 58 Sup. Ct. 459 (1938).

court consecration of contracts hastily negotiated with unrepresentative but friendly employee groups.

While the Board was justified in assuming jurisdiction, the institution of proceedings before two dissimilar tribunals involves the employer in a series of legal labyrinths from which no easy formula can extricate him. Of course, if the conflicting claims of rival unions raise genuine doubts in the employer's mind, he may at the outset avoid the possibility of being subjected to inconsistent decrees by refusing to contract with a union until it has been certified as the proper representative by the Board.¹⁰ But when an employer either deliberately or unwittingly enters into a contract with a possible minority union, he may be placed in the position of defending actions both in a court and before the NLRB. Various alternatives are then open to the court, acting upon its own motion or at the initiative of the Board, employer, or rival union.

When a court has under consideration an action based upon a contract whose validity under the Wagner Act will shortly be adjudicated by the NLRB, several devices are available to avoid a conflict. Since the court can not examine the validity of the contract in issue, the simplest would be to relinquish jurisdiction completely in favor of the Board.¹¹ This was the course recently adopted by a Minnesota Federal District Court. An employer sought to restrain a striking minority of his employees from interfering with the contract he had made with the alleged majority on the ground that such interference was unlawful under the Wagner Act. In declining jurisdiction, the court pointed to the "anomalous situation" which would result if the courts attempted to usurp the NLRB's function of determining whether or not the union purporting to represent the majority of employees is appropriate for the purposes of collective bargaining.¹² That no case was pending

10. For the procedure when an employer consents to an election and agrees to recognize the winner as the exclusive bargaining agents for all his employees, see *Certifying Bargaining Agents: A Case Study* (1937) 1 LAB. REL. REP. 90. The New York Labor Relations Act [N. Y. Laws 1937, c. 443, art. 20 §705.3] provides for an investigation of a controversy concerning representation upon petition by the employer. See Comment (1938) 51 HARV. L. REV. 722, 725.

11. Federal courts have surrendered jurisdiction to the Interstate Commerce Commission for the sake of uniformity of decision and the exercise of expert opinion. *Texas & Pacific Ry. v. American Tie Co.*, 234 U. S. 138 (1914); *Standard Oil Co. v. United States*, 283 U. S. 235 (1931). But the remedy afforded by the I. C. C. is just as complete as that offered by a district court. Cf. also *Pennsylvania v. Williams*, 294 U. S. 176 (1935) (Federal District Court should have relinquished jurisdiction over receivership suit when state had set up agency to administer assets of insolvent building and loan associations); In the Matter of *Genesee Valley Gas Co., Inc.*, File No. 52-1 SEC Release No. 981 (Jan. 24, 1938, Public Utility Holding Company Act of 1935) (Fact that current accounting practices investigation by New York Public Service Commission might render unfeasible reorganization plan given as one of grounds for SEC's withholding approval of plan); *American Brake Shoe & Foundry Co. v. Pittsburgh Rys.*, 270 Fed. 812 (W. D. Pa. 1918).

12. *Lund v. Woodenware Workers Union*, 19 F. Supp. 607 (D. Minn. 1937). The court refused to decide whether the Wagner Act proscribed picketing by a minority union even when a contract was made with a union certified by the Board.

before the Board at the time especially emphasizes the responsibility of the court when one is. But while the result may be satisfactory when the employer seeks to restrain some of his employees from tortious interference with a labor contract of dubious validity, adherence to such a precedent when a union sues for specific performance of a bona fide labor contract¹³ would seriously impair one of labor's important remedies.¹⁴ For this reason, the court would perhaps do better to avoid a conflict with the Board by staying its own action until the determination of the Board proceedings involving the contract rather than by relinquishing jurisdiction entirely.¹⁵

The granting of a stay in this situation would be in accordance with the relevant standards traditionally considered in a private law case.¹⁶ While none of these criteria are in themselves controlling, in order to exercise its discretion in this manner the court generally must be satisfied that the eventual decree of the other court would have a binding effect. Although the parties and issues in these two actions are not so identical as to make one of the suits superfluous, it is clear that the ultimate issue is the legality of the contract; and should this be decided adversely, the plaintiff in the court action would be precluded from obtaining a decree of specific performance even though it was not a party to the case before the Board.¹⁷ Ordinarily, courts also consider whether the action sought to be preferred was commenced before the one sought to be stayed, whether the interests of the stayed party will be adequately represented in the other case, and whether the stayed party will be otherwise prejudiced. If priority is deemed significant in this type of situation, the court should consider whether filing

13. The *Lund* case might be distinguished from the instant case on the ground that the cause of action there was based on the Wagner Act while the right to specific performance exists independently of that Act.

14. The growing tendency specifically to enforce collective agreements at the behest of a union is discussed in Simpson, *Fifty Years of American Equity* (1936) 50 HARV. L. REV. 171, 200 *et seq.* See also Comment (1938) 51 HARV. L. REV. 520, 525, *et seq.*

15. This assumes, of course, that at least preliminary Board proceedings have already been started.

16. See (1937) 46 YALE L. J. 897.

17. Especially when the validity of a contract is in issue, it may plausibly be argued that, like the decision of a probate court as to the validity of a will [*United States v. Napoleon*, 296 Fed. 811 (C.C.A. 5th, 1924)], the proceedings before the Board are in rem, binding "all the world." Even without pursuing this line of argument, the plaintiff union would be bound where, as in the instant case, it was made a party to the proceedings, although it did not appear. And even if a party in the stayed action is not a party to the preferred action, a stay may be issued where the preferred tribunal has undertaken to determine the validity of the contract in issue. *Holt v. Uvalde Co.*, 269 S. W. 73 (Tex. Comm. App. 1935). These arguments are most persuasive when the Board's order becomes *res judicata* upon affirmation by the Circuit Court, either upon application of the Board for enforcement or upon petition for review by the employer. But even without a review, the Board's decision might be analogized to an unreviewed BTA decision which, under certain circumstances, is *res judicata* in subsequent court proceedings. *Greenbaum v. United States*, 17 F. Supp. 83 (Ct. Cl. 1936); *Griswold, Res Judicata in Federal Tax Cases* (1937) 46 YALE L. J. 1320, especially 1326, n. 33.

of charges before the Board¹⁸ or issuance of the formal complaint by the Board¹⁹ preceded the preliminary steps in the court action. It would seem, however, that the time differential should not rate as a substantial factor,²⁰ especially since the rights of the stayed party will be adequately protected if that party is allowed to intervene in the Board proceedings.²¹ If the plaintiff complains of suffering from the delay, it may be pointed out that where required by the public interest—here embodied in the Wagner Act—equitable relief may be withheld or a stay granted even though private rights may thereby be impaired.²² A final persuasive factor in inducing a court to grant a stay is the possibility that the Board decision may render subsequent court action unnecessary, thus obviating unnecessary expenditures of time and money, and avoiding a multiplicity of suits against one defendant. Nevertheless, the court might be reluctant to relinquish jurisdiction or to grant a stay since the plaintiff may well be injured by the delay. In view of this possibility, a future conflict could best be avoided by so framing the decree enforcing an untested labor contract as to retain the cause for further action in the event of an NLRB decision on the contract.²³

18. In the principal case, the bill of complaint in the District Court was filed by the Brotherhood a few days prior to the date of service of the Board's complaint, but considerably later than the date when charges were filed before the Board by the United.

19. The precedents do not indicate whether an action commences with the filing of charges or the issuance of a formal complaint. See (1926) 74 *UNIV. OF PA. L. REV.* 506. The date of issuing a complaint might seem preferable since the Regional Director, subject to an appeal to the Board, may refuse to issue a complaint on the charges filed. *NATIONAL LABOR RELATIONS BOARD, RULES AND REGULATIONS* (1937) art. II, §§ 5, 9. But *cf.* *Louisville & N. R.R. v. Sloss-Sheffield Co.*, 269 U. S. 217 (1925) (informal complaint to ICC in reparation suit sufficient to toll running of Statute of Limitations although formal complaint not filed until after statutory period); *Louisville & N. R. Co. v. Dickerson*, 191 Fed. 705 (C. C. A. 6th, 1911).

20. Other considerations may outweigh mere priority in time. *Oppenheimer v. Carabaya Rubber & Navigation Co.*, 145 App. Div. 830, 130 N. Y. Supp. 587 (1st Dep't 1911); *Mutual Life Ins. Co. v. Marzec*, 146 Misc. 26, 262 N. Y. Supp. 558 (Sup. Ct. 1932); *cf.* *Levy v. Pacific Eastern Corp.*, 154 Misc. 655, 277 N. Y. Supp. 659 (Sup. Ct. 1935).

21. In the instant case the A. F. of L. union was served with copies of the complaint and notice of hearing, and the Board's opinion indicated that intervention would have been granted, had it been sought. See *NATIONAL LABOR RELATIONS BOARD, RULES AND REGULATIONS* (1937) art. II, § 19; art. III, § 4; art. VII, § 1. The Board has occasionally denied petitions for intervention by unions, but only under circumstances clearly distinguishable from those in the principal case. See, *e.g.*, *In the Matter of Star Pub. Co.*, 4 NLRB No. 69 (1937).

22. *Virginian Ry. Co. v. System Federation No. 40*, 300 U. S. 515 (1937) (injunction); *Landis v. North American Co.*, 299 U. S. 248 (1936) (stay), (1937) 46 *YALE L. J.* 897.

23. See the form of order in *Prentis v. Atlantic Coast Line*, 211 U. S. 210 (1903). See *McCLINTOCK, EQUITY* (1936) § 28; 1 *POMEROY, EQUITY JURISPRUDENCE* (4th ed. 1918) §§ 115, 116; *Survel Realty Corp. v. Brooklyn Edison Co.*, 139 Misc. 113, 246

Whichever of these procedures is adopted — relinquishment of jurisdiction, stay of proceedings, or conditional decree—the court may act either on its own motion²⁴ or upon that of the employer, union, or Board. Thus a petition might be directed to the court by an employer acting in good faith and anxious to avoid the expense and uncertainty of defending two suits.²⁵ More likely, however, would be intervention by either the NLRB or the rival union, or perhaps appearance in the capacity of *amici curiae*.²⁶ But there would still remain the problem of bringing the other proceedings to the official attention of the court.²⁷ While the court might find it difficult to take judicial notice of the proceedings,²⁸ it could, of course, listen to evidence from the defendant, and from the interveners²⁹ or *amici curiae* as well.³⁰

The instant case, however, illustrates the difficulty besetting an employer when none of these devices are utilized. Since the Board may be called upon to invalidate a contract whose specific performance has been decreed by a court, the employer may be ordered to obey two conflicting decrees. Though perhaps primarily responsible for the confusion, the employer may escape from the dilemma without further flouting the purposes of the Wagner Act. It is possible, of course, that the election of representatives will favor the group with whom he has negotiated,³¹ thereby presumably terminating these legal complications. If, however, the election results unfavorably for the employer's choice, a review of the Board order might be secured either

N. Y. Supp. 409 (Sup. Ct. 1928); *Town of West Rutland v. Rutland Ry., Light & Power Co.*, 98 Vt. 379, 127 Atl. 883 (1925).

24. *Latham v. Tombs*, 32 Tex. Civ. App. 270, 73 S.W. 1060 (1903); *cf. Patitucci v. Gerhardt*, 206 Wis. 358, 363, 240 N.W. 385, 387 (1932).

25. Stays are customarily granted at the request of a party called upon to defend two or more suits. *Landis v. North American Company*, 299 U. S. 248 (1936), (1937) 46 YALE L. J. 897.

26. An *amicus curiae* can suggest to the court action which the court may take of its own motion [*Stewart v. Herten*, 125 Neb. 210, 249 N.W. 552 (1933); *Jackson v. Birk*, 84 S.W. (2d) 332 (Tex. Civ. App. 1935)], even as to matters going to the court's jurisdiction. *Helmbright v. Gebelein, Inc.*, 19 F. Supp. 621 (D. Md. 1937); *Muskogee Gas Co. v. Haskell*, 38 Okla. 358, 132 Pac. 1098 (1913); *Flinn v. Krotz*, 293 S.W. 625 (Tex. Civ. App. 1927).

27. Although the court itself would be unlikely to undertake the burden of inquiring into the existence of Board proceedings [5 WIGMORE, EVIDENCE (2d ed. 1923) § 2579], any of the above-mentioned parties might bring them to its attention. Of course, there is just a bare possibility that a speedy collusive suit will be so veiled in secrecy as to prevent other parties from taking action before a decree. But such a judgment might be vacated later by motion of a third party. FREEMAN, JUDGMENTS (5th ed. 1925) § 258.

28. It is said that a court will usually not notice any other legal proceedings than those immediately before it. 5 WIGMORE, EVIDENCE (2d ed. 1923) § 2579. But see cases cited note 39, *infra*.

29. An intervener has the privileges of a regular party. See *Grand Rapids v. Consumers' Power Co.*, 216 Mich. 409, 414, 185 N.W. 852, 854 (1921).

30. *The Claveresk*, 264 Fed. 276 (C.C.A. 2d, 1920); *In re Perry*, 83 Ind. App. 456, 148 N.E. 163, (1925); *Irwin v. Armuth*, 129 Ind. 340, 28 N.E. 702, (1891).

31. This actually happened in the instant case. See note 4, *supra*.

by the employer's appeal to the Circuit Court³² or by awaiting a petition for enforcement by the Board.³³ While neither procedure would be likely to yield a reversal when, as here, the Board's power is clear, affirmance of the Board order would considerably clarify his position. Since courts will not ordinarily attempt to enforce a decree of specific performance when a contract has subsequently become illegal,³⁴ the employer could then disregard the court decree.³⁵ Should the court nevertheless attempt to enforce its decree, such action could be contested by appealing a citation for contempt. But in view of the risk of a contempt commitment, it would be more prudent for the employer to take some affirmative action. The safest course would probably lie in a petition to the district court to vacate the decree,³⁶ supplemented by a notice of appeal³⁷ from the original decree.³⁸ Then, in the unlikely event that the court denied the motion to vacate, the Circuit Court would probably set aside the original decree.³⁹ As a last resort, in case both the appeal period and term time have elapsed⁴⁰ without alteration of the

32. Authorized by Sec. 10(f), 49 STAT. 453 (1935), 29 U.S.C. § 160(a) (Supp. 1936). Defendant adopted this procedure in the principal case. See note 4, *supra*. The employer might also petition the Circuit Court for a stay of the election. In the principal case, the Company's request for a stay of the election was refused by the Circuit Court, 1 LAB. REL. REP. 35 (1937).

33. Section 10(e) 49 STAT. 455 (1935), 29 U.S.C. § 160(e) (Supp. 1937).

34. See 1 FREEMAN, JUDGMENTS (5th ed. 1925) § 253 and cases cited.

35. The illegality of the contract would be established by the Circuit Court decision. Sec. 10(e) of the Wagner Act provides that, subject to review, the jurisdiction of the Circuit Court "shall be exclusive and its judgment and decree shall be final." Even if no attempt were made to review the Board decision, it might be regarded as *res judicata*, thereby rendering inoperative the district court decree. See note 17, *supra*.

36. Before the close of the term a court may vacate equity decrees and judgments at law for any reason, provided that it does not act arbitrarily. See FREEMAN, JUDGMENTS (5th ed. 1925) §§ 195, 212.

37. The Company also appealed the district court decree [reported in 1 PRENTICE-HALL LAB. SERV. ¶ 15642]. See note 4, *supra*. An appeal from a federal district court decree must be taken within three months. 43 STAT. 940 (1925) 28 U.S.C. § 230, (1927). Protracted Board proceedings should not, however, prevent prompt action by the employer, for notice of appeal could always be filed within the required time if the outcome were at all uncertain.

38. Denial of the motion to vacate would not be considered an "appealable order." *Bensen v. United States*, 93 F. (2d) 749 (C.C.A. 9th, 1937).

39. When changes in fact or law—including court decisions—occur since the entry of the judgment appealed from, they may be brought to the appellate court's attention by affidavit, concession of counsel, or other satisfactory evidence, if they affect the disposition of the case. *California v. San Pablo & T. R. Co.*, 149 U.S. 303 (1893); *St. Louis Southwestern Ry. v. Board of Directors*, 32 F. (2d) 124 (C.C.A. 8th, 1929). The appellate court may then dispose of the case in any manner it deems just. *Watts, Watts & Co. v. Unione Austriaca di Navigazione*, 248 U.S. 9 (1918); *Mutual Life Insurance Co. of N. Y. v. Lipp*, 28 F. (2d) 863 (C.C.A. 9th, 1928). The result would not be affected if the specific performance decree came before a state court or a circuit court other than the one where the Board order was in issue.

40. Except for reasons inapplicable here, a district court may not vacate its decree after the expiration of the term in which it was made. *Farmers' and Merchants' Bank of Phoenix v. Arizona Mut. Savings and Loan Ass'n*, 220 Fed. 1 (C.C.A. 9th, 1915).

original decree, the employer might petition for a bill of review,⁴¹ or move the district court to stay enforcement of the decree.⁴²

DEPLETION ALLOWANCES IN TAXATION OF INCOME DERIVED FROM OIL ROYALTIES AND OIL PAYMENTS*

IN THE growth of income tax administration, divergent methods of exempting that amount of gross income representing return of capital investment have evolved. Where gross receipts flow from a contract right to future contingent payments not closely allied with extraction of minerals, the technique has generally been to treat the periodic payments received as entirely a return of capital until the original investment has been recovered in full, and thereafter, as income.¹ With few exceptions,² there has been no attempt to apportion each payment between capital and income. On the other hand, when gross income is derived from the exhaustion of mineral resources, Congress has granted depletion allowances³ on the theory that the value of

41. This would be granted only if the subsequent decision of the Board could be categorized as newly discovered evidence. Cf. *Obear-Nester Glass Co. v. Hartford-Empire Co.*, 61 F. (2d) 31 (C. C. A. 8th, 1932).

42. Since the order would stay all proceedings under the decree, it would have the same practical effect as a motion to vacate. Cf. *Barnett Foundry Co. v. Iron Works Co.*, 85 N. J. Eq. 359, 96 Atl. 490 (Ch. 1915).

The employer might ask the district court for a declaratory judgment to relieve him from the insecurity of awaiting the plaintiff's petition for enforcement of the original decree. See BORCHARD, *DECLARATORY JUDGMENTS* (1934) 313, 320, 410 and cases there cited. But this might savor too much of collateral attack upon a valid judgment.

*Comm'r of Int. Rev. v. *Laird*, 91 F. (2d) 498 (C. C. A. 5th, 1937).

1. *Burnet v. Logan*, 283 U. S. 404 (1931); X-2 Cum. BULL. 221 (1931). The Board of Tax Appeals has held that the rule of the *Logan* case will be applied only where the return of capital is especially hazardous. *Brown*, 26 B.T.A. 781, *aff'd*, 69 F. (2d) 863 (C. C. A. 5th, 1934).

2. In several cases lower federal courts have apportioned receipts from contract rights to future contingent payments between capital and income by use of either of two methods: (1) each payment is discounted back to the date the contract was purchased and the resulting figure is a capital return, and the remainder of the payment, taxable income; (2) the portion of each payment representing interest on the unreturned capital is taxable income, and the remainder is a capital return. 1 PAUL AND MERTENS, *LAW OF FEDERAL INCOME TAXATION* (1934) §5.34. Annuities for many years were tax free until the entire cost had been returned, but in 1934 Congress provided that prior to full capital return, a portion of each payment equal to 3% of the aggregate cost of the contract should be taxable as income. 48 STAT. 687 (1934), 26 U. S. C. §22(b)(2) (Supp. 1936). See *Tyler and Ohl, The Revenue Act of 1934* (1935) 83 U. OF PA. L. REV. 607, 632.

3. The first provision for depletion allowances appeared in 1913. 38 STAT. 167 (1913), Rev. Act of 1913, §§ B, G(b). But substantially full depletion was not provided until 1916. 39 STAT. 759 (1916), Rev. Act of 1916, §§ 5(a) eighth (a), 12(b) second (b). For a collection and discussion of the depletion provisions of all subsequent Rev. Acts, see 2 PAUL AND MERTENS, *LAW OF FEDERAL INCOME TAXATION* (1934) §21.02 *et seq.*

each unit recovered represents in part a return of capital investment equal to the value of the unit of mineral in place, and in part income representing the increment of value added by the process of severance.⁴

Computation of depletion allowances at first was accomplished by dividing the capital investment by the estimated recoverable units of mineral and deducting the resulting figure, multiplied by the number of units recovered in the taxable period, from the gross income for that period.⁵ In the case of oil and gas reserves, however, the migratory nature of the mineral precludes a satisfactory estimate of recoverable units.⁶ Consequently, Congress departed from the normal practice of measuring capital return by cost, and provided for annual depletion deductions measured by an arbitrary figure of 27½% of the gross income derived from the extraction of oil or gas.⁷ The result is that in the event of unexpectedly prolonged productivity of a well, the taxpayer is often returned not only his capital investment but also additional sums representing the excess of the actual value of the oil reserves over and above the purchase price.⁸ Though Congress has deemed the administrative simplicity gained by percentage depletion more valuable than the revenue lost by holding tax exempt this possible increment of gross income over and above capital, it has not departed from the fundamental theory of capital return, as shown by its refusal to tax capital where percentage depletion returns less than actual capital cost.⁹ In any event, each unit of gross income from mineral operations is treated as if composed in part of taxable income and in part of capital.

4. *Signal Gasoline Corp. v. Comm'r of Int. Rev.*, 77 F. (2d) 728, 730 (C. C. A. 9th, 1935); (1937) 47 YALE L. J. 278.

5. 381 C. C. H. 1938 Fed. Tax Serv. ¶ 245.01; HOLMES, *FEDERAL TAXES* (6th ed. 1925) § 664, n. 33. In the case of land purchased prior to March 1, 1913, fair market value as of that date and not cost is the basis for the allowance. 39 STAT. 759 (1916), Rev. Act of 1916, §§ 5(a) eighth (a), 12(b) second (b); and all subsequent Rev. Acts. The Act of 1918 added the provision that as to oil discovered subsequent to March 1, 1913, depletion allowances to the discoverer should be based not on cost or value as of March 1, 1913, but on fair market value on the date of discovery or thirty days thereafter. This special subsidy to discoverers of oil was omitted from the Act of 1926 and all subsequent acts though it was retained as to discoverers of mines. For a discussion of cost computation of depletion allowances, see Comment (1934) 43 YALE L. J. 466.

6. GLASSMIRE, *OIL AND GAS LEASES AND ROYALTIES* (1935) § 5.

7. 44 STAT. 16 (1926), Rev. Act of 1926 § 204(c) (2); and all subsequent Rev. Acts. That the attainment of administrative simplicity was the sole purpose behind the departure from the cost basis, see *Comm'r of Int. Rev. v. Fleming*, 82 F. (2d) 324, 326 (C. C. A. 5th, 1936).

8. *Tyler and Ohl, The Revenue Act of 1934* (1935) 83 U. OF PA. L. REV. 607, 647. Both percentage computation and the substitution of discovery value for cost have been severely criticized as subsidizing a small class of property owners by allowing for exemption of more than cost from income taxation. 78 CONG. REC. 1775 (1934); N. Y. Times, Dec. 16, 1933, p. 28, col. 1.

9. *Mountain Producers' Corp.*, 34 B.T.A. 409 (1936). All of the Rev. Acts providing for percentage depletion also provide that in no case shall the allowance be less than if it were computed on the unit cost basis. See note 7, *supra*.

A recent case reveals the necessity for a judicial survey of the borderline between situations appropriate for the application of these two divergent methods of recognizing a capital return. A taxpayer, as beneficiary under a will, received an undivided part interest in an estate including both a right to receive royalties reserved in leases of oil lands and a right to receive oil payments reserved in the sale of oil lands.¹⁰ For federal estate tax purposes the Commissioner of Internal Revenue estimated the value of each of these rights to contingent future payments. The Commissioner later assessed an income tax against the beneficiary upon royalties and oil payments which accrued to him subsequent to his acquisition of the rights from which those payments flowed.¹¹ The Board of Tax Appeals upheld the taxpayer's contention that the royalties and oil payments constitute a return of capital and not income until they equal the estate tax evaluations of the taxpayer's respective legacies.¹² The Circuit Court of Appeals for the Fifth Circuit affirmed as to the oil payments, but ruled that the royalties were income immediately taxable, with allowance of deductions only for depletion.¹³

Oil royalties constitute payments of a percentage of the oil produced or its value which are to continue until exhaustion of the oil reserves or earlier termination of the lease.¹⁴ At first it was held that ownership in fee alone constituted a depletable interest¹⁵ and that a right to royalties arose from a contract resembling an annuity, which was not closely enough associated with the oil reserves to amount to a depletable interest in them;¹⁶ capital was therefore returned in full before levy of the income tax rather than pro rated under the concept of depletion. But judicial recognition of a depletable interest was rapidly broadened to include any legal estate in the oil lands,¹⁷ and recently the Supreme Court has taken the further step of including any "economic interest" in the oil in place.¹⁸ Though the term "economic inter-

10. For purposes of income taxation, one who takes as a beneficiary is considered in the position of an assignee of the estate, and the estimated value of his legacy is the measure of the beneficiary's capital investment. *Burnet v. Logan*, 283 U. S. 404, 412 (1931); cf. *Fink v. Comm'r of Int. Rev.*, 76 F. (2d) 335 (C. C. A. 10th, 1935). The fact that the rights to royalties and oil payments were acquired by the taxpayer by inheritance rather than by out-of-pocket investment consequently has no bearing upon the point at issue, and the estate tax, which was levied upon the right to testamentary transfer and not on the property itself [*Shukert v. Allen*, 273 U. S. 545, 546 (1927)], has no bearing upon the question of income taxation in the instant case.

11. For the methods used by the Commissioner in estimating depletion allowances, see note 7, *supra*, as to the royalties, and note 33, *infra*, as to the oil payments.

12. Transcript of Record No. 8413, 21, *Comm'r of Int. Rev. v. Laird*, 91 F. (2d) 498 (C. C. A. 5th, 1937).

13. *Comm'r of Int. Rev. v. Laird*, 91 F. (2d) 498 (C. C. A. 5th, 1937).

14. 2 THORNTON, OIL AND GAS (Willis' ed. 1932) § 363; see (1935) 45 YALE L. J. 363.

15. IX-2 CUM. BULL. 214 (1930), as amended by X-2 CUM. BULL. 221 (1931); cf. *Burnet v. Logan*, 283 U. S. 404 (1931).

16. *Weiss v. Mohawk Mining Co.*, 264 Fed. 502 (C. C. A. 6th, 1920). The decision has been explained as a misinterpretation of *United States v. Biwabik Co.*, 247 U. S. 116 (1918). See HOLMES, FEDERAL TAXES (6th ed. 1925) 1143.

17. 2 PAUL AND MERTENS, LAW OF FEDERAL INCOME TAXATION (Supp. 1937) § 21.18.

18. *Palmer v. Bender*, 287 U. S. 551 (1933).

est" has caused considerable confusion,¹⁹ there is no longer any doubt that it includes the right to royalties.²⁰ Thus the Court in the instant case was consistent with precedent in holding that the capital investment in the right to royalties should be returned through depletion allowances.

Oil payments flow from a right to a stipulated sum to be paid out of production. Like royalties, they constitute a percentage of production and cease upon an unexpected exhaustion of mineral reserves, but in the absence of prior exhaustion the right to receive these payments continues until the stipulated sum has accrued, and is not terminated by the expiration of an agreed period of time as is the right to royalties.²¹ This limitation by amount instead of time would not seem material enough to warrant a distinction in the treatment of oil payments and royalties. The courts have been perturbed, however, by the fact that oil payments are generally created by instruments purporting to "sell" the taxpayer's entire right, title, and interest in the property whereas royalties usually accompany a "lease" of the taxpayer's interest. To allow depletion on oil payments runs counter to the concept of a sale as a single transaction giving rise to an immediate gain or loss,²² and the courts have been slow to accept the idea that one who has parted with his entire legal interest in mineral reserves by sale may still retain a relationship to those reserves that is sufficiently allied with production to warrant depletion allowances.²³ This confusion has continued in spite of the Supreme Court's decision in *Palmer v. Bender*²⁴ which would seem to make questions of title immaterial by defining depletable interest as synonymous with "economic interest." The Supreme Court has recently settled the problem by adopting the view that the assignor does not convey that portion of the oil which he is to receive by way of oil payments.²⁵ By this theory,²⁶ depletion of oil payments is allowed without injury to the concept of a sale.

19. See 2 PAUL AND MERTENS, LAW OF FEDERAL INCOME TAXATION (Supp. 1937) § 21.18; (1937) 47 YALE L. J. 278.

20. Royalties are depletable whether received as rent by a lessor [*New Creek Coal Co. v. Lederer*, 295 Fed. 433 (C. C. A. 3d, 1924); III-1 CUM. BULL. 192 (1924)], as payment by a lessee-assignor [XII-2 CUM. BULL. 198 (1933)]; or as overriding royalties in payment for services or other consideration. *Smith v. U. S.*, 17 F. Supp. 353 (S. D. W. Va. 1936); (1937) 23 VA. L. REV. 837.

21. See *Comm'r of Int. Rev. v. Fleming*, 82 F. (2d) 324, 325 (C. C. A. 5th, 1936); GLASSMIRE, OIL AND GAS LEASES AND ROYALTIES (1935) 160.

22. Profits from an outright sale of oil lands are taxed not as income but as a capital gain. *Dixon v. United States*, 13 F. Supp. 620 (D. Wyo. 1935); *Fritz*, 28 B. T. A. 408 (1933); *Macon Oil and Gas Co.*, 23 B. T. A. 54 (1931).

23. *Comar Oil Co. v. Burnet*, 64 F. (2d) 965, 968 (C. C. A. 8th, 1933).

24. 287 U. S. 551 (1933).

25. *Thomas v. Perkins*, 301 U. S. 655 (1937). Direct authority for the allowance of depletion on oil payments is by no means lacking. *Comm'r of Int. Rev. v. Fleming*, 82 F. (2d) 324 (C. C. A. 5th, 1936); *Comm'r of Int. Rev. v. Williams*, 82 F. (2d) 328 (C. C. A. 5th, 1936); *Alexander v. Continental Petroleum Co.*, 63 F. (2d) 927 (C. C. A. 10th, 1933); *Comm'r of Int. Rev. v. Jones*, 82 F. (2d) 329 (C. C. A. 5th, 1936).

26. The quantity of oil reserved by the assignor from the operation of the conveyance is that amount which when removed at intervals over a period of years will equal in

If, as is customary, the contract giving rise to the oil payments also provides for the payment of a cash amount, or "cash bonus," as part of the consideration, then the cash bonus is deemed the purchase price of that portion of oil which is not retained by the assignor, and with reference to it capital is returned not by depletion but in a lump sum as is the rule in taxing capital gain.²⁷ If the transaction can be brought into the category of a lease, then the courts are not troubled by the sale concept and the cash bonus is considered not as purchase money but as advance royalties and therefore subject to depletion.²⁸ Indeed, if a small royalty is provided for in the contract of sale in addition to a cash bonus and oil payments, the presence of that royalty will bring the cash bonus under the depletion concept.²⁹ Thus the Supreme Court seems not to have departed completely from the conceptual approach based upon notions of title which the *Palmer* case was thought to have divorced from depletion.³⁰

Despite the confusion as to cash bonuses, the latest authority is that the recipient of oil payments has a depletable interest in the oil in place.³¹ The Court in the instant case recognized this rule and held that the taxpayer was entitled to depletion allowances on the oil payments. The Court went further, however, and stated that before any of the payments become taxable at all, the taxpayer's capital investment should first be returned in toto. Thus, the taxpayer seems to be accorded a return of his entire capital investment first under the method customarily applied to a contract right to future contingent payments, and a second time under the system of depletion allowances. Certainly there can be no justification for returning the same capital twice.³²

total value a stated sum. Under this rationale, as the market value of oil fluctuates, the quantity of oil to which the assignor has retained title must change correspondingly.

27. *Comm'r of Int. Rev. v. Fleming*, 82 F. (2d) 324 (C. C. A. 5th, 1936); *Laird*, 35 B. T. A. 75 (1936); *Simms*, 28 B. T. A. 988 (1933); cf. *Thomas v. Perkins*, 301 U. S. 655 (1937). But see *Elbe Oil Land Development Co. v. Comm'r of Int. Rev.*, 91 F. (2d) 127, 130 (C. C. A. 9th, 1937). In computing the capital gain, cost must be allocated between the interest sold for the cash bonus and the retained right to oil payments. It would seem that the cost of the interest sold is that portion of the original cost which bears the same ratio to the entire original cost as the cash bonus bears to the sum of the cash bonus and the present value of the right to oil payments.

28. *Burnet v. Harmel*, 287 U. S. 103 (1933); *Murphy Oil Co. v. Burnet*, 287 U. S. 299 (1933); *Palmer v. Bender*, 287 U. S. 551 (1933). For the method of computing depletion allowances on cash bonuses, see U. S. Treas. Reg. 94, Art. 23(m)-10 (1936). When percentage depletion is applied to both bonus and royalties the simplicity of tax administration originally sought by Congress through the percentage method of computation is attained. By introducing technical property distinctions, the courts have sacrificed this simplicity and gained nothing since capital is ultimately returned either through depletion or through a cost deduction in computing the tax on capital gain.

29. *Palmer v. Bender*, 287 U. S. 551 (1933).

30. See *Ross, Depletion of Oil Leases* (1936) 14 TAX MAG. 323.

31. See note 25, *supra*.

32. In recomputing the taxpayer's assessment under the mandate of the principal case, the Board of Tax Appeals realized the inconsistency of granting a return of the same capital by two methods. *Laird*, 36 B. T. A., mem. op., Nov. 18, 1937. The estate was entitled to \$37,722 in oil payments. The estate tax evaluation of this right was

Once it was decided that depletion allowances should be granted, it would seem to follow that depletion is the exclusive method by which capital may be returned.³³ Apparently the Court failed to recognize that depletion allowances are provided for the sole purpose of returning capital.³⁴

It may be argued that because of the unpredictable factors determining the ultimate productivity of oil wells,³⁵ it is unfair to force the taxpayer to risk a cessation of royalties or oil payments before his capital has been recovered, and therefore no income should be taxable until that recovery has occurred.³⁶ However, if a loss is suffered through an unexpected exhaustion of oil reserves, the taxpayer will generally be in a position to avail himself of an ordinary loss deduction.³⁷ His only risk is that his income at the time of the loss will not be sufficiently large to enable him to take full advantage of the deduction. Compensation for this risk is usually found in the possibility that much more than actual capital investment may be saved free from taxation by the arbitrary percentage depletion allowances.³⁸ Moreover, the

\$22,633. The payments for the year in question totalled \$27,090. The Board deducted \$22,633 (full cost) from the sum of \$27,090, but refused depletion allowances on the remaining \$4,457, saying that the Circuit Court above had not been clear as to the treatment of this sum. Provided that the remaining \$10,632 of oil payments are received and depletion allowances granted as ordered, the estate will receive a further unwarranted return of capital amounting to \$2,923.

33. If the depletion concept had been employed exclusively, the taxpayer undoubtedly would have resorted to the unit-cost method, for percentage depletion would return less than the original cost of \$22,633. See note 9, *supra*. Difficulties in application would arise since the total number of units recoverable by the taxpayer is dependent not only upon the uncertain longevity of production, but also upon the ever-changing market value of oil. To prorate cost to units, it would be necessary either arbitrarily to fix an estimated average market value or to consider the dollars of the payment instead of the barrels of oil represented by those dollars as the units for the purpose of the calculation. This latter method, which seems to have been used by the Commissioner in the principal case, would only be applicable when it is reasonably certain that the oil reserves will not be exhausted prior to completion of the contract payments. In the principal case the Commissioner allowed deductions of 60% of the payment in question on the basis that the estate tax evaluation of the right to payments was set at 60% of the total contracted payments. In view of the contingencies involved this method seems a reasonable compromise between accuracy and simplicity of administration. However, it points to an inconsistency on the part of the Commissioner who seems to have taken into account the possible exhaustion of reserves before receipt of the total oil payments as well as postponement of enjoyment in reaching the estate tax evaluation, but to have ignored the first of these two factors in computing the depletion allowance.

34. *Comm'r of Int. Rev. v. Fleming*, 82 F. (2d) 324, 326 (C. C. A. 5th, 1936); 2 PAUL AND MERTENS, LAW OF FEDERAL INCOME TAXATION (Supp. 1937) §21.01.

35. See note 6, *supra*.

36. *Burnet v. Logan*, 283 U. S. 404, at 412 (1931).

37. *Simms Petroleum Co.*, 28 B. T. A. 1107 (1933), *aff'd*, 74 F. (2d) 561 (C. C. A. 2d, 1935); *United Oil Co.*, 25 B. T. A. 101 (1932); see *Witherspoon Oil Co.*, 34 B. T. A. 1130, 1137 (1936).

38. This element of compensation for the risk borne is present in the instant case as to the royalties but not as to the oil payments, for depletion allowance as to the

element of risk to the taxpayer that during early tax periods he will be subjected to income taxation on the proceeds of a venture which may ultimately result in a loss instead of a gain would seem to be far outweighed by the advantages of a system of taxation which will produce ascertainable revenue payable at regular intervals.³⁰

DISBARMENT OF ATTORNEY RETAINED TO DEFEND AGAINST CRIMES WHEN AND IF COMMITTED*

· DESPITE increasingly rigid requirements which must be met by those entering the practice of law, changing social conditions have rendered maintenance of the traditional standards of professional conduct of the American Bar increasingly difficult.¹ In metropolitan areas, the impact of a highly competitive profession, a litigious population, and a society too preoccupied to be bothered with abstract morality for the little man has tended to place upon the courts the ultimate burden of supervising the conduct of the attorneys who practice before them. To meet these trends the courts have found it necessary to expand their inherent disciplinary power, always jealously guarded.² Thus, although several earlier decisions indicated that attorneys could not be disbarred for other than statutory grounds,³ the more recent cases are virtually unanimous in holding that statutory definitions of misconduct are not exclusive.⁴ Similarly, while it has long been established

latter would have to be computed by the unit-cost instead of the percentage method. See note 33, *supra*. However, in cases where cost represents an actual investment, the courts have not been swayed to deviate from the application of depletion methods of capital return because of the absence of this element of compensation for the taxpayer's risk; an investment which represents a windfall in the nature of a legacy certainly deserves no more protection than an out-of-pocket investment.

39. *Burnet v. Sanford and Brooks Co.*, 282 U. S. 359, 365 (1931); *Fawcett v. Comm'r of Int. Rev.*, 63 F. (2d) 445 (C. C. A. 7th, 1933); 1 PAUL AND MERTENS, *LAW OF FEDERAL INCOME TAXATION* (1934) § 11.04.

**In re Davis*, 252 App. Div. 591, 299 N. Y. Supp. 632 (1937); *In re Disbarment Proceedings*, 321 Pa. 81, 184 Atl. 59 (1936), and *In re Salus*, 321 Pa. 106, 184 Atl. 70 (1936).

1. See generally GISNET, *A LAWYER TELLS THE TRUTH* (1931); SCHLOSSER, *LAWYERS MUST EAT* (1933).

2. That appellate courts have inherent power to discipline attorneys is clearly established. *State v. Cannon*, 206 Wis. 374, 240 N. W. 441 (1932); 2 THORNTON, *ATTORNEYS AT LAW* (1914) § 758.

3. *In re Collins*, 147 Cal. 8, 81 Pac. 220 (1905); *Ex parte Smith*, 28 Ind. 47 (1867); *Kane v. Haywood*, 66 N. C. 1 (1872); *In re Eaton*, 4 N. D. 514, 62 N. W. 597 (1895).

4. *In re Bailey*, 30 Ariz. 407, 248 Pac. 29 (1926); *State v. Laughlin*, 10 Mo. App. 1 (1881); see *Wood v. State*, 45 Ga. App. 783, 789, 165 S. E. 908, 911 (1932); *In re Zirinsky*, 234 App. Div. 470, 474, 255 N. Y. Supp. 492, 496 (1932).

that an offense need not be indictable to warrant disbarment,⁵ early cases intimated that only professional misconduct would be considered;⁶ today non-professional misconduct often results in striking an attorney's name from the rolls.⁷ A conveniently vague formula, the concept of an "offense involving moral turpitude," has been developed to give the courts a wide latitude in their disciplinary action.⁸ And certain courts have recently assumed the function of investigating a general practice in search of professional misconduct,⁹ along with their more commonly invoked power of investigating a specific charge of misconduct to decide whether a particular individual should be disbarred. In the course of this development, a series of increasingly acute problems has arisen with concomitant attempts at reform. Courts, bar associations, and legislatures have successively dealt with the controversy over the contingent fee,¹⁰ with the emergence of the divorce specialist,¹¹ and with the many-sided problem of the "ambulance chaser."¹² The latest

5. *United States v. Porter*, 27 Fed. Cas. No. 16,072 (C. C. D. C. 1812); *Baker v. Commonwealth*, 73 Ky. 592 (1874). *Contra: In re Stryker*, 1 Wheeler Cr. Cases 330 (N. Y. 1816).

6. *State v. Weber*, 141 La. 448, 75 So. 111 (1917); *In re Stryker*, 1 Wheeler Cr. Cases 330 (N. Y. 1816); *State v. Byrnett*, 3 Ohio N. P. 28 (1894); *In re Dickens*, 67 Pa. 169 (1870).

7. *Ex parte Wall*, 107 U. S. 265 (1882) (inciting riot); *Grievance Committee Hartford County Bar Ass'n v. Broder*, 112 Conn. 269, 152 Atl. 292 (1930) (adultery); *In re Wellcome*, 23 Mont. 450, 58 Pac. 47 (1899) (political bribe); *Matter of Percy*, 36 N. Y. 651 (1867) (perjury—bad reputation); *cf. People v. Hocnig*, 317 Ill. 390, 148 N. E. 299 (1925) (fraud).

8. For an analysis of judicial efforts to clarify the meaning of "moral turpitude" and a plea for a more concrete formula, see *Bradway, Moral Turpitude As the Criterion of Offenses that Justify Disbarment* (1935) 24 CALIF. L. REV. 9.

9. *People ex rel. Karlin v. Culkun*, 248 N. Y. 465, 162 N. E. 487 (1923); *Rubin v. State*, 194 Wis. 207, 216 N. W. 513 (1927); (1928) 13 CORN. L. Q. 438; (1928) 13 MINN. L. REV. 62.

10. The contingent fee was illegal and unenforceable at common law. *In re Bleakly*, 5 Paige 311 (N. Y. 1835). It is now legalized in 46 states [WOOD, *FEE CONTRACTS OF LAWYERS* (1936) § 16 and cases cited] subject to the generally recognized exception that a contract to obtain a divorce for a percentage of the alimony is void on grounds of public policy. *Id.*, § 92 and cases cited. The question is by no means a dead issue. A reform bill to restrict contingent fees to 33 1/3% was killed by the lawyers of the Judiciary Committee in the New York legislature in 1929. Very recently the Association of the Bar of the City of New York adopted a recommendation that the judiciary law be amended to permit control of contingent fees by the courts. N. Y. Times, Feb. 24, 1938, p. 4, col. 4.

11. See SCHLOSSER, *LAWYERS MUST EAT* (1933) 94 *et seq.*

12. Ambulance chasing was the evil which led to the decision that courts had inherent power to investigate a general practice to see whether misconduct was prevalent. See cases cited note 9, *supra*. See SCHLOSSER, *LAWYERS MUST EAT* (1933) 117 *et seq.* Disbarment for ambulance chasing is of course frequent. See, *e.g.*, *Chreste v. Comm.*, 178 Ky. 311, 198 S. W. 929 (1917); *In re Newell*, 174 App. Div. 94, 160 N. Y. Supp. 275 (1916). For legislation making ambulance chasing grounds for disbarment, see MINN. STAT. (Mason, Supp. 1936) § 5687-5; NEW YORK PENAL LAW § 274; WIS. STAT. (1935) c. 256, § 29.

product of our social development is the lawyer who is more than a shyster—the lawyer who has achieved the full dignity and status of the racketeer.

In the course of a search for information concerning Dutch Schultz while he was a fugitive from justice, federal agents obtained evidence by tapping wires which implicated his attorney in the "numbers" or "policy" racket. In a disbarment proceeding instituted by the Bar Association of the City of New York, the referee rejected this evidence on the ground that the New York rule of admissibility of evidence procured by tapping wires¹³ was applicable only to criminal prosecutions,¹⁴ and held that the charges were not sustained. The Appellate Division admitted the evidence, stated that the charges could be proved by circumstantial evidence,¹⁵ and concluded that the latter clearly showed a retainer or agreement to defend all the "numbers" men who might run afoul of the law. The court held that such a retainer to defend persons for offenses thereafter to be committed was in effect aiding and abetting the perpetration of crime and was conduct meriting disbarment.¹⁶

The same problem recently arose in Pennsylvania and received similar treatment. After an investigation instituted by the Court of Common Pleas of Philadelphia County and conducted by a committee of the Philadelphia Bar Association, several attorneys involved in the "numbers" racket were disbarred. The Supreme Court affirmed this action, holding that attorneys who agreed in advance to defend persons when and if arrested for criminal offenses forfeited all right to practice law.¹⁷

Although these two cases are apparently without direct precedent, there are others which point in the same general direction. It was early held that a retainer to defend a person in the event of criminal prosecution in the

13. *People v. Defore*, 242 N. Y. 13, 150 N. E. 585 (1926); *People v. McDonald*, 177 App. Div. 806, 165 N. Y. Supp. 41 (1917). Evidence obtained by wire tapping is no longer admissible in the federal courts. *Nardone v. United States*, 58 Sup. Ct. 275 (1937), *distinguishing* *Olmstead v. United States*, 277 U. S. 438 (1928).

14. The general rule is that disbarment is a civil action. *In re Herrmann*, 175 App. Div. 310, 161 N. Y. Supp. 977 (1916); see *Ex parte Wall*, 107 U. S. 265, 288 (1882); 2 THORNTON, ATTORNEYS AT LAW (1914) § 867. A few courts, however, have held it to be in the nature of a criminal proceeding. *Bar Assoc. of San Francisco v. Goldman*, 53 Cal. App. 42, 199 Pac. 836 (1921); *Buhler v. Trick*, 195 Ind. 190, 144 N. E. 840 (1924); *In re Boluss*, 28 Mich. 507 (1874). And a fair-sized minority of courts view a disbarment proceeding as neither civil nor criminal but *sui generis*. *State v. Kaufman*, 202 Iowa 157, 209 N. W. 417 (1926); *In re Richards*, 333 Mo. 907, 63 S. W. (2d) 672 (1933).

15. The formula for the amount of evidence required in a disbarment proceeding depends upon the court's interpretation of the nature of the action. Thus, a preponderance of the evidence is usually said to be sufficient; but where the action is considered to be of a criminal nature, the defending attorney has the benefit of all reasonable doubt; and where the action is considered to be *sui generis*, it is generally stated that the evidence must be clear and convincing. See cases cited *supra* note 14. See (1921) 9 CALIF. L. REV. 484.

16. *In re Davis*, 252 App. Div. 591, 299 N. Y. Supp. 632 (1937).

17. *In re Disbarment Proceedings*, 321 Pa. 81, 184 Atl. 59 (1936), and *In re Salus*, 321 Pa. 106, 184 Atl. 70 (1936).

future was void and unenforceable on grounds of public policy,¹⁸ but apparently at that time the attorney involved was not even censured. Similarly, an agreement to collect debts which might in the future be resisted as gambling debts has been declared unenforceable as an attempt to reap the fruits of crime,¹⁹ but again the attorney was not reprimanded. In a more recent case, attorneys who agreed to defend all members of a mercantile association against all actions civil or criminal, which might be brought against them were censured, but not disbarred.²⁰ And, of course, attorneys actually convicted of crime,²¹ or guilty of obstructing the enforcement and administration of the law²² have always been subject to strict disciplinary action.

One can hardly quarrel with the result in either of the principal cases, but, divorced from the facts, the decision that the taking of a retainer to defend against possible future criminal charges justifies disbarment has further implications. It raises the question of the status of the attorney who has a retainer with a business organization, if the latter subsequently becomes liable to criminal prosecution under such legislation as the Securities Exchange Act of 1934 and the Robinson-Patman Act. It is hardly to be expected, however, that any court would apply the rule strictly in such a situation. The distinction which most readily suggests itself is that where the enterprise is legitimate and advance intention to commit infractions of the law is either lacking or unknown to the attorney retained, no disciplinary action against the attorney is warranted. Thus the court in both the principal cases was careful to distinguish the general retainer by organizations engaged in legitimate business; intent to aid and guide a combination of persons formed solely for the purpose of engaging in crime was the ultimate basis for disbarment. In fact, the rule of the instant cases may be viewed as a convenient substitute for the conviction of the attorney as a co-conspirator or accessory before the fact, from which disbarment would follow as a matter of course. Whereas sufficient evidence for conviction is often extremely difficult to obtain,²³ only a preponderance of the evidence is required to effect a disbarment in New York and many other states.²⁴ Moreover, the

18. *Bowman v. Phillips*, 41 Kan. 364, 21 Pac. 230 (1889).

19. *Delahunty v. Canfield*, 118 App. Div. 883, 103 N. Y. Supp. 939 (1907).

20. *In re Gill*, 104 Wash. 160, 176 Pac. 11 (1918).

21. *State v. Stringfellow*, 128 La. 463, 54 So. 943 (1911); *In re McCarthy*, 42 Mich. 71, 51 N. W. 963 (1879); *In re Singer*, 233 App. Div. 467, 254 N. Y. Supp. 371 (1931). It is generally held that an executive pardon after conviction does not offset the court's inherent power to disbar for the offense. See (1937) 21 MINN. L. REV. 837.

22. *People v. Barrios*, 237 Ill. 527, 86 N. E. 1075 (1909); *In re Feinstein*, 245 App. Div. 740, 280 N. Y. Supp. 267 (1935); *Ex parte Miller*, 37 Ore. 304, 60 Pac. 999 (1900).

23. In the Pennsylvania case the court pointed out that none of the "bankers" or leaders of the racket had been arrested, or their identity even disclosed, at the time the disbarment proceeding occurred. In the New York case, however, the attorney involved, apparently himself the real leader of the racket, had been indicted when the disbarment proceeding took place. He was recently arrested and held for extradition in Philadelphia. N. Y. Times, Feb. 3, 1938, p. 1, col. 1.

24. *In re Herrmann*, 175 App. Div. 310, 161 N. Y. Supp. 977 (1916). See note 14 *supra*. See 5 WIGMORE, EVIDENCE, (2d ed. 1923) § 2498(2).

courts relax the rigid and firmly-established safeguards available to the accused in a criminal trial, on the ground that a disbarment proceeding is an extra-judicial action aimed not so much at punishing the individual attorney as at purging the profession.²⁵

RIGHT OF CUSTOMER OF INSOLVENT BANK TO SET OFF HIS DEPOSIT AGAINST HIS OBLIGATIONS PLEDGED AS COLLATERAL SECURITY*

THE INSOLVENCY of a commercial bank leaves in its wake numerous set-off problems. Most common but least troublesome are those growing out of direct dealings between customer and bank.¹ The amount which may be recovered by the receiver or proved by the customer in that situation is determined, as before sequestration, by the balance of the current account.² A similar result is reached where one or more of the opposing obligations represent independent causes of action acquired from third parties.³ While the principle of equal distribution of the assets among the general creditors is never repudiated, this form of preference to the depositor has customarily received statutory and judicial approval as a convenient method of settling accounts between debtor and creditor.⁴ But the problem is not so easily solved when some interest of a third party is intertwined with the banker-customer relationship, as when a customer's note has been pledged either to the bank by a third party, or to a third party by the bank, as collateral security for the pledgor's indebtedness.⁵ Additional complications are then introduced by

25. *In re Hettrick*, 203 App. Div. 512, 514, 197 N. Y. Supp. 6, 8 (1922); *In re Law Ass'n of Philadelphia*, 312 Pa. 555, 563, 167 Atl. 579, 582 (1933). The distinction seems unreal, for the moral and economic effects of disbarment upon the disbarred attorney may be no less severe than penalties imposed upon the convicted criminal.

**Meeker v. Halsey*, 87 F. (2d) 299 (C. C. A. 2d, 1937); *Red Bank Building and Loan Ass'n v. Alling*, 20 F. Supp. 474 (D. N. J. 1937); *Willing v. Lupin Building and Loan Ass'n*, 20 F. Supp. 774 (E. D. Pa. 1937); *Powell v. Hood, ex rel. United Bank and Trust Co.*, 211 N. C. 137, 189 S. E. 483 (1937); *Perring v. Baltimore Trust Corp.*, 171 Md. 618, 190 Atl. 516 (1937).

1. These problems are fully discussed in Moore and Sussman, *The Current Account and Set-Offs between an Insolvent Bank and its Customer* (1932) 41 YALE L. J. 1109. For a history of the doctrine of set-off, see authorities cited in Comment (1932) 41 YALE L. J. 881, at 882, n. 2.

2. *Scott v. Armstrong*, 146 U. S. 499 (1892); Moore and Sussman, *supra* note 1, at 1118 *et seq.*

3. Except where the customer may be indemnified from another source for his payment on the instrument. *E.g.*, an endorser is not entitled to set off where the maker is solvent [*Bank of United States v. Braveman*, 259 N. Y. 65, 181 N. E. 50 (1932), (1932) 2 BKLN. L. REV. 122; (1932) 32 COL. L. REV. 1063]; nor a surety where the principal is solvent [*Hutchinson Coal Co. et al. v. Miller*, 20 F. Supp. 718 (N. D. W. Va. 1937); Comment (1932) 41 YALE L. J. 881].

4. See Moore and Sussman, *supra* note 1.

5. This note is confined to these situations. General set-off principles are equally applicable here. As long as the bank's obligation to the customer is already due, most

the convergence of general set-off principles with the legal consequences of pledging a note as collateral security.

The relevant principles regulating realization upon notes pledged as collateral security may be briefly stated.⁶ Upon maturity of the debt, if the pledgor fails to redeem the collateral by payment, the pledgee may sue in his own name for the entire amount due upon the note.⁷ If the amount of the collateral does not exceed the debt, the pledgee may retain the entire proceeds; but if the collateral is worth more than the debt, he must return the surplus to the pledgor.⁸

A simple set of facts forms the framework for the series of situations in which the issue of set-off arises in connection with the depositor's note held by the receiver for the bank as pledgee. A borrower from a bank pledges a note of a customer of the bank as collateral security for the loan. Upon sequestration of the bank's assets, the receiver, unable to collect from the borrower, sues the maker-customer on the collateral note. The maker claims the right to set off his deposit balance in the bank. If the collateral note does not exceed the pledgor's debt, the depositor is clearly entitled to a set-off.⁹

courts will not bar a set-off merely because the customer's obligations may not yet have matured at the time of sequestration. *Upham v. Bramwell*, 105 Ore. 597, 209 Pac. 100 (1922), 25 A. L. R. 938 (1923); *Clark, Set-off in Cases of Immature Claims in Insolvency and Receivership* (1920) 34 HARV. L. REV. 178; (1932) 80 U. OF PA. L. REV. 420. Relative rights are determined as of the time of sequestration [*Dakin v. Bayly*, 290 U. S. 143, 90 A. L. R. 999 (1933)]; *Gerseta Corp. v. Equitable Trust Co.*, 241 N. Y. 418, 150 N. E. 501 (1926); *Sloss v. Taylor*, 182 Ark. 1031, 34 S. W. (2d) 231 (1931)], and the receiver stands in the shoes of the insolvent, being subject to all the set-offs, counter-claims, liens and encumbrances valid against the insolvent. *Advance Exchange Bank v. Baldwin*, 31 S. W. (2d) 96 (Mo. 1930); *Bank of Woodward v. Robertson*, 111 Okla. 58, 238 Pac. 844 (1925).

6. A variety of nebulous legal theories have been advanced to rationalize the simple practical result: (1) The pledgee is said to be the legal owner to the extent of the debt but with only a qualified interest and a special title, any remainder belonging to the pledgor. See *Pearce v. Rice*, 142 U. S. 28, 38 (1891); *Lewis v. Smith*, 289 S. W. 1018, 1019 (Tex. Civ. App. 1927). (2) The pledgee may be considered the legal owner of all the collateral, holding it in trust for himself to the extent of the debt and for the pledgor for the remainder. But, until the principal obligation is paid, only the pledgee may sue on the collateral note. See *In re Thompson*, 276 Fed. 313, 317 (W. D. Pa. 1921); *Ball-Thrash & Co., v. McCormick*, 162 N. C. 471, 474, 78 S. E. 303, 306 (1913); COLEBROOKE, COLLATERAL SECURITIES (2d ed. 1898) § 87. (3) The "general property" remains in the pledgor with only a "special property" vesting in the pledgee. *Sparks v. Caldwell*, 157 Cal. 401, 108 Pac. 276 (1910); *Winnemucca State Bank and Trust Co. v. Corbell*, 42 Nev. 378, 178 Pac. 23 (1919). For the sake of uniformity in exposition, this note will call the pledgee a "trustee" of the surplus, as in *Aab v. French*, 279 S. W. 435 (Mo. 1926).

7. *National Bank of Republic of Chicago v. American Brewing Co.*, 79 Mont. 605, 257 Pac. 1043 (1927); *Hodge v. Truax*, 184 Wash. 360, 51 P. (2d) 357 (1935); BRANNAN, NEGOTIABLE INSTRUMENTS LAW (5th ed. 1932) §§ 27, 51.

8. See *Tooke v. Newman*, 75 Ill. 215, 218 (1874); 2 DANIEL, NEGOTIABLE INSTRUMENTS (7th ed. 1933) § 974.

9. *Willing v. Lupin Building and Loan Ass'n*, 20 F. Supp. 774, *id.* 777 (E. D. Pa. 1937) (collateral note less than debt); *Aab v. French*, 379 S. W. 435 (Mo. 1926) (col-

The bank as pledgee is treated as a holder for value in toto; it could apply the entire proceeds of the note to the debt of the pledgor, and the relationship between pledgee and maker is identical with the ordinary banker-customer set-off. Nor do the general creditors occupy a more disadvantageous position than customarily, for the real amount of the debt, as in the case of independent causes of action, is deemed to be the difference between the two series of obligations. And unless the pledgor also possesses a credit balance with the bank at the time of insolvency—a situation to be considered later—he suffers no prejudice, for despite the set-off his debt is deemed paid to the extent of the collateral note.¹⁰

A different result occurs, however, when the collateral note exceeds the debt for which it was pledged. The pledgee is then a holder for value only to the extent of the debt and the maker is entitled to set off his deposit only up to that amount. Since the excess must be returned to the pledgor, to that extent the receiver is suing only as trustee and there is no basis for a set-off.¹¹ More complicated is the problem where the depositor's note represents only a small part of the collateral which, in the aggregate, exceeds the pledgor's debt. Then the question of whether the depositor's note is to be considered a part of the surplus may depend upon the fortuitous circumstance of how the receiver chose to realize on the collateral. If the customer's note is one of those selected before satisfaction of the debt, the customer could claim a set-off as in the first type situation.¹² But for any amount collected afterwards, the receiver would again be considered a trustee and "mutuality," as the courts term it, would be lacking.¹³

If the pledgor in either of these situations had a credit balance in the bank at the time of sequestration, he too may claim a set-off. Rather than accept a dividend on the basis of his entire deposit claim while the collateral note is used to eradicate his indebtedness, the pledgor obviously would prefer to set-off his deposit against his debt and recover the full proceeds of the collateral note independently. The effect would be to deprive the maker of the collateral note of the benefits of a set-off to which he would otherwise be entitled. This result is permitted on the ground that the pledgor is primarily liable and is entitled to a return of his collateral upon payment of his debt.¹⁴ However, if the pledgor's deposit is less than his debt, it seems con-

lateral note exactly equal to debt); *Love v. Hytken*, 168 Miss. 194, 150 So. 777 (1933) (*semble*). But *cf.* *Cosmopolitan Trust Co. v. Golub*, 252 Mass. 574, 147 N. E. 847 (1925) (shares of credit union as collateral; set-off denied).

10. *Aab v. French*, 279 S. W. 435 (Mo. 1926).

11. *Meeker v. Halsey*, 87 F. (2d) 299 (C. C. A. 2d, 1937) (because it was not clear whether the collateral exceeded the debt for which it was pledged, the case was remanded for a new trial, with instructions to permit a set-off only in case the pledged assets were not enough to pay the pledgor's debt). But *cf.* *Leonard v. Taylor*, 183 Ark. 933, 39 S. W. (2d) 704 (1931) (state warrants; court apparently overlooked fact that collateral greatly exceeded the debt).

12. *Meeker v. Halsey*, 87 F. (2d) 299 (C. C. A. 2d, 1937).

13. *Cf.* *Perring v. Baltimore Trust Corp.*, 171 Md. 618, 190 Atl. 516 (1937).

14. *Southern Ry. Co. v. Elliott*, 86 F. (2d) 294 (C. C. A. 4th, 1936). It might also be argued that the pledgor is more entitled to a set-off than the maker, since the pledgor

sistent with existing doctrine to permit the maker to set off his own deposit to the extent of the difference.¹⁵

When the insolvent bank occupies the position of pledgor rather than pledgee, the commingling of the doctrines of set-off and collateral presents another set of problems. To secure a loan from a third party, the bank pledges a note upon which one of its depositors is obligated as maker.¹⁶ The right of the customer to set off his deposit balance may then be raised in three types of suit: (1) By the receiver for the pledgor bank against the customer-maker after redemption of the pledge; (2) by the pledgee against the customer-maker; and (3) by the customer against the pledgor to be reimbursed for money paid to the pledgee.

The question of set-off may arise in a suit by the receiver for the bank upon the customer's collateral note which the receiver has redeemed after the sequestration of assets. Since events after insolvency are supposedly inoperative as to set-offs,¹⁷ denial of a set-off might theoretically be anticipated, especially where the depositor's note would have had to satisfy the pledgee's lien if the latter had collected upon the collateral in order of maturity. But a suit against a depositor on a redeemed note resembles so closely the ordinary banker-customer situation, that courts unhesitatingly permit the set-off. Justification is found in the idea that the redeemed note is an asset of the insolvent estate and, as such, a proper subject for a set-off.¹⁸

The crux of the second problem is whether the pledgee, in a suit against the maker upon the collateral note, is subject to claims of set-off which the maker, as depositor, may have had against the pledgor bank. This depends upon the time and character of the pledge. If the note is transferred after sequestration as security for an antecedent debt, the pledgee takes subject to the customer's right of set-off, regardless of whether the note had yet matured when pledged.¹⁹ However, if the pledge was made before sequestration, the pledgee is deemed a holder for value; ordinarily he could recover the full amount of the collateral note and retain the excess, if any, in trust for the pledgor.²⁰ But to avoid circuity of action, a pledgee is limited to the extent

consciously entered into the transaction with the bank which gave rise to the set-off possibility, whereas a set-off would come as a mere "windfall" to the maker.

15. The pledgor would not be injured, nor would the general creditors lose any more than where the receiver for the pledgee bank sues on the maker's note which it holds as collateral security for a debt larger or equal in amount. See note 10, *supra*.

16. Bank borrowings from the Reconstruction Finance Corporation have recently accounted for many of these situations. See cases cited note 25, *infra*. Rediscounting of a customer's note raises similar problems. See Moore & Sussman, *supra* note 1, at 1131.

17. See note 5, *supra*.

18. *Ellerbe v. Studebaker Corp.*, 21 F. (2d) 993 (C. C. A. 4th, 1927); *Clute v. Warner*, 8 App. Div. 40, 40 N. Y. Supp. 392 (3d Dep't 1896); *Williams v. Burgess*, 74 W. Va. 623, 82 S. E. 507 (1914); *French v. Commercial Wall Paper Mills, Inc.*, 100 Ind. App. 573, 197 N. E. 716 (1935).

19. *First Nat. Bank of Rocky Ford v. Lewis*, 57 Colo. 124, 139 Pac. 1102 (1914) (after maturity); *Merchants' Exchange Bank v. Fuldner*, 92 Wis. 415, 66 N. W. 691 (1896) (before maturity).

20. See note 8, *supra*.

of his beneficial interest whenever the maker of the note has a right of set-off against the pledgor. Thus if the collateral note exceeds the debt for which it was pledged, the maker can set off his deposit with the pledgor to the extent of the surplus.²¹ But where the customer's note is only one of many items pledged in an amount exceeding the debt, as usually happens in large-scale borrowing, the question arises whether it is fair to permit his note to be collected when the pledgee has available other collateral notes whose makers are not entitled to set-offs. One solution has been to require the pledgee to demonstrate as a prerequisite to recovery that other collateral security for the debt was invalid or uncollectible;²² and it has been suggested that the maker may safeguard its interest by bringing an action against the pledgee to compel it to exhaust other collateral first.²³ But this remedy is usually denied on the ground that the customer-maker is a debtor of the pledgee and therefore not entitled to the marshalling rights of a co-creditor.²⁴

The customer is not without a remedy, however, where, unaware of his set-off rights,²⁵ he has paid the full amount of his note to a pledgee whose total collateral exceeded the debt from the bank to the pledgee. In an action against the receiver, the customer may then be reimbursed for the amount of his note out of the surplus returned by the pledgee.²⁶ This is on the theory

21. Otherwise, the pledgee would have to return the surplus to the receiver for the pledgor bank and the customer would then be entitled to reimbursement out of the excess. *Yellowstone Nat. Bank v. Gagnon*, 19 Mont. 402, 48 Pac. 762 (1897); *National Bank of Commerce v. Bottolfson*, 55 S. D. 196, 225 N. W. 385 (1929), 69 A. L. R. 898 (1930).

22. *Livestock State Bank v. Locke*, 277 S. W. 405 (Tex. Civ. App. 1925).

23. This procedure is suggested in *Seymour v. Becker*, 71 Minn. 394, 73 N. W. 1096 (1898). Supporting authority is scanty. In *Chemical Nat. Bank v. Kiam*, 52 Tex. Civ. App. 253, 113 S. W. 948 (1908), the court applied the doctrine of marshaling assets and securities.

24. *Sowell v. Federal Reserve Bank of Dallas*, 294 Fed. 798 (C. C. A. 5th, 1923); *Merchants and Marine Bank of Pascagoula, Miss. v. Hibernia Bank & Trust Co.*, 16 F. Supp. 433 (E. D. La. 1936); *Hanesley v. National Park Bank of New York*, 147 Ga. 96, 92 S. E. 879 (1917).

25. The effect is the same whether the customer was totally ignorant of his rights or whether he was forced to relinquish his verbal claims by the superior bargaining position of the pledgee. *Red Bank Bldg. & Loan Ass'n v. Alling*, 20 F. Supp. 474 (D. N. J. 1937) (no waiver even though collateral note was non-negotiable). See also *Merchants' Ice & Fuel Co. v. Holland Banking Co.*, 8 S. W. (2d) 1030 (Mo. 1928) (pledgee represented that collateral note was sold to him); *Powell v. Hood*, 211 N. C. 137, 189 S. E. 483 (1937) (R. F. C., pledgee, claimed to be holder in due course).

26. Reimbursement is allowed whether the returned surplus is composed of uncollected notes [*Red Bank Bldg. & Loan Ass'n v. Alling*, 20 F. Supp. 474 (D. N. J. 1937); *Seymour v. Becker*, 71 Minn. 394, 73 N. W. 1096 (1898); *Powell v. Hood*, 211 N. C. 137, 189 S. E. 483 (1937)], or of collected proceeds [*Merchants' Ice & Fuel Co. v. Holland Banking Co.*, 8 S. W. (2d) 1030 (Mo. 1928); *Schaeffer v. Ruden*, 61 S. D. 64, 246 N. W. 105 (1932)]. *Contra*: *Balbach v. Frelinghuysen*, 15 Fed. 675 (C. C. D. N. J. 1883)]. Where a number of depositors are similarly situated, the receiver is to distribute the surplus *pro rata*. *Hall v. Burrell*, 22 Colo. App. 278, 124 Pac. 751 (1912). But apparently no reimbursement will be allowed if the total collateral at the time of the realization on the pledge did not exceed the debt for which it was pledged. *Leach v. City-Commercial Sav. Bank of Mason City*, 207 Ia. 1254, 219 N. W. 496 (1928) (*semble*).

that since the customer could have set off his deposit balance if the bank had not pledged his note, he should be entitled to a share of the surplus for which his payment was partially responsible. The general creditors are said to have no interest in the pledged collateral until the claims of the pledgee and the equities of the maker-depositor have been satisfied.²⁷

The almost monotonous consistency with which the various combinations of collateral security and set-off principles dovetail tends to obscure the fortuitous nature of the depositor's set-off rights. Where his note has been pledged by a third party to the depositor's bank, the outcome depends upon the course of the receiver's action. And the customer apparently has no remedial device to compel the receiver to realize upon collateral in a manner which will procure for him the benefit of a set-off. On the other hand, the receiver has some power to further the interests of the general creditors by diminishing as far as possible the opportunity for customers to set off their deposits. When he holds the customer's note as collateral for another's debt, he can first exhaust every other means of collecting the principal debt not only by pressing the principal debtor but also, if he finds a large amount of excess collateral for the third party's debt, by attempting to realize upon collateral other than the customer's note. A pledgor who is also a depositor is in a better position, however, to claim any credit balance in his current account with the pledgee bank as an off-set against his own debt, thus leaving him free to collect the entire proceeds of the collateral note from the principal obligor. In instances where the customer's note has been pledged by his bank, the sphere of ingenuity is severely circumscribed by the readiness with which courts grant reimbursement to the customer. The primary aim, then, should be to avoid circuitry in achieving the ultimate satisfaction of claims.

ENFORCEMENT OF AFFIRMATIVE COVENANTS RUNNING WITH THE LAND*

ALTHOUGH the English courts have consistently held that affirmative covenants will not be made to run with the land either in law or in equity,¹ the American law on this point has fallen into confusion. Of forty-two cases involving the running of affirmative covenants decided during the last ten

27. See cases cited note 26, *supra*. A few courts have reached a contrary decision either on the legalistic ground that since the bank had no right to demand any part of its collateral until full payment of its indebtedness, a set-off was precluded because the collateral note was not its property at the time of insolvency [*Balbach v. Frelinghuysen*, 15 Fed. 675, 686 (C. C. D. N. J. 1883)], or on the ground that the depositor has waived any right of set-off by voluntarily paying the note, even though under protest. *Leach v. City-Commercial Savings Bank of Mason City, Ia.*, 207 Ia. 1254, 219 N.W. 496 (1928). But see *Red Bank Bldg. & Loan Ass'n v. Alling*, 20 F. Supp. 474 (D. N. J. 1937) (no waiver even though collateral note was non-negotiable).

**Maher v. Cleveland Union Stockyards Co.*, 55 Ohio App. 412, 9 N. E. (2d) 995 (1936).

1. *E. & G. C., Ltd. v. Bate* (1935) 79 L. J. 203 (K. B. 1935).

years,² the covenants were enforced in twenty-one,³ stated by way of dicta to run in two,⁴ and not enforced in nineteen.⁵ Twenty-five states are represented by these decisions, of which ten are to be found in the enforcing column, nine in the non-enforcing column, and six in both.

The chaotic condition of the American cases has resulted from both an uncritical acceptance and an inconsistent use of ancient theories. Conventionally, a real covenant is said to have four "essentials:" nature, form, intent, and privity.⁶ "Nature" refers to the sixteenth century doctrine that

2. Covenants to pay rent have been excluded from this discussion. It is well settled that such covenants run with the land. See (1936) 102 A. L. R. 781, 784.

3. *Zanes v. Lehigh Valley Transit Co.*, 41 F. (2d) 552 (E. D. Pa. 1930); *Cummings v. Alexander*, 233 Ala. 10, 169 So. 310 (1936) (running of benefit); *Pedro v. Humboldt County*, 217 Cal. 493, 19 P. (2d) 776 (1933) (running of benefit); *Wanamaker Ditch Co. v. Pettit*, 89 Colo. 344, 3 P. (2d) 295 (1931); *Proctor v. Redfern*, 182 Ga. 175, 185 S. E. 255 (1936); *Carder v. Hughett*, 243 Ill. App. 170 (1926); *Dodd v. Rotterman*, 330 Ill. 362, 161 N. E. 756 (1928); *Stover v. Harlan*, 87 Ind. App. 347, 154 N. E. 882 (1927); *Fair Bldg. Co. v. Wineman Realty Co.*, 87 Ind. App. 520, 156 N. E. 433 (1927); *Swiss Oil Corp. v. Dials*, 232 Ky. 298, 22 S. W. (2d) 912 (1929); *Union Trust Co. of Md. v. Rosenberg*, 171 Md. 409, 189 Atl. 421 (1937); *Mueller v. Bankers Trust Co. of Muskegon*, 262 Mich. 53, 247 N. W. 103 (1933) (running of benefit); *Robins v. Wright*, 331 Mo. 377, 53 S. W. (2d) 1046 (1932); *Child v. C. H. Winans Co.*, 119 N. J. Eq. 556, 183 Atl. 300 (1936); *Morgan Lake Co. v. N. Y., N. H. & H. R.R.*, 262 N. Y. 234, 186 N. E. 685 (1933); *Kennilwood Owners' Ass'n, Inc. v. Jaybro Realty & Development Co., Inc.*, 156 Misc. 604, 281 N. Y. Supp. 541 (Sup. Ct. 1935); *Matter of Acquiring Title to East 96th St.*, N. Y. L. J., Dec. 21, 1937, p. 2296, col. 1 (Sup. Ct.) (running of benefit); *Maher v. Cleveland Union Stockyards Co.*, 9 N. E. (2d) 995 (Ohio App. 1936); *Guild v. Wallis*, 130 Ore. 148, 279 Pac. 546 (1929); *Beck v. Lane County*, 141 Ore. 580, 18 P. (2d) 594 (1933); *Cohen v. Turner*, 90 Pa. Super. Ct. 255 (1926).

4. See *Levy v. Schnurmacher Construction Corp.*, 255 N. Y. 83, 86, 174 N. E. 70, 71 (1930); *Parks v. Hines*, 68 S. W. (2d) 364, 367 (Tex. Civ. App. 1934).

5. *Brewster-Greene v. Robinson*, 34 Ariz. 547, 273 Pac. 538 (1929); *Holthoff v. Joyce*, 174 Ark. 248, 294 S. W. 1006 (1927); *Ft. Smith Gas Co. v. Gean*, 186 Ark. 573, 55 S. W. (2d) 63 (1932); *Layne v. Bryant*, 108 Cal. App. 324, 291 Pac. 615 (1930); *Coulter v. Sausalito Bay Water Co.*, 122 Cal. App. 480, 10 P. (2d) 780 (1932); *Bradford Realty Corp. v. Beetz*, 108 Conn. 26, 142 Atl. 395 (1928); *Keogh v. Peck*, 259 Ill. App. 503 (1931); *Cambais v. Douglas*, 167 La. 791, 120 So. 369 (1929); *Gilman v. Forgione*, 129 Me. 66, 149 Atl. 620 (1930) (running of benefit); *Mayo v. Dearborn*, 131 Me. 455, 163 Atl. 779 (1933) (running of benefit); *Orenburg v. Johnston*, 269 Mass. 312, 168 N. E. 794 (1929); *Buhl Land Co. v. Franklin Co.*, 258 Mich. 377, 242 N. W. 772 (1932); *Poage v. Quincy, O. & K. C. R.R.*, 23 S. W. (2d) 221 (Mo. App. 1930); *Guaranty Trust Co. of N. Y. v. New York & Q. C. Ry.*, 253 N. Y. 190, 170 N. E. 887 (1930), *reargument denied*, 254 N. Y. 126 (1930), *appeal dismissed*, 282 U. S. 803 (1930); *Greenfarb v. R. S. K. Realty Corp.*, 229 App. Div. 250, 241 N. Y. Supp. 439 (1930) (running of benefit); *Epting v. Lexington Water Power Co.*, 177 S. C. 308, 181 S. E. 66 (1935); *Montgomery v. Creager*, 22 S. W. (2d) 463 (Tex. Civ. App. 1929); *Lincoln Fireproof Warehouse Co. v. Greusel*, 199 Wis. 428, 224 N. W. 98 (1929), *aff'd on reargument*, 199 Wis. 428, 227 N. W. 6 (1929); *Lingle Water Users' Ass'n v. Occidental Bldg. & Loan Ass'n*, 43 Wyo. 41, 297 Pac. 385 (1931).

6. See CLARK, REAL COVENANTS AND OTHER INTERESTS WHICH "RUN WITH LAND" (1929) 74.

only covenants which touch and concern the thing demised may run with the land.⁷ Although this principle appears in almost all the decisions, its meaning is still uncertain. In cases involving covenants to maintain drainage ditches upon land conveyed, the Oregon court held that the covenant touched and concerned the land,⁸ while the California court stated that the agreement was not a covenant touching and concerning, but was a mere personal undertaking;⁹ yet both courts enforced the agreement. A covenant to furnish electric power from land conveyed to land retained has been denied enforcement on the ground that it did not concern the land,¹⁰ but it has been held that a grantor's agreement to build a bridge upon land other than that conveyed related to and ran with the grantee's land.¹¹ The decisions on the second of the four "essentials," the need for technical requirements, are also irreconcilable. Two courts held technical words unnecessary and enforced the covenants.¹² Two other courts refused to enforce the covenants on the express ground of failure to follow technical form and include the cabalistic words.¹³ Furthermore, in regard to the relation of the intent of the original parties to the question of the covenant's running,¹⁴ it has been held that intent is always a material inquiry,¹⁵ that it is the decisive element even where the covenant concededly touches the land,¹⁶ and, on the other hand, that it does not control even where the parties clearly intended the covenant to run.¹⁷ Finally, of the "four essentials of a real covenant," only the last, privity, seems to have lost its argumentative significance. The courts have generally accepted the definition of privity which limits it to the mere

7. *Spencer's Case*, 5 Coke, 16(a) (K. B. 1583). For a modern apotheosis of touch and concern, see Gavit, *Covenants Running with the Land* (1930) 24 ILL. L. REV. 786.

8. *Guild v. Wallis*, 130 Ore. 148, 279 Pac. 546 (1929). Although the court enforced the obligation, it became so engrossed in the touch and concern doctrines that it quoted from a previous case to prove that the covenant was beneficial to the plaintiff as owner, and to no other person, and consequently ran with the plaintiff's land. Since the running of the benefit was not at issue, and since that fact would furnish no reason for the running of the burden, it is difficult to determine the relevance of this test.

9. *Pedro v. Humboldt County*, 217 Cal. 493, 19 P. (2d) 776 (1933) (running of the benefit). Accord: *Greenfarb v. R. S. K. Realty Corp.*, 229 App. Div. 250, 241 N. Y. Supp. 439 (1930). For the status of the New York Rule, see (1927) 12 CONN. L. Q. 404; (1933) 19 CORN. L. Q. 145.

10. *Epting v. Lexington Water Power Co.*, 177 S. C. 303, 181 S. E. 66 (1935), (1936) 13 N. Y. U. L. Q. REV. 313.

11. *Mueller v. Bankers Trust Co. of Muskegon*, 262 Mich. 53, 247 N. W. 103 (1933) (running of the benefit).

12. *Pedro v. Humboldt County*, 217 Cal. 493, 19 P. (2d) 776 (1933); *Union Trust Co. of Md. v. Rosenberg*, 171 Md. 409, 189 Atl. 421 (1937), (1937) 1 MD. L. REV. 320.

13. *Mayo v. Dearborn*, 131 Me. 455, 163 Atl. 779 (1933) (stipulation in deed poll, instead of sealed covenant signed by both parties); *Lincoln Fireproof Warehouse Co. v. Greusel*, 199 Wis. 428, 224 N. W. 98 (1929) (failure to refer to "assigns").

14. CLARK, *op. cit. supra* note 6, at 74, 75.

15. *Bradford Realty Corp. v. Beetz*, 103 Conn. 26, 142 Atl. 395 (1928).

16. *Gilman v. Forgiione*, 129 Me. 66, 149 Atl. 620 (1930).

17. *Keogh v. Peck*, 259 Ill. App. 503 (1931).

succession to the interest of one of the original parties to the covenant,¹⁸ and either ignore or glide over it in the decisions.¹⁹

Another element producing confusion has been the union of law and equity.²⁰ The equity courts had developed a doctrine that an assignee who took the land with actual or constructive notice of a restrictive covenant was bound by the covenant.²¹ With the union of law and equity, courts were able to draw upon this doctrine as well as those developed at common law to enforce affirmative covenants. The result was to blur whatever indistinct lines had theretofore existed between legal and equitable covenants, and to render it difficult to determine whether the equitable doctrines were maintaining a separate existence or had caused an extension of the common law rule. Furthermore, the equitable doctrines were no more consistently applied than the common law rules. In the eyes of one court notice is an immaterial element,²² and in the eyes of another it is a requisite for liability on a covenant already held to run with the land.²³ It has been held, on one hand, that purchase with notice of the covenant could not render enforceable a covenant which did not relate to or concern the land,²⁴ and, on the other, that constructive notice rendered a covenant enforceable whether it ran with the land or not.²⁵ Moreover, some courts employ constructive notice as a basis for implying—from vague words in the grant—an assumption of the covenant by the assignee.²⁶

A recent case, however, seems to indicate a willingness to lay aside many of these metaphysical doctrines and look solely at the intent of the parties and the equities of the situation. From plaintiff's father, defendant's prede-

18. An exception to this general development is the "Massachusetts doctrine of substituted privity," which requires a tenure relation, *i.e.*, that covenantor and covenantee each have an interest in the land beyond the covenant. See (1930) 39 YALE L. J. 911. This view has been criticized by Dean Clark as masking a policy against encumbrances under the cover of another doctrine. See Clark, *The Doctrine of Privity of Estate in Connection with Real Covenants* (1922) 32 YALE L. J. 123, 142.

19. For example, in *Maher v. Cleveland Union Stockyards Co.*, 9 N. E. (2d) 995 (Ohio App. 1936), the court expressly found the plaintiff in privity with the covenantee by virtue of a deed passing all the covenantee's interest, but never considered the question of privity between the defendant and the covenantor.

20. *Lloyd, Enforcement of Affirmative Agreements Respecting the Use of Land* (1928) 14 VA. L. REV. 419.

21. This theory is the "equitable doctrine of *Tulk v. Moxhay*," 2 Phil. 774 (Ch. 1848), so-called from the renowned decision which is accredited with the birth of the rule.

22. *Coulter v. Sausalito Bay Water Co.*, 122 Cal. App. 480, 10 P. (2d) 780 (1932).

23. *Poage v. Quincy, O. & K. C. R.R.*, 23 S. W. (2d) 221 (Mo. App. 1930). The court was here applying the equitable doctrine to a covenant to maintain ditches, the sort of covenant clearly cognizable at law.

24. *Montgomery v. Creager*, 22 S. W. (2d) 463 (Tex. Civ. App. 1929).

25. *Guild v. Wallis*, 130 Ore. 148, 279 Pac. 546 (1929).

26. *Zanes v. Lehigh Valley Transit Co.*, 41 F. (2d) 552 (E. D. Pa. 1930); *Wanamaker Ditch Co. v. Pettit*, 89 Colo. 344, 3 P. (2d) 295 (1931); *Swiss Oil Corp. v. Dials*, 232 Ky. 298, 22 S. W. (2d) 912 (1929). *Contra*: *Lingle Water Users' Ass'n v. Occidental Bldg. & Loan Ass'n*, 43 Wyo. 41, 297 Pac. 385 (1931).

cessor in title bought a strip of land for a consideration of two dollars and a promise to save the grantor harmless from all assessments on his adjoining property for the opening by the city of a street over the strip. The deed conveying the strip to defendant from the covenantor referred to the conditions in the deed to its predecessor. Thirty years after the sale, the city opened the street, and several years later laid a sewer. The tract conveyed by her father to plaintiff was assessed for the opening of the street and installation of the sewer. In an action against defendant, plaintiff recovered both assessments. But the Court of Appeals of Ohio reversed the judgment for the sewer assessment²⁷ while affirming that for the street assessment.²⁸

To one result of the instant case, the running of the benefit of the covenant, there should be little objection. The court relied on a supposition that the assignee had succeeded to all the interest of the grantor by means of a quitclaim deed. Actually the deed was not a quitclaim,²⁹ but this fact would not affect the succession theory. Furthermore, the court did not need to look to the terms of the deed, for only a present owner of the retained property could benefit directly from performance of the covenant. As assessments are charged against the land and not against the individual owner, the covenant would seem to be a promise to pay the city. There would be nothing for the promisee of a personal covenant to take, for the only claimant who could show an interest beside the city would be the present owner whom the covenantor has failed to protect and who has been forced to pay the city himself. Finally, the running of the benefit is generally to be favored, for it is then easier to ascertain and locate the holder of that beneficial interest, an important problem whenever a release of the obligation is desired.

But the other result of the instant case, that affirmative covenants which the parties intend to run will bind an assignee who takes with notice, might well be questioned. In applying this test, the court found both constructive notice in the recording of the first deed and actual notice in the second deed's reference to conditions set out in the first. And to find the requisite intent the court regarded the covenant as the actual consideration and the conveyance as a grant of bare title with a postponement of payment of the consideration.³⁰ Adoption of intent as a guiding test would introduce no

27. The court considered the laying of a sewer unnecessary to the opening of a street and found that the parties did not intend the covenant to include anything done upon the street subsequent to the opening.

28. *Maier v. Cleveland Union Stockyards Co.*, 9 N. E. (2d) 995 (Ohio App. 1936). A settlement was reached after this decision, and no further appeal was prosecuted. Communication to the YALE LAW JOURNAL from defendant's counsel, Oct. 15, 1937.

29. Brief for Defendant filed in the Supreme Court of Ohio for an appeal which was later abandoned.

30. This splitting of the transferred estate is analogous to the theory of a grant of title with restriction upon user, which has been employed in the party-wall cases. See Clark, *Party Wall Agreements as Real Covenants* (1924) 37 HARV. L. REV. 301, 311. The court also used an argument of estoppel, which has been relied upon to enforce the running of the benefit of a similar covenant. *Matter of Acquiring Title to East 96th St.*, N. Y. L. J., Dec. 21, 1937, p. 2296, col. 1 (Sup. Ct.).

certainty into this confused field of law, but would re-emphasize the judicial discretion to decide what covenants shall run—a discretion of which the courts have often lost sight because the ancient theories designed merely to aid in administering a rule were permitted to obscure the rule. But to say that intent exists where a covenant is the consideration for a deed would make all covenants run; for every covenant may properly be said to constitute part of the consideration.³¹ The same result would probably ensue from general use of the notice doctrine. For although the finding of the specific fact of notice, constructive or actual, is required, such a finding has become increasingly easier under modern recordation systems.³²

Furthermore, the general enforcement of all affirmative covenants that are unlimited in duration will encounter the policy of fostering the alienability of land which underlies both the English affirmative covenant rule and the Rule against Perpetuities.³³ Against that policy must be weighed two opposing policies: to promote freedom of contract and to prevent unjust enrichment. But the unjust enrichment argument, once it had been held that no affirmative covenants run, would not seem very persuasive to a court willing to indulge in the presumption regarding knowledge of the law; yet today it is a strong force in specific instances.³⁴ The freedom of contract justification, however, directly contradicts the argument advanced in behalf of the English rule, for the proposition is that by fostering freedom of contract men will derive the greatest possible economic advantage from the use of land. Indeed, the English view has been controverted by supporters of the American rule who maintain that the running of affirmative covenants and equitable servitudes will not clog but will enhance land's alienability.³⁵ The final resolution of this conflict may well await a factual analysis of the effect of affirmative covenants upon land's alienability.³⁶ But until that time,

31. This effect might be narrowed by distinguishing between covenants recognized as the substantial consideration and covenants regarded as merely incidental consideration.

32. Different requirements for title search might bear on the finding of constructive notice. See (1936) 21 CORN. L. Q. 479.

33. The Rule against Perpetuities is directed against remoteness in the vesting of interests and not against remoteness in the accrual of liability. It does not apply to real covenants or other contracts which do not offend against the vesting doctrine. *Clem v. Valentine*, 155 Md. 19, 141 Atl. 710 (1928) (restrictive covenant); see Leach, *Perpetuities in a Nutshell* (1938) 51 HARV. L. REV. 638, 660; Comments (1934-35) 23 GEO. L. J. 105, 301, and 519. It has been maintained that the Rule should apply to option-to-purchase covenants and to party-wall covenants. For a device to avoid the Rule in the latter class of covenants, see Clark, *supra* note 30, at 311. For arguments against applying the Rule to the former class of covenants, see Comment (1925) 35 YALE L. J. 213.

34. See *Maher v. Cleveland Union Stockyards Co.*, 9 N. E. (2d) 995, 998 (Ohio App. 1936) (running of burden); *Pedro v. Humboldt County*, 217 Cal. 493, 497, 19 P. (2d) 776, 777 (1933) (running of benefit).

35. See 2 SIMES, FUTURE INTERESTS (1936) § 513.

36. A compromise in this policy conflict has been suggested. Its proponents would permit affirmative covenants to run only in the building subdivision situations, where there is the additional social purpose of fostering city planning, as opposed to the more directly selfish aims of the individual contractors in the ordinary covenant case. Comment (1938) 51 HARV. L. REV. 320, 326. Not only would this compromise add another

it would seem that the controlling considerations should be the doctrines of intent and notice. For these doctrines should remove much of the confusion in analysis and argument, and the result avoids the inconsistency of the English rule which permits restrictive covenants to run despite the fact that the alienability arguments apply equally well to them.

APPLICATION OF STATUTE OF LIMITATIONS TO FORGED INDORSEMENTS IN CHECK COLLECTION CASES*

THE POINT at which the Statute of Limitations begins to run in favor of one who indorses a check upon which a prior indorsement has been forged is generally said to depend upon whether the bank receiving the check is a purchaser or an agent of the prior party.¹ If it is considered a purchaser, the collection bank may recover from previous indorsers upon any one of three rationales. But whichever one of the various theories of action the purchaser may happen to select, the running of the Statute is approximately the same, for, according to the majority rule, the time of discovery of the forgery is always immaterial.²

As the first of his alternative courses of action, the purchaser may sue on the theory that the forged indorsement was wholly inoperative,³ and that

category to invite interpretation and exceptions, but also it would leave unchanged, except for the extension in this one situation, the inconsistency in allowing the running of restrictive covenants. Horizontal limitations on encumbrances are preferable to vertical limitations but should be left to legislative edict. See CLARE, *op. cit. supra* note 6, at 139, n. 58.

*Federal Reserve Bank of Atlanta, for use of American Surety Co. of New York v. Atlanta Trust Co., 91 F. (2d) 283 (C. C. A. 5th, 1937).

1. Turner, *Deposits of Demand Paper as Purchases* (1928) 37 YALE L. J. 874. The distinction between a bank as purchaser or agent has usually been made in contemplation of the problem involving the liability of the bank of deposit for negligent collection of checks. Under the New York collection rule, the bank of deposit is the purchaser, and is liable for the acts of its sub-agents, while under the so-called Massachusetts rule, it is merely an agent for transmission of paper to the proper correspondents. For a brief discussion of the two rules, their origin, and relative merits, see Comment (1924) 33 YALE L. J. 753, n. 1.

In the present discussion, "purchaser," or "agent," refers to the relationship between the intermediate banks through which the paper has to pass in its way from the bank of deposit to the drawee. This relationship is not based on the relation of the original bank of deposit to its depositor but upon the nature of the transaction between each indorsee bank and its immediately prior indorser. See Steffen, *The Check Collection Muddle* (1936) 10 TULANE L. REV. 537.

2. *Leather Manufacturers Bank v. Merchants Bank*, 128 U. S. 26 (1888); *United States v. National Bank of Commerce*, 205 Fed. 433 (C. C. A. 9th, 1913); *Ladd & Tilton Bank v. United States*, 30 F. (2d) 334 (C. C. A. 9th, 1929); *Fourth Nat. Bank v. Gainesville Nat. Bank*, 80 F. (2d) 490 (C. C. A. 5th, 1935). *Contra*: *Ripley v. Withee*, 27 Tex. 14 (1863).

3. NEGOTIABLE INSTRUMENTS LAW § 23.

it therefore deprived his transferor of any title to the proceeds received by the latter from the sale of the instrument.⁴ Payment having been made by mistake,⁵ the purchaser would acquire a quasi contractual remedy in the nature of an action for money had and received.⁶ This cause of action undoubtedly accrues at the time of payment, and, consequently, the Statute starts running at that date.⁷ Secondly, the transferee may base his suit upon Section 66 of the Negotiable Instruments Law, which provides that one who negotiates an instrument by general indorsement warrants, *inter alia*, that the instrument is genuine and that he has title to it.⁸ Since the "pay any bank or banker — all prior indorsements guaranteed" indorsement commonly used between banks in collection transactions is usually considered general rather than restrictive in form,⁹ the holder may sue any prior indorser¹⁰ back to the forger's transferee¹¹ to recover the money he has paid, for breach of either of these warranties. In this event, it is at least arguable that, if the indorser did not have the title he asserts by his indorsement, the warranties of title

4. *District Nat. Bank of Washington v. Washington Loan and Trust Co.*, 65 F. (2d) 831 (App. D. C. 1933); 1 JOYCE, DEFENSES TO COMMERCIAL PAPER (2d ed. 1924) § 196.

5. See *Leather Manufacturers Bank v. Merchants Bank*, 128 U. S. 26, 35 (1888).

6. *Leather Manufacturers Bank v. Merchants Bank*, 128 U. S. 26 (1888); *Central Nat. Bank v. North River Bank*, 44 Hun 114 (Sup. Ct. N. Y. 1887); see *Canal Bank v. Bank of Albany*, 1 Hill 287, 292 (Sup. Ct. N. Y. 1841).

The language in some cases seems to imply that the action for money had and received is confined to suit against the immediately prior indorser who actually got the plaintiff's money. *Main Street Bank v. Planters Nat. Bank*, 116 Va. 137, 81 S. E. 24 (1914). It has long been held in cases where no forgery is involved, however, that there is privity between the holder and prior indorsers of the instrument which enables the holder to sustain an action of indebitatus assumpsit against any one of them. *Frazer v. Carpenter*, 9 Fed. Cas. No. 5,069 (C. C. D. Mich. 1840). No similar cases have been found where the issue of forgery was raised, but it would seem reasonable to apply the foregoing doctrine in such suits to allow an action for money had and received against any indorser subsequent to the forger.

7. See note 6, *supra*; Comment (1928) 41 HARV. L. REV. 1051.

8. NEGOTIABLE INSTRUMENTS LAW § 66(1).

9. *National Bank of Commerce v. Bossemeyer*, 101 Neb. 96, 162 N. W. 503 (1917); *Interstate Trust Co. v. United States Nat. Bank*, 67 Colo. 6, 185 Pac. 260 (1919). Some authorities have assumed that the indorsement in question is qualified. See 8 ZOLLMAN, BANKS AND BANKING (1936) § 5632; *Main Street Bank v. Planters Nat. Bank*, 116 Va. 137, 140, 81 S. E. 24, 25 (1914), criticized in BEUTEL, BRANNAN'S NEGOTIABLE INSTRUMENTS LAW (5th ed. 1932) 754. Even if the indorsement is qualified, the holder may recover upon the warranties of genuineness and title under § 65. For a discussion of the reasons for the express warranty of "all prior indorsements guaranteed," see *Inquiries and Correspondence* (1919) 36 BANKING L. J. 71.

10. See *Sprague v. West Hudson County Trust Co.*, 92 N. J. Eq. 639, 643 (Ct. of Errors and App. 1921).

11. *Thorpe Bros. Co. v. Dickey*, 51 Iowa 676, 2 N. W. 581 (1879) (holder denied recovery against one who forged indorsement on ground that he lacked title); cf. *Scott v. Brazile*, 292 S. W. 187 (Tex. Civil App. 1927) (assignee of forged notes allowed to recover in tort from indorsement forger).

and genuineness were breached at the moment of transfer,¹² and it is generally held, as in the case of an action for money had and received, that the Statute starts to run at the time of indorsement or payment.¹³ Section 66 also affords a third remedy to the transferee, for under this section a general indorser further engages that on due presentment the instrument will be accepted or paid according to its tenor. If the forged check is in fact dishonored, the holder may sue prior parties upon the contract expressed in this latter warranty.¹⁴ Where suit is brought upon this particular contract of indorsement, however, a somewhat different rule prevails as to the Statute of Limitations, and there is authority for the proposition that such an action does not accrue until dishonor actually occurs.¹⁵ But this exception to the usual rule that the action arises at the time of payment is of no great significance insofar as collection transactions are concerned. In the first place, if dishonor takes place at all, it will occur shortly after payment,¹⁶ and secondly, as a matter of actual practice, this rationale is very seldom used. In all collection cases, the real hardship arises only when the forged indorsement remains undiscovered for a considerable length of time, and in such cases there is no dishonor of the instrument.¹⁷ The drawee bank will normally pay the amount of the check and debit the drawer's account, and, when the forgery is finally brought to light, will sue prior indorsees either for breach of warranty of title and genuineness or for money had and received.

If the bank receiving a check for collection is considered an agent rather than a purchaser, different factors are determinative in fixing the period during which the action must be brought. An agent is entitled to indemnity

12. See 1 WOOD, LIMITATIONS (4th ed. 1916) 754.

13. Colley v. Rowan, 71 Colo. 17, 203 Pac. 669 (1922). But cf. Bowman v. Wright, 70 Ky. 375 (1870); Mann v. Bradshaw's Administrator, 136 Va. 351, 118 S. E. 326 (1923).

14. See Willis v. French, 84 Me. 593, 598, 24 Atl. 1010 (1892). For a brief discussion of the differences between a suit on the warranties of § 66 of the Negotiable Instruments Law as contrasted with a suit on the contract to pay if the maker does not, consult BIGELOW, BILLS, NOTES AND CHECKS (3d ed. 1928) §§ 299-301.

15. See note 14, *supra*. There is some question as to the necessity for presentment to charge an indorser when such presentment is obviously futile because of a forged indorsement. See Wells, Fargo & Co. v. Simpson Nat. Bank, 19 Tex. Civ. App. 636, 637, 47 S. W. 1024 (1898) (presentment held unnecessary). *Contra*: Collier & Pettus v. Budd, 7 Mo. 485 (1842).

16. In the case of checks, if holder and drawee bank are in the same place, presentment must be made on the next secular day after receipt, if in different places, the check must be put in the course of collection within the same time. BIGELOW, *op. cit. supra*, note 14, § 351. It becomes apparent that unless the forgery is discovered almost immediately, suit on the contract of § 66 of the Negotiable Instruments Law would be barred in about the same time as an action for money had and received.

17. No cases have been found discussing the problem of whether "dishonor" would include situations in which the discovery of the forgery subsequent to payment results in a disavowal of the instrument and an obligation to reimburse the drawee. But since the instrument is actually accepted and paid such an interpretation seems unlikely. For a discussion of the possible differences in the theory of recovery on the warranties rather than on the contract of indorsement, see BIGELOW, *loc. cit. supra*, note 14.

fication from his principal for money paid out on the latter's behalf.¹⁸ This cause of action does not accrue until the agent has in fact paid the money out, or, in the bank collection cases, until the transferee has been forced to reimburse a subsequent indorsee or the drawee bank.¹⁹ The effect of calling a collection bank an agent of its transferor is, therefore, to delay the running of the Statute until the forgery has actually been discovered and the bank's title disturbed. This agency relationship usually arises because of a contractual agreement between the respective banks.²⁰ Thus, in a recent case, the defendant bank cashed checks in ignorance that the payee's signature had been forged. With the usual guarantee of prior indorsements, it then turned the checks over to plaintiff Federal Reserve Bank for collection. When the forgery was later discovered, the plaintiff, after having reimbursed its correspondent to which it had in turn sent the checks, brought suit against the defendant for the amount thus paid out. More than six years had elapsed between the last payment by the plaintiff to the defendant for the checks, and the defendant pleaded the Statute of Limitations. The Circuit Court of Appeals for the Fifth Circuit held that, since Federal Reserve Regulation J stipulated that the plaintiff had taken the checks only as agent of the defendant bank,²¹ its action for indemnification for money paid out on the principal's behalf had not accrued until such payment was actually made.²²

By utilization of accepted concepts governing an agent's general right of indemnification, the court in the principal case avoided what would have otherwise been a patently harsh result. There can be no doubt that if the plaintiff's cause of action had been predicated on its rights as a purchaser of the checks under the Negotiable Instruments Law, the Statute of Limitations would have barred recovery for the loss incurred as a result of the forgeries.²³ But the very fact that such an action is barred by the Statute unless the parties clearly provide for an agency relationship is illustrative of the inadequacy of the present negotiable instruments rule. Under this rule it is possible for a drawee bank to be liable to its depositor and yet have no remedy against prior indorsers upon whose warranties it had relied.²⁴ This

18. *Riggs v. Lindsay*, 7 Cranch. 500 (1813); *Bibb v. Allen*, 149 U. S. 481 (1892); RESTATEMENT, AGENCY (1933) § 439.

19. *Hidalgo Steel Co. v. Moore & McCormack Co.*, 298 Fed. 331 (D. C. S. D. N. Y. 1923); *Legare & O'Hear v. Fraser*, 3 S. C. 377 (Strobhart 1849); *Shearer v. Guardian Trust Co.*, 136 Mo. App. 229, 116 S. W. 456 (1909); cf. *Knapp v. Simon*, 96 N. Y. 284 (1884).

20. For a discussion of the provisions of the A.B.A. Uniform Bank Collection Code, among which is included a provision creating the agency relation under discussion, see Steffen, note 1, *supra*. Similar provisions are included in the Federal Reserve Regulations. See note 21, *infra*. By sending its check for collection to the Federal Reserve Bank, the remitting bank is held to have agreed to the conditions set forth in the regulations. *Early v. Federal Reserve Bank of Richmond*, 281 U. S. 84 (1930).

21. DIGEST OF RULINGS OF THE FEDERAL RESERVE BOARD (1928) 177.

22. *Federal Reserve Bank of Atlanta, for use of American Surety Co. of New York v. Atlanta Trust Co.*, 91 F. (2d) 283 (C. C. A. 5th, 1937).

23. *Id.*, at 285; see notes 2, 7, *supra*.

24. The drawee of a bill of exchange who pays a holder in due course cannot recover back the sum so paid upon discovering that the signature of the drawer is forged. Price

is so because as between immediate indorsers the Statute runs from the time of indorsement or payment,²⁵ while as between drawer and drawee no action accrues until the drawer has made a demand within a reasonable time after the discovery of the forged indorsement.²⁶ Nor is it possible to toll the Statute on the ground of fraudulent concealment unless the defendant indorser was himself the forger or had notice thereof when he indorsed.²⁷ The injustice of the present rule is well demonstrated in those cases where the various intermediate indorsers are domiciled in different states. Since these parties cannot all be vouched into the original adjudication of the forgery,²⁸ it is possible for the Statute to have run before the original indorser has been sued by a subsequent party who has had to reimburse the drawee.²⁹

The negotiable instruments rule that in the absence of an agency relationship the Statute of Limitations starts to run at the time of payment, is not, however, a necessary consequence of the present wording of Section 66. In the sale of chattels, a conflict exists as to the time when the action for

v. Neal, 3 Burr. 1354 (K. B. 1762); Aigler, *The Doctrine of Price v. Neal* (1926) 24 MICH. L. REV. 809.

Where it is an indorsement rather than the drawer's signature which is forged, all authorities are agreed that the drawee has a right to compel the holder to refund money paid on a check having the genuine signature of the drawer, although they do not agree upon the theory of the obligation which creates the right. See *First Nat. Bank v. United States Nat. Bank*, 100 Ore. 264, 292, 197 Pac. 547, 556 (1921). Three theories of recovery are available to the drawee bank. First, it may sue upon the quasi contractual duty of its transferor to return money paid by mistake. See note 5, *supra*. Second, it may rely upon the implied warranty of the transferor that he has either the title or the authority to collect money for the instrument. *United States v. National Exchange Bank of Providence*, 214 U. S. 302 (1909). Third, under the decisions of some courts, the warranties of §§ 65, 66 of the Negotiable Instruments Law may be employed by drawees as to indorsements, where they would not, under *Price v. Neal*, *supra*, apply to the drawer's signature. See *American Exchange Nat. Bank v. Yorkville Bank of New York*, 122 Misc. 616, 621 (Sup. Ct. N. Y. 1924), 204 N. Y. Supp. 621, 626, *aff'd*, 210 App. Div. 885 (1st Dep't 1924), 206 N. Y. Supp. 879, criticized in BEUTEL, BRANNAN'S NEGOTIABLE INSTRUMENTS LAW (5th ed. 1932) 749.

This problem has largely been taken care of by the general practice now utilized by banks of requiring the addition of "all prior indorsements guaranteed" to all indorsements of checks among banks. See *Inquiries and Correspondence* (1919) BANKING L. J. 71.

25. See notes 7, 13, *supra*.

26. *First Nat. Bank v. Whitman*, 94 U. S. 343 (1876); *Kleinman v. Chase Nat. Bank of N. Y.*, 124 Misc. 173 (App. Div. 1st Dep't 1924), 207 N. Y. Supp. 191. But where the bank either in terms or in effect has denied liability to the depositor for the amount in question, this constitutes an act on the part of the bank which obviates the necessity for such demand and starts the statute running. *Kansas City Title & Trust Co. v. Fourth Nat. Bank*, 135 Kan. 414, 10 Pac. (2d) 896 (1932).

27. 2 WOOD, LIMITATIONS (4th ed. 1916) § 276(f) (3).

28. Out of state prior indorsers cannot be made to come in and aid in the defense of a subsequent indorser being sued on the note because no process of the court adjudicating the matter can reach them. 3 FREEMAN, JUDGMENTS (5th ed. 1925) 2825.

29. *Cf. Fourth Nat. Bank v. Gainesville Nat. Bank*, 80 F. (2d) 490 (C. C. A. 5th, 1935).

breach of warranty of title accrues. The minority holding is in accord with the common interpretation of the Negotiable Instruments Law, that the cause of action arises at the moment of sale.³⁰ But the majority of courts have taken a different stand and have refused to start the running of the Statute until the vendee's title is in fact disturbed.³¹ The Uniform Sales Act has approved this latter view by adding a warranty of quiet enjoyment so as to prevent the vendee from losing his remedy by limitation before he has had any notice of the defect in his title.³² Since the problems raised by the sale of a chattel with defective title and by the indorsement of a forged negotiable instrument are substantially the same, no reason can be found why a similar interpretation should not be adopted of the title warranty in Section 66. The Statute of Limitations is designed primarily as a statute of repose, to prevent fraud and afford security against stale claims which might otherwise be made long after the facts of the transaction had been forgotten.³³ Certainly, this general purpose is not served by the present rule which may bar a remedy to one who did not discover his cause of action until the Statute had run.

ADMINISTRATIVE DISCRETION UNDER LOWEST RESPONSIBLE BIDDER STATUTES*

IN THEIR capacity as large consumers of manufactured goods, both federal and local governments are in a strong position to secure the effectuation of desired labor policies in private industry by exerting pressure against those with whom they do business. Thus, the federal government, by enactment of the Walsh-Healey Act,¹ has taken steps to improve the remuneration and working conditions of laborers employed to fulfill government contracts. But the formulation of a similar policy by state and municipal bodies awarding public contracts has generally been prevented by lowest responsible bidder provisions in state statutes and municipal charters. These provisions, which require that contracts be awarded upon the basis of competitive bidding to the lowest responsible bidder were devised to protect taxpayers by outlawing improvident and fraudulent contracts.² For this reason the courts have in-

30. *Chancellor v. Wiggins*, 43 Ky. 201 (1843); *Perkins v. Whelan*, 116 Mass. 542 (1875).

31. *Barnum v. Cochrane*, 143 Cal. 642, 77 Pac. 656 (1904), (1905) 18 HARV. L. REV. 152.

32. UNIFORM SALES ACT, § 13(1), (2); see WILLISTON, SALES (2d ed. 1924) § 221.

33. See *Wood v. Carpenter*, 101 U. S. 135, 139 (1879); *Dawson, Mistake and the Statute of Limitations* (1936) 20 MINN. L. REV. 481.

**Pallas v. Johnson*, 100 Colo. 449, 68 P. (2d) 559 (1937).

1. 49 STAT. 2036 (1936), 41 U. S. C. § 35 (Supp. 1936). For a discussion of the Act, see *Legis.* (1937) 37 COL. L. REV. 102; (1936) 25 GEO. L. J. 140.

2. See *Lassiter & Co. v. Taylor*, 99 Fla. 819, 825, 128 So. 14, 17 (1930); *Attorney General v. Public Lighting Commission*, 155 Mich. 207, 213, 118 N. W. 935, 938 (1908). But see *In re Tuller Const. Co.*, 231 App. Div. 174, 175, 246 N. Y. Supp. 611, 612 (2d Dep't 1930).

terpreted these legislative mandates to furnish a definite and compulsory course of procedure and have invalidated attempts to award contracts in any other manner.³ Evasion by indirect methods has also been prevented. Thus a board cannot ignore bids,⁴ accept bids which materially vary from the specifications,⁵ change the contractual provisions after an award,⁶ split up the work to be done into several contracts each of which is below the statutory requirement of competitive bidding,⁷ suspend bidding requirements by declaring an emergency to exist,⁸ or provide that any bid may be rejected in its absolute discretion.⁹ To insure administrative compliance with lowest responsible bidder provisions, the courts not only have permitted unsuccessful bidders and taxpayers to challenge the board's award by mandamus or injunction¹⁰ but also have sanctioned the imposition of criminal penalties upon public officers failing to comply with these provisions.¹¹

The contracting board, however, performs something more than a ministerial function in selecting the lowest responsible bidder, for responsibility is not solely a matter of pecuniary ability. Thus, the lowest bidder furnishing a completion bond is not entitled to the contract.¹² To the contrary, the test

3. *Saginaw v. Consumers' Power Co.*, 213 Mich. 460, 182 N. W. 146 (1921); *Philadelphia Co. v. Pittsburgh*, 253 Pa. 147, 97 Atl. 1083 (1916); *cf. Callaghan & Co. v. Smith*, 304 Ill. 532, 136 N. E. 748 (1922) (statute violating constitutional provision that contracts be awarded the lowest responsible bidder held unconstitutional). The provisions are not construed, however, to embrace all types of contracts. For a list of those excluded, see *Notes* (1926) 44 A. L. R. 1150, (1934) 92 A. L. R. 835.

4. *Kratz v. Allentown*, 304 Pa. 51, 155 Atl. 116 (1931).

5. *Tufano v. Borough of Cliffside Park*, 110 N. J. L. 370, 165 Atl. 628 (1933); *Ohio ex rel. Mathis Bros. Co. v. Board of Education of Cincinnati*, 27 Ohio C. C. 832 (1905). Moreover, the specifications must be precise and definite so as to serve as a common standard for all. *Tice v. Long Branch*, 98 N. J. L. 214, 119 Atl. 25 (1922); *State ex rel. Hoeffler v. Griswold*, 35 Ohio App. 354, 172 N. E. 438 (1930).

6. *Diamond v. Mankato*, 89 Minn. 48, 93 N. W. 911 (1903); *Scola v. Board of Education of Montclair*, 77 N. J. L. 73, 71 Atl. 299 (Sup. Ct. 1908); *Loucheim v. Philadelphia*, 218 Pa. 100, 66 Atl. 1121 (1907).

7. *Ganewell Fire Alarm Telegraph Co. v. Los Angeles*, 45 Cal. App. 149, 187 Pac. 163 (1919); *Tompkinsville v. Miller*, 195 Ky. 143, 241 S. W. 809 (1922).

8. *Safford v. Lowell*, 255 Mass. 220, 151 N. E. 111 (1926); *Green v. Olanogon County*, 60 Wash. 309, 111 Pac. 226 (1910).

9. *Walker v. People ex rel. Collector of Cook County*, 170 Ill. 410, 48 N. E. 1010 (1897).

10. Taxpayer: *Baltimore v. Keyser*, 72 Md. 106, 19 Atl. 705 (1890); *Ledwith v. Lincoln*, 110 Neb. 425, 193 N. W. 763 (1923). Unsuccessful bidder: *St. Landry Lbr. Co. v. Bunkie*, 155 La. 892, 99 So. 687 (1924); *Ohio ex rel. United Dist. Heating, Inc. v. State Office Bldg. Comm.*, 125 Ohio St. 301, 181 N. E. 129 (1932). *Contra: Colorado Paving Co. v. Murphy*, 78 Fed. 28 (C. C. A. 8th, 1897). When relief is denied in this type of case, it is usually upon the score that the unsuccessful bidder has no standing in court.

11. *State v. Kern*, 51 N. J. L. 259, 17 Atl. 114 (Sup. Ct. 1889); see *Ellefson v. Smith*, 182 Wis. 398, 401, 196 N. W. 834, 835 (1924) (malfeasance in office although no intent to evade).

12. *Wilmott Coal Co. v. State Purchasing Commission*, 246 Ky. 115, 54 S. W. (2d) 634 (1932); see *Hibbs v. Arensberg*, 276 Pa. 24, 30, 119 Atl. 727, 729 (1923).

of responsibility is said to be the ability to furnish complete and timely performance according to specifications.¹³ Under this test the agency has considerable discretion and may reject the lowest bidder because of his location,¹⁴ performance upon prior contracts,¹⁵ facilities and equipment,¹⁶ or judgment and integrity.¹⁷

Although lowest responsible bidder provisions thus confer a certain amount of discretion upon the authority awarding contracts, they generally have been construed to prevent any policy formulation by the contract letting agency. To achieve this end, the courts have developed a rationale based upon cost to test the validity of awards. Under this formula an administrative agency may not impose upon prospective bidders restrictions which might increase costs directly or indirectly by restricting competition; nor may it predict a determination of responsibility upon criteria whose fulfillment would have the same effect. Consequently, in the absence of statutory authorization, boards cannot promulgate a system of prequalification which limits the number of bidders who may compete for a contract.¹⁸ And even where statutory authority does exist, any system of prequalification tending to stifle competition is invalid.¹⁹ The cost rationale has been invoked to prevent a specification of the amount that will be paid for parts of the work.²⁰ Moreover, it has precluded payment to a contractor in bonds, because bidders without sufficient financial strength to hold the bonds until they could be sold upon the market to advantage might thereby be eliminated.²¹ But the confining nature of these statutory provisions has become most apparent when the board for political or humanitarian reasons has attempted to impose upon bidders restrictions beneficial to labor. The courts have utilized these provisions to preclude contracting authorities from requiring the employment of home

13. See *Walter v. McClellan*, 113 App. Div. 295, 303, 99 N. Y. Supp. 78, 84 (1st Dep't 1906), *aff'd*, 190 N. Y. 505, 83 N. E. 1133 (1907); *Wilson v. New Castle*, 301 Pa. 358, 364, 152 Atl. 102, 103 (1930).

14. *Seventh-Day Adventist Pub. Ass'n v. Board of State Auditors*, 116 Mich. 672, 75 N. W. 95 (1898).

15. *Girvin v. Simon*, 116 Cal. 604, 48 Pac. 720 (1897).

16. See *State ex rel. Neb. Bldg. & Inv. Co. v. Board of Com'rs of State Institutions*, 105 Neb. 570, 573, 181 N. W. 530, 532 (1921); *Wilson v. New Castle*, 301 Pa. 358, 364, 152 Atl. 102, 103 (1930).

17. See *Wilmott Coal Co. v. State Purchasing Commission*, 246 Ky. 115, 118, 54 S. W. (2d) 634, 635 (1932); *Chaffee v. Crowley*, 49 N. D. 111, 114, 190 N. W. 308 (1922).

18. *Weinstein Bldg. Corp. v. Scoville*, 141 Misc. 902, 254 N. Y. Supp. 384 (Sup. Ct. 1931).

19. *Harris v. Philadelphia*, 299 Pa. 473, 149 Atl. 722 (1930).

20. *In re Mahan*, 20 Hun. 301 (N. Y. App. Div. 1st Dep't 1880), *aff'd*, 81 N. Y. 621 (1880).

21. *Ledwith v. Lincoln*, 110 Neb. 425, 193 N. W. 763 (1923); *cf. Philpot v. Taylor*, 179 Ark. 356, 16 S. W. (2d) 4 (1929) (award of construction contract to contractor making best bid on bonds). Payment in bonds has also been held objectionable in that the contractor tends to overbid, and consequently the bonds are issued below par. *Buffalo v. Walker*, 126 Okla. 6, 257 Pac. 766 (1925); *Wilson v. Hebert*, 174 S. W. 861 (Tex. Civ. App. 1915).

labor,²² the exclusion of convict or alien labor,²³ and the observance of minimum wages or maximum hours.²⁴ Furthermore, where bidding has been restricted to union bidders or where responsibility has been predicted upon the maintenance of a union shop, the courts have not only objected upon grounds of increased costs but also have found the action contrary to public policy or in violation of the Fourteenth Amendment.²⁵

But the result seemingly demanded by a strict application of the cost rationale has been avoided by several rationalizations which nevertheless leave the doctrine inviolate. First, by placing upon the complainant the burden of proving increased costs, one court has sustained a provision compelling the employment of resident labor.²⁶ Furthermore, by virtue of a presumption that high wages are productive of a better quality of labor, wage and hour restrictions have also been sustained, for boards with authority to contract can specify the quality of the work and materials desired.²⁷ And finally, to sustain an administrative award from challenge by mandamus or injunction, a court may require a showing of fraud,²⁸ or abuse of discretion²⁹ upon the

22. *McDonough v. Washington*, 20 Pa. Co. C. 345 (1898); see *Altschul v. Springfield*, 48 Ohio App. 356, 364, 193 N. E. 788, 791 (1933).

23. *Inge v. Board of Public Works*, 135 Ala. 187, 33 So. 678 (1903); *Glover v. People ex rel. Raymond*, 201 Ill. 545, 66 N. E. 820 (1903).

24. *Hillig v. St. Louis*, 337 Mo. 291, 85 S. W. (2d) 91 (1935); *Frame v. Felix*, 167 Pa. 47 (1895).

25. Restrictions upon prospective bidders: *Wright v. Hctor*, 95 Neb. 342, 145 N. W. 704 (1914) (denial of due process to taxpayers); *Atlanta v. Stein*, 111 Ga. 789, 36 S. E. 932 (1900) (public policy); *Marshall & Bruce Co. v. Nashville*, 109 Tenn. 495, 71 S. W. 815 (1902) (equal protection). But see *Amalithone Realty Co. v. New York*, 162 Misc. 715, 716, 295 N. Y. Supp. 423, 425 (Sup. Ct. 1937). Identification of responsibility with union shop: *Davenport v. Walker*, 57 App. Div. 221, 68 N. Y. Supp. 161 (3d Dep't 1901) (public policy); *Miller v. Des Moines*, 143 Iowa 409, 122 N. W. 226 (1909) (equal protection); *Ohio ex rel. United District Heating, Inc. v. State Office Bldg. Comm.*, 125 Ohio St. 301, 181 N. E. 129 (1932) (same). *Contra*: *Pugh Printing Co. v. Deputy State Supervisors of Elections*, 22 Ohio C. C. 584 (1901). Successful bidders have been permitted to fulfill the contracts without regarding the union provisions. *People ex rel. Single Paper Co. v. Edgcomb*, 112 App. Div. 604, 93 N. Y. Supp. 965 (4th Dep't 1906); *Marshall & Bruce Co. v. Nashville*, 109 Tenn. 495, 71 S. W. 815 (1902).

26. *Ebbeson v. Board of Public Education*, 18 Del. Ch. 37, 156 Atl. 286 (1931), (1933) 31 MICH. L. REV. 858; cf. *Altschul v. Springfield*, 48 Ohio App. 356, 193 N. E. 788 (1933) (bidder's employment of local labor may be considered in determining responsibility). In suits to collect tax assessments levied to pay the contractor, the burden of proving that restrictions imposed upon the contractor have increased costs is generally placed upon the taxpayer. *Pasche v. South St. Joseph Co.*, 174 Mo. App. 614, 190 S. W. 30 (1916); *Allen v. Labsap*, 188 Mo. 692, 87 S. W. 926 (1905).

27. *Wagner v. Milwaukee*, 180 Wis. 640, 192 N. W. 994 (1923), *writ of error dismissed*, 266 U. S. 585 (1924).

28. *Street Improvement Dist. of Hot Springs v. Crockett*, 181 Ark. 869, 28 S. W. (2d) 331 (1930); *Missouri Service Co. v. Stanberry*, 108 S. W. (2d) 25 (Mo. 1937).

29. *State ex rel. Ross v. Board of Education*, 42 Ohio St. 374 (1884); *Wilson v. New Castle*, 301 Pa. 358, 152 Atl. 102 (1930).

part of the board rather than a finding that reasonable men would have reached a different conclusion.³⁰

A recent decision suggests that the increasing unionization of workers has made possible another exception to the uniform application of the cost formula, an exception which permits a board to find in certain situations that non-union employers in a union town are irresponsible even though they can render a letter-perfect performance of the contract. A state purchasing board, required by statute to award contracts to the lowest responsible bidder, refused to accept the lowest bid, which was tendered by a bidder maintaining an open shop, and awarded a construction subcontract to a contractor who operated a union shop. In affirming a dismissal of a taxpayer's suit to enjoin the award, the Colorado Supreme Court held that since the general contractor's men were union members, the possible delays should they strike when forced to work beside union men justified a finding that the subcontractor was not responsible.³¹

Although the instant decision would not permit a requirement that all bidders must maintain union shops,³² it adopts a broad definition of responsibility by permitting a board making an award to consider the bidder's labor practices in relation to those of the rest of the community. To that extent it averts any necessity for a legislative definition of responsibility with its attendant inflexibility³³ and extends into other fields of public contracts the policy which has prompted much recent federal legislation. But these are not the only effects of the decision. In the first place, since the National Labor Relations Act would prevent a bidder for subcontracts from compelling his employees to unionize,³⁴ and since he cannot interfere with the union affiliations of the general contractor's employees,³⁵ determination of the subcontractor's responsibility will depend upon factors entirely without his control. Furthermore, it is doubtful if this decision will foster the purpose of decreasing costs to taxpayers which the lowest responsible bidder provisions were designed to achieve; while increased costs resulting from the employment of union labor on government contracts might be offset by a reduced tax burden for such items as unemployment relief, these offsets may be nonexistent unless unionization is accompanied by the employment of home labor. On the other hand, of course, it may be desirable to restate the meaning of "responsible" in terms of broader social ends than those subserved by safeguarding the taxpayer's purely pecuniary interests.

30. *Paterson Contracting Co. v. Hackensack*, 99 N. J. L. 260, 122 Atl. 741 (1923); *American Water Corp. v. Mayor and Council of Florham Park*, 139 Atl. 169 (N. J. Sup. Ct. 1927).

31. *Pallas v. Johnson*, 100 Colo. 449, 68 P. (2d) 559 (1937), (1937) 110 A. L. R. 1406.

32. For a statement that such restriction would be proper, see *Amalithone Realty Co. v. New York*, 162 Misc. 715, 716, 295 N. Y. Supp. 423, 425 (Sup. Ct. 1937).

33. See (1933) 31 MICH. L. REV. 858 (suggesting necessity for legislative definition).

34. *In re National Electric Products Corp.*, C-219 and R-241, 3 NLRB, No. 47 (Aug. 30, 1937); see Comment (1938) 32 ILL. L. REV. 568.

35. Cf. *United Electric Coal Cos. v. Rice*, 80 F. (2d) 1 (C. C. A. 7th, 1935), (1936) 45 YALE L. J. 1320.

PERSONAL LIABILITY OF TRUSTEE IN BANKRUPTCY FOR
FAILURE TO PAY TAX CLAIMS*

WHILE ACTING as trustee in bankruptcy for an insolvent corporation, the Irving Trust Company distributed the bankrupt's estate without paying state taxes levied against the bankrupt. After the estate had been distributed and the bankrupt granted its discharge, the State of Delaware brought suit to hold the trustee personally liable for the unpaid taxes.¹ The complaint alleged that no notice of the bankruptcy had been given to the plaintiff, that the trustee failed to procure a bar order directing the plaintiff to present its claim, that sufficient assets had been collected with which to pay the plaintiff's claim, and that the defendant therefore became obligated to pay the taxes in full. The defendant answered that it had neither knowledge nor notice of the plaintiff's claim, that the claim was not duly scheduled, and that it had distributed the assets under a court order. Judgment on the pleadings in favor of the defendant was affirmed by the Circuit Court of Appeals for the Second Circuit on the ground that there was no active duty to discover tax claims and that the allegations were not sufficient to indicate that the trustee had been negligent.²

In order to protect public revenues,³ the Bankruptcy Act accords priority to taxes owing to federal, state, county, or municipal governments over general creditors⁴ and provides that they are to be paid by the trustee in bankruptcy under a court order before general distribution.⁵ But in those instances where taxes are not liens upon specific property which may be followed into the hands of third parties,⁶ the protection of public revenue may be small, for the court may order the distribution of the estate in ignorance of the existence of tax claims. To bring the existence of unpaid taxes to the knowledge of the court, initial reliance is placed upon the bankrupt by the requirement that he schedule his outstanding liabilities.⁷ The facts of the

*State of Delaware v. Irving Trust Co., 92 F. (2d) 17 (C. C. A. 2d, 1937), *cert. denied*, 58 Sup. Ct. 283 (1937).

1. The taxes due were franchise taxes, payable as a license for the corporate franchise and assessed annually upon the basis of the corporation's total authorized stock. DEL. REV. CODE (1935) §§ 96, 98. The state was seeking to enforce these taxes as obligations, not as liens, although all taxes owed the state become liens upon the real property of the taxpayer within the county in which the taxes are assessed. DEL. REV. CODE (1935) § 3351. This corporation probably had no property upon which a lien could be imposed.

2. State of Delaware v. Irving Trust Co., 92 F. (2d) 17 (C. C. A. 2d, 1937), *cert. denied*, 58 Sup. Ct. 283 (1937); (1938) 16 N. C. L. REV. 156.

3. See United States v. State Bank of North Carolina, 6 Pet. 29, 34 (U. S. 1832); *In re Kallak*, 147 Fed. 276, 278 (D. N. D. 1906); 1 COOLEY, TAXATION (4th ed. 1924) § 57. Some protection is needed since property in the custody of a court is not subject to distraint for the collection of taxes. *In re Tyler*, 149 U. S. 164 (1893).

4. Bankruptcy Act § 64(b), 11 U. S. C. § 1 *et seq.*

5. Bankruptcy Act § 64(a).

6. See McKennon v. Warneck, 115 Oregon 163, 166, 236 Pac. 1051, 1053 (1925); *Elmhurst State Bank v. Stone*, 346 Ill. 157, 161, 178 N. E. 362, 364 (1931); 3 COOLEY, TAXATION (4th ed. 1924) § 1238.

7. Bankruptcy Act § 7(8).

instant case indicate, however, the inexpediency of relying solely upon the schedule submitted by the bankrupt to protect the interests of the taxing body. Consequently, where federal tax claims are involved, additional protection is afforded the government by a general statute under which any fiduciary may be held personally liable if he fails to pay a debt due the United States before satisfying other of the estate's obligations.⁸ While this statute does not explicitly impose a duty upon the trustee in bankruptcy, it achieves the same result; for he will be compelled to see that outstanding tax claims are paid before general distribution if he wishes to escape personal liability. But the trustee's liability is not absolute. In the first place, it has been confined to those cases in which it can be shown that he had "knowledge" of the existence of the claim.⁹ Secondly, the trustee may protect himself by requesting the court to issue a bar order. Such an order directs governments to present their claims within a definite period; and, if the taxing body has been served with notice, failure to comply with the order will discharge the trustee from all liability for the tax.¹⁰

On the other hand, where state or local government taxes are involved, there is no federal statute imposing personal liability upon the trustee. In the absence of statutory liability, responsibility might be imposed upon him through the application of ordinary tort doctrines provided a duty to use care can be found. Relying upon dicta found in many cases,¹¹ the plaintiff in the instant case argued that there is an absolute duty to pay all taxes, a breach of which rendered the trustee personally responsible. This duty, it was said, might be implied from Section 64(a) of the Bankruptcy Act which provides that the court "shall order the trustee to pay taxes . . ." and from the trustee's ability to obtain a bar order protecting him against personal liability. But since Section 47 of the Bankruptcy Act, which relates to the required duties of the trustee, does not specifically provide for such

8. REV. STAT. §§ 3466, 3467 (1875), 31 U. S. C. §§ 191, 192 (1934). Taxes due the United States are "debts" within the meaning of these sections. *Price v. United States*, 269 U. S. 492 (1926). The effect of this statute is modified to the extent that Section 64(b) of the Bankruptcy Act accords priority to other claims ahead of taxes. *United States v. Kaplan*, 74 F. (2d) 664 (C. C. A. 2d, 1935).

9. *United States v. Clark*, 25 Fed. Cas. No. 14,807 (C. C. D. N. Y. 1826); *United States v. Barnes*, 31 Fed. 705 (C. C. S. D. N. Y. 1887); *United States v. Eyges*, 286 Fed. 683 (D. Mass. 1923). For the meaning of "knowledge," see *infra*, p. 839.

10. *New York v. Irving Trust Co.*, 288 U. S. 329 (1933), (1933) 1 GEO. WASH. L. REV. 268 (state claim); *In re Anderson*, 279 Fed. 525 (C. C. A. 2d, 1922). But cf. *United States v. Elliott*, 57 F. (2d) 843 (C. C. A. 6th, 1932), (1933) 46 HARV. L. REV. 517. The need for bar orders arises because governments, unlike other creditors, are not bound to take initiative in submitting and proving claims within the time specified. Bankruptcy Act § 57(n); *Villere v. United States*, 18 F. (2d) 409 (C. C. A. 5th, 1927); *Wechsler v. United States*, 27 F. (2d) 850 (C. C. A. 3d, 1928); see 6 REMINGTON, BANKRUPTCY (4th ed. 1931) § 2808.

11. See *Stanard v. Dayton*, 220 Fed. 441, 444 (C. C. A. 8th, 1915); *In re De Angeles*, 36 F. (2d) 218, 219 (C. C. A. 10th, 1929); *In re Kallak*, 147 Fed. 276, 277 (D. N. D. 1906); *In re Montgomery and Son*, 17 F. (2d) 404, 406 (N. D. Ohio 1927); *In re Serval*, 45 F. (2d) 660, 661 (D. Idaho 1930); 2 REMINGTON, BANKRUPTCY (4th ed. 1931) § 847. But cf. *United States v. Eyges*, 286 Fed. 683 (D. Mass. 1923).

a duty, and since a trustee might have difficulty in obtaining a bar order against taxes of which he has no knowledge,¹² it would seem more reasonable to adopt the court's theory in the instant case that there is no duty to discover and pay all tax claims, a theory which has also been used in denying recovery for federal taxes.¹³

Although the trustee is under no duty to discover all taxes, it is clear that he owes a duty to the creditors to exercise due diligence in administering the estate.¹⁴ Therefore, if the trustee should disregard known tax claims and distribute the bankrupt's estate to general creditors, he would ordinarily be personally liable to the taxing body for negligently performing his trust.¹⁵ But in most cases a dereliction of duty will not be so easily found, for the trustee will ordinarily deny that he knew of the unpaid taxes. To overcome this defense, resort may be had to the doctrine of "constructive" knowledge. But precisely what constitutes "constructive" knowledge of tax claims is not clear. It has been said that the trustee is bound to take notice of taxes assessed during the bankruptcy proceedings.¹⁶ And it is patent that he should not be allowed to deny knowledge of tax claims scheduled by the bankrupt.¹⁷ Furthermore, it is arguable that the trustee should be charged with knowledge of the tax claims which appear on the bankrupt's books, or which are matters of public record, or which would become known or barred by the issuance of a bar order. Several dicta have suggested this basis of liability,¹⁸ and one case has held the trustee personally liable for failure to collect assets whose existence was not brought to his knowledge but might have been discovered by searching the bankrupt's books.¹⁹ It might well be argued that the doctrine should be extended to hold as a matter of law that the trustee,

12. Two difficulties stand in the way of obtaining such an order. First, although no case holds that bar orders may not be issued in those instances where government claims are not known to the trustee, they have generally been issued only against known tax claims. See cases cited *supra* note 10. Secondly, there is a practical difficulty in serving notice of a bar order upon every taxing authority that might possibly have a claim against the bankrupt.

13. *United States v. Eyges*, 286 Fed. 683 (D. Mass. 1923) (federal income tax).

14. It is, of course, an elementary principle of trust law that the trustee owes to his beneficiaries the duty of exercising, at the very least, the skill of a man of ordinary prudence. *Carson, Pirie Scott & Co. v. Turner*, 61 F. (2d) 693 (C. C. A. 6th, 1932); *In re Piece Dyeing Co.*, 89 F. (2d) 37 (C. C. A. 2d, 1937) (receiver pending adjudication as a bankrupt); see *In re Montgomery and Son*, 17 F. (2d) 404, 405 (N. D. Ohio 1927); 2 REMINGTON, BANKRUPTCY (4th ed. 1931) § 1125; RESTATEMENT, TRUSTS (1935) § 174.

15. *City of Dallas v. Menezes*, 16 F. (2d) 779 (C. C. A. 5th, 1927); cf. *In re Montgomery and Son*, 17 F. (2d) 404 (N. D. Ohio 1927) (labor claim).

16. *In re William F. Fisher & Co.*, 148 Fed. 907 (D. N. J. 1906); cf. *United States v. Eyges*, 286 Fed. 683 (D. Mass. 1923).

17. *City of Dallas v. Menezes*, 16 F. (2d) 779 (C. C. A. 5th, 1927).

18. See *In re Anderson*, 279 Fed. 525, 529 (C. C. A. 2d, 1922); *In re Kallak*, 147 Fed. 276, 277 (D. N. D. 1906); *In re Milwaukee Sheep and Wool Co.*, 186 Wis. 320, 329, 202 N. W. 693, 696 (1925).

19. *In re Kuhn Bros.*, 234 Fed. 277 (C. C. A. 7th, 1916).

who might have learned of the existence of the tax claims by inquiry of the state authorities, had been negligent.

The immunization of the trustee from liability in the instant case does not, however, deprive the plaintiff of all possibility of collecting the taxes. In the first place, it may still pursue the bankrupt, since unpaid taxes are not affected by a discharge in bankruptcy.²⁰ But in view of the fact that the bankrupt usually does not retain any non-exempt assets, this remedy will ordinarily be only a nominal one. Secondly, the taxing body may be able to recover from the general creditors pro rata portions of their distributed dividends on the theory that they were recipients of funds rightfully belonging to the taxing body.²¹

LIABILITY OF DIRECTORS OF NATIONAL BANK RECEIVING PREFERENTIAL
PAYMENT FROM INSOLVENT CORPORATION*

THE DIRECTORS of a national bank approved a loan to a New York corporation of a sum greater than that permitted by statute. Upon learning of the borrower's imminent insolvency, the directors demanded reduction of the indebtedness, and the corporation complied by assigning title to certain accounts receivable to the bank. Although the borrower retained control over the accounts, some of the proceeds were paid to the bank from time to time over a period of five months in reduction of the loan.¹ The borrower was then adjudicated a bankrupt, and its trustee brought suit against the directors and the bank, which had also become insolvent, to recover the proceeds so paid both as a fraudulent conveyance under the Bankruptcy Act and

20. Bankruptcy Act § 17(1).

21. See *City of Dallas v. Menezes*, 16 F. (2d) 779 (C. C. A. 5th, 1927); *In re Montgomery and Son*, 17 F. (2d) 404, 407 (N. D. Ohio 1927). In both cases, the bankruptcy proceedings were still in progress. In a prior proceeding in the instant case, the court refused to reopen the proceedings to require the creditors of the bankrupt to pay back a portion of their distributed shares. *In re American Solvents & Chemical Corp.*, 73 F. (2d) 301 (C. C. A. 2d, 1934). Cf. 48 STAT. 748 (1934), 26 U. S. C. § 311 (1934), which provides for a summary proceeding against transferees of a taxpayer who is unable to meet his tax liabilities.

The taxing authority may also have a claim against the surety on the trustee's bond. But a showing of negligence would be a pre-requisite to recovery. *United States v. Perkins*, 280 Fed. 546 (C. C. A. 8th, 1922); *In re Hoyt*, 119 Fed. 987 (E. D. N. C. 1903); cf. *Howard v. United States*, 87 F. (2d) 243 (C. C. A. 7th, 1937).

**Duell v. Brewer*, 92 F. (2d) 59 (C. C. A. 2d, 1937).

1. The "dominion" retained by the borrower over the assigned accounts was sufficient to render the assignment fraudulent as against creditors. *Benedict v. Ratner*, 268 U. S. 353 (1925). The assignment was hence voidable by the trustee and gave the bank no right either to the proceeds actually paid or to the balance remaining on the accounts. But the trustee in bankruptcy chose to predicate his case upon the preferential or fraudulent character of the payments and did not stress the rule of *Benedict v. Ratner*, *supra*.

as a voidable preference under the New York Stock Corporation Law. On motion to dismiss, the lower court found the bank liable on both counts but dismissed the suit as against the directors. On appeal, the Circuit Court of Appeals for the Second Circuit held that, since the directors were responsible over to the bank for all damages resulting from the illegal loan, they had received sufficient benefit from the payments, which had reduced *pro tanto* the amount of the bank's claim, and that they should hence be liable for whatever preferential or fraudulent payments the bankrupt had made.²

Although directors' liability has apparently never before been considered under a fact situation like that of the instant case, there can be no doubt that the principle of indirect benefit, upon which liability was here predicated,³ can be spelled out of each of three pertinent statutory provisions. Section 67e of the Bankruptcy Act provides that the trustee may recover property transferred by the debtor with intent to hinder, delay or defraud creditors within four months of the filing of the petition.⁴ Section 60b of the same Act provides that a transfer or payment made by an insolvent debtor within four months of the petition may be avoided by the trustee if " . . . the person receiving it or to be benefited thereby . . . " had reasonable cause to believe that the transfer would effect a preference.⁵ Section 15 of the New York Stock Corporation Law is substantially identical with 60b except that it makes no specific reference to the beneficial recipient and contains no four-month limitation.⁶ Because of this latter omission⁷ and because no proof of fraud is required to establish a preference, this section affords a more satisfactory basis for liability in the instant case than do either of the other two. Nor is the absence of any mention of the person to be benefited by the preference fatal to an action thereunder against the directors, for it has generally been held that all three statutory provisions apply to any actual beneficiary as well as to the nominal transferee.⁸ Thus,

2. *Duell v. Brewer*, 92 F. (2d) 59 (C. C. A. 2d, 1937).

3. The fact that the beneficial recipients were directors and hence agents of the bank would seem to be immaterial. *Duell v. Brewer*, 92 F. (2d) 59 (C. C. A. 2d, 1937). But *cf.* *Carson v. Federal Reserve Bank*, 254 N. Y. 218, 172 N. E. 475 (1930).

4. The liability provided by this section is absolute except as against "purchasers in good faith and for a present fair consideration." In view of the allegations of the complaint neither the bank nor the directors would seem to fall within this class. There might, however, be some difficulty in proving intent to defraud. *Cf.* *Coder v. Arts*, 213 U. S. 223 (1909).

5. 36 STAT. 842 (1910), 11 U. S. C. §96 (1934).

6. Since a trustee in bankruptcy takes all the rights of the creditors, he may avoid any transfer which a creditor had the power to set aside and may thus utilize state laws.

7. Since the payments from the accounts extended over a period of five months preceding bankruptcy, reliance on Sections 60b or 67d of the Bankruptcy Act, would limit the trustee's recovery to those payments made within the last four months. See notes 4 and 5, *supra*.

8. *Kobusch v. Hand*, 156 Fed. 660 (C. C. A. 8th, 1907); *Walters v. Zimmerman*, 208 Fed. 62 (N. D. Ohio 1913); *Goldman v. Cohen*, 261 Fed. 672 (C. C. A. 1st, 1919); *Landry v. Andrews*, 22 R. I. 597, 48 Atl. 1036 (1901); *cf.* *Roberts v. Johnson*, 151 Fed. 567 (C. C. A. 4th, 1907); see *National Bank of Newport v. Herkimer Bank*, 225 U. S. 178, 184 (1912); GILBERT'S COLLIER ON BANKRUPTCY (4th ed. 1937) 886.

if a preferential or fraudulent payment of a debt owed by *A* to *B* is made at *B*'s request to *B*'s creditor *C*, *B* having received an indirect benefit is liable to *A*'s trustee in bankruptcy just as if payment had been made directly to him.⁹ Of course *C*'s benefit is obvious, and, provided he knowingly induced and received the preference or fraudulent transfer, he too would be liable.¹⁰

Since all the directors in the principal case were alleged to have had the requisite knowledge regarding the borrower's precarious financial condition¹¹ and the nature of the transfer, their liability under Section 15 was clear upon a showing that they benefited from the payments to the bank. To determine the existence of such a benefit, it is necessary to refer to pertinent provisions of the National Banking Act. These forbid loans to any one corporation beyond an amount equal to 10% of the bank's surplus and paid in capital stock¹² and provide that directors who knowingly participate in or assent to a violation of this restriction shall be personally responsible for all damages suffered by the bank in consequence of the violation.¹³ Although it seems reasonably certain that the liability contemplated by this statute extends to the net loss to the bank resulting from the illegal loan,¹⁴ there is

9. See cases cited note 8, *supra*.

10. At common law, the recipient of a fraudulent transfer was not liable to the debtor's creditors unless a lien had been impressed upon the property prior to the conveyance. *Adler v. Fenton*, 24 How. 407 (U. S. 1860); *Lamb v. Stone*, 28 Mass. 526 (1831); (1918) 18 Col. L. Rev. 363.

11. The liability under Section 67e is broader than that of Section 60b, for under the former provision a fraudulent intent by the debtor is sufficient cause for setting aside the transfer, whereas under the latter the recipient must have reasonable cause to believe that a preference would result. But the difficulty in proving fraudulent intent on the part of the bankrupt counteracts this benefit. Compare *Van Iderstine v. National Discount Co.*, 227 U. S. 575 (1913), with *Dean v. Davis*, 242 U. S. 438 (1916); Comment (1933) 28 ILL. L. REV. 103. Assets of the bankrupt must be depleted before a preference is created. *First Nat. Bank of Danville v. Phalen*, 62 F. (2d) 21 (C. C. A. 7th, 1932).

The Chandler Bill proposes to include the salient features of the Uniform Fraudulent Conveyance Act. H. R. REP. No. 8046, 75th Cong., 1st Sess. (1937).

12. 34 STAT. 451 (1906), 12 U. S. C. § 84 (1934). A borrower of an excessive loan cannot escape repayment on the ground that the advance was void. *Shoemaker v. National Mechanics' Bank*, 21 Fed. Cas. No. 12,801 (C. C. D. Md. 1869); *People ex rel. Nelson v. First State Bank of Barrington*, 274 Ill. App. 46 (1934); 7 ZOLLMAN, BANKS AND BANKING (1936) § 4844.

13. 36 STAT. 1167 (1911), 12 U. S. C. § 93 (1934).

14. *Corsicana Nat. Bank v. Johnson*, 251 U. S. 68 (1919); *Gamble v. Brown*, 29 F. (2d) 366 (C. C. A. 4th, 1928); *McRoberts v. Spaulding*, 32 F. (2d) 315 (S. D. Iowa 1929); *McQueen v. First Nat. Bank of Mesa City*, 36 Ariz. 74, 283 Pac. 273 (1929). The rationale of these decisions has been that the borrower would not have accepted a lesser amount. The directors may, however, escape from this proposition by authorizing two loans, one for the statutory limit, and a second for an additional sum, and thus confine their liability to the second loan only. See *McRoberts v. Spaulding*, 32 F. (2d) 315, 318 (S. D. Iowa 1929).

A small minority of courts have held that the liability of the directors extends only to the illegal portion of the loan. *Witters v. Sowles*, 43 Fed. 405 (C. C. D. Vt. 1890);

some doubt as to how and when such liability accrues.¹⁵ The divergence of opinion on this point, however, can have no important bearing upon the decision of the principal case. If liability is considered to vest upon making the loan,¹⁶ the directors received immediate benefit from the preferential payments, since their existing responsibility to the bank was reduced by the amount of the payments made. And even though liability were contingent upon the failure of the bank to recover the full amount of the loan,¹⁷ the amount of the directors' liability would be determined in the same way. In either case the benefit is obvious, and whether it is conditional or unconditional seems of little significance.¹⁸

Nor does the decision in the instant case result in any hardship to the directors, for in no respect does it increase their ultimate liability for the illegal loan—namely the original amount of the bank's claim, less any dividends on that amount obtainable from the borrower's bankrupt estate.¹⁹ In determining what the rights of the directors in the instant case will be immediately following the foregoing decision, the distinction between absolute and contingent liability is largely a matter of procedure, for whatever course the bank is forced to adopt, the result as to the directors will be the same. If the bank's realization of a deficiency on the loan is a condition of the director's liability, its recovery against the directors would be limited to the full amount of the claim less the dividend on that amount obtainable from the bankrupt estate. And since the directors will have already paid the amount of the preferential transfer in full, the total extent of their liability will remain unchanged.²⁰ If, on the other hand, the directors first pay off

Rankin v. Cooper, 149 Fed. 1010 (C. C. W. D. Ark. 1907). But in view of the wording of the statute, this interpretation cannot be taken seriously.

15. See cases cited notes 16 and 17, *infra*.

16. Adams v. Clarke, 22 F. (2d) 957 (C. C. A. 9th, 1927); Anderson v. Akers, 7 F. Supp. 924 (W. D. Ky. 1934); see Corsicana Nat. Bank v. Johnson, 251 U. S. 69, 87 (1919). Under this rule the Statute of Limitations runs from the making of the loan and directors who retain control may thus escape responsibility. Anderson v. Gailey, 33 F. (2d) 589 (N. D. Ga. 1929); Hughes v. Reed, 46 F. (2d) 435 (C. C. A. 10th, 1931); Payne v. Ostrus, 50 F. (2d) 1039 (C. C. A. 8th, 1931); cf. Purcell v. Baker, 110 S. W. (2d) 1079 (1937).

17. Schilling v. Parman, 35 F. (2d) 780 (D. Ore. 1928); Emerson v. Gaither, 103 Md. 564, 64 Atl. 26 (1906).

18. Cf. cases cited note 8, *supra*. These cases seem to imply that any "benefit" is sufficient. The only situation in which the directors would receive no benefit whatsoever would be when the assets of the bankrupt are sufficient to pay the entire amount of the loan. This possibility is so remote, however, that it does not warrant serious consideration. See Comment (1937) 46 YALE L. J. 1177.

19. See note 13, *supra*.

20. Section 57i of the Bankruptcy Act provides that if any creditor fails to prove his claim in the bankruptcy proceedings, his surety may do so in the creditor's name and may then be subrogated to the extent that he has satisfied the claim. The liability of the directors in the instant case is closely analogous to that of a surety on the loan. In any event they will have paid the debt under compulsion, and their right to subrogation will be clear. See General Order 21 (4); McLaughlin, *Amendment of the Bankruptcy Act* (1927) 40 HARV. L. REV. 585. Cf. Smith v. Tostevin, 247 Fed. 102 (C. C. A. 2d, 1917); Swarts v. Siegel, 117 Fed. 13 (C. C. A. 8th, 1902).

the borrower's indebtedness in full, they will be subrogated to all the rights of the bank and they may hence file a claim in the creditor's name for the entire loan.²¹

The only difficulty which the directors may encounter in establishing their claims against the bankrupt centers around the statutory restrictions on proof of claims in bankruptcy. It is clear that neither the directors nor the bank may recover any dividends from the trustee until the preferential payments have been surrendered in full.²² But even though the directors satisfy the judgment secured by the trustee in the instant case, and hence obviate the difficulty of the preferential payment, they must be careful to avoid the limitations of Section 57n. This Section of the Bankruptcy Act provides that no claim may be filed more than six months after adjudication unless it is liquidated by litigation and the final judgment therein is rendered within "thirty days before or after the expiration of such time." On its face, this provision seems to bar the filing of any new claim either by the directors or by the bank following the decision in the instant case, since the litigation was not terminated until five years after the borrower's adjudication. Actually, however, the courts have adopted a liberal interpretation of this section of the Act. It is well settled that litigation over a preference comes within the meaning of the clause.²³ Moreover, the courts have refused to restrict the scope of the provision to judgments rendered within thirty days of the termination of the six months period simply by construing the words "such time" in Section 57n as modifying the word "litigation" rather than the phrase "six months after adjudication."²⁴ The result of this interpretation is that where the directors are responsible to the bank for the full amount of the loan, they may file and prove their claim for that amount

21. See note 20, *supra*.

22. See Section 57g of the Bankruptcy Act. It seems that satisfaction of a judgment secured by the trustee constitutes a "surrender" within the meaning of the section. *Keppel v. Tiffin Savings Bank*, 197 U. S. 356 (1904).

23. *Page v. Rogers*, 211 U. S. 575 (1909); *In re Roeber*, 127 Fed. 122 (C. C. A. 2d, 1903); *In re John A. Baker Notion Co.*, 180 Fed. 922 (S. D. N. Y. 1910).

24. Although this interpretation seems strained it has generally been accepted by the courts. *Page v. Rogers*, 211 U. S. 575 (1909); *Larson v. First State Bank*, 21 F. (2d) 936 (C. C. A. 8th, 1927). It seems that after the preference has been set aside, the claim may be filed for the first time. *In re Salvation Brewing Co.*, 188 Fed. 522 (S. D. N. Y. 1911).

The Chandler Bill [H. R. REP. No. 8046, 75th Cong., 1st Sess. (1937)] codifies the existing law on this subject and provides that the six months limitation shall not apply to a "... claim arising in favor of a person by reason of the recovery by the trustee from such person of money or property, or the avoidance by the trustee of a lien held by such person, may be filed within thirty days from the date of such recovery or avoidance"

A possible objection to this codification may arise from the fact that it tends to encourage the retention of preferences. A creditor may refuse to file a claim at the outset of the proceeding because he prefers to retain a preferential payment which is larger than the expected dividend. If the trustee sues for the preference, the creditor will be in no worse position than he was originally, since his right to file a claim will not be impaired.

even though the bank had not previously filed in the bankruptcy court.²⁵ But, in filing their claim, the directors would probably have to pay up the balance of their obligation to the bank within sixty days rather than wait to be sued in order to come within the limitation of Section 57n. Similarly, where their liability is contingent, they should see that the bank files within the statutory period; if it fails to do so, they should themselves file in the bank's name under Section 57i.

25. If the bank filed proof of claim immediately after the borrower's adjudication, the directors would not, of course, have to file again. *In re Heyman*, 95 Fed. 800 (S. D. N. Y. 1899); *Matter of Hanson and Tyler Auto Co.*, 286 Fed. 161 (N. D. Iowa 1922); ARNOLD, *SURETYSHIP AND GUARANTY* (1927) 243. In that event they would be subrogated to the right of the bank to whatever dividends were forthcoming.