NOTES

SUBORDINATION OF MORTGAGE-GUARANTOR'S CLAIM IN BANKRUPTCY REORGANIZATIONS*

IN the course of bankruptcy proceedings for the principal debtors of mortgages serviced by New York's large mortgage-guaranty companies,[1] federal courts have had to determine the applicability of the highly developed local case law[2] adjusting the relationships betweeen mortgagor, guaranty company, and the holders of participating mortgage certificates.[3] In many New York insolvency cases the guaranteeing company, holding a retained or reacquired interest in its own certificate issue, has claimed the right to share in the mortgage security on a parity with the public holders. The state decisions,[4] however, have required clear and unmistakable contractual stipulation to entitle the guarantor to participate in the security on an equal basis with public claimants.

In *Geist v. Prudence Realization Corporation*,[5] a recent case arising in the Section 77B reorganization[6] of a corporation holding property subject to a mortgage, the federal District Court for the Eastern District of New York applied this state rule and subordinated certificates owned by the bankrupt guarantor of that issue to those publicly held. The Prudence Company and the Prudence-Bonds Corporation, twin subsidiaries of New York Investors, Incorporated, were together engaged in the mortgage-guaranty business.[7] According to their customary procedure,[8] Prudence,

* Geist v. Prudence Realization Corp., 122 F. (2d) 503 (C. C. A. 2d, 1941). Petition for certiorari filed with Supreme Court, Nov. 24, 1941.

1. The exclusion from federal bankruptcy jurisdiction of banking and insurance companies has forced most of the mortgage-guaranty companies to seek liquidation or rehabilitation under local statutes. 52 STAT. 845 (1938), 11 U. S. C. § 22 (Supp. 1939); *In re* New York Title & Mortgage Co., 9 F. Supp. 319 (N. D. N. Y. 1934). Although organized under the state banking law, the guarantor in the principal case was allowed to undergo § 77B reorganization as a banking corporation in name only. *In re* Prudence Co., Inc., 10 F. Supp. 33 (E. D. N. Y. 1935).

2. Where the mortgage-guaranty company has been liquidated or rehabilitated locally, the New York statutes have provided an elaborate administrative mechanism, protecting both guaranty company and public certificate holders. N. Y. UNCONSOLIDATED LAWS, §§ 1751-1852. See Comment (1934) 34 COL. L. REV. 663.

3. These certificates represent fractional undivided shares in a single bond and mortgage or in groups of bonds and mortgages.

4. Pink v. Thomas, 282 N. Y. 10, 24 N. E. (2d) 724 (1939); Matter of Lawyers Title & Guaranty Co. (236 West Seventieth St.), 164 Misc. 292, 298 N. Y. Supp. 666 (Sup. Ct. 1937).

5. 122 F. (2d) 503 (C. C. A. 2d, 1941).

6. Presumably the same issues would arise today in a proceeding for corporate reorganization under Chapter X.

7. The procedure used by the two companies was deviational in method, but normal in result. Usually a single guarantor appraises the security, advances the loan, deposits bond and mortgage with a depository, and issues the guaranteed certificates.

8. This procedure is described in detail in *In re* Westover, Inc., 82 F. (2d) 177 (C. C. A. 2d, 1936).

after lending funds to a New York realty company on a bond and real property mortgage, assigned both to Prudence-Bonds, which placed them in a public depository.[9] Prudence-Bonds then issued and Prudence guaranteed and sold to the public $382,800 worth of certificates representing fractional shares in the bond and mortgage. By various subsequent transactions, Prudence acquired $816.67 in these certificates[10] and a $7,200 uncertificated balance of the loan.[11] Thereafter, in 1935, Prudence underwent reorganization under Section 77B, and Prudence Realization Corporation, respondent in the principal case, emerged from this proceeding as its successor. Amalgamated Properties, Incorporated, a subsidiary of Prudence, obtained the property subject to the Prudence mortgage by foreclosure of a junior mortgage in 1933, but in 1936 it filed a voluntary petition for reorganization under Section 77B. During this Amalgamated proceeding a plan for the reorganization of this certificate issue[12] was confirmed, and Geist, petitioner in the principal case, was appointed trustee. But the order of confirmation did not decide the question of the participation to be granted Prudence on its $8,016.67 interest in the bond and mortgage. Geist brought the present action by petitioning in the Amalgamated proceeding for an order subordinating the Prudence claim, now held by the Prudence Realization Corporation, to the claims of the public certificate holders. With one judge dissenting,[13] the Second Circuit Court of Appeals affirmed the District Court in following the New York law and subordinating the interest held by the Prudence Realization Corporation.

This New York rule[14] in the guaranty situation is an exception to the general proposition that assignment of an aliquot share of a mortgage does not subordinate the interest retained by the assignor.[15] In determining the rights

9. The depository, Central Hanover Bank and Trust Company, authenticated all certificates as issued, following the institutional practice in the business.

10. Certificates with face values of $500 and $300 were reacquired by Prudence on May 29, 1932, when their owners requested a change in investment to another of Prudence-Bonds' issues. A certificate representing a $16.67 balance after several transactions was issued to Prudence on October 26, 1932.

11. Prudence claimed the uncertificated portion of the issue as assignee of Prudence-Bonds, a theory that would have gained it parity participation since Prudence-Bonds made no guaranty. Title Guaranty & Trust Co. v. Mortgage Commission, 273 N. Y. 415, 7 N. E. (2d) 841 (1937). The court held, however, that Prudence was in fact the equitable owner of this interest at all times. Geist v. Prudence Realization Corp., 122 F. (2d) 503 (C. C. A. 2d, 1941). Strict contract construction has often denied equal participation to such an uncertificated interest where the guaranty agreement has permitted the company only to hold "certificates." Matter of People (Union Guaranty & Mortgage Co.), 285 N. Y. 337, 34 N. E. (2d) 345 (1941).

12. Under the state practice, reorganization of a single certificate issue, or of groups of issues, took place in the guaranteeing company's statutory insolvency proceeding.

13. Judges Clark and Swan comprised the majority. Judge Frank dissented with opinion.

14. Other jurisdictions have a similar rule. *In re* Phillippi, 329 Pa. 581, 198 Atl. 16 (1938); *accord,* Louisville Title Co.'s Rec. v. Crab Orchard Banking Co., 249 Ky. 736, 61 S. W. (2d) 615 (1933).

15. Where the assignor, not also a guarantor, has retained an interest, the courts are divided, but New York allows the assignor to participate on a parity with the as-

of the guarantor, the local courts have consistently announced that the intention of the parties as expressed in their contract of guaranty shall govern.[16] But in construing intention, which is rarely explicit,[17] courts have arrived at the exception by resorting to the maxim that a contract shall be construed against its author,[18] and by invoking a presumption that the parties intended to subordinate the guarantor's certificates.[19]

The sole basis of this New York rule, however, does not lie in judicial construction of the guaranty contracts. The role of the guaranty as producing a "special equity"[20] or a "debtor-creditor"[21] relationship, or as raising an "equitable rule"[22] has been constantly reiterated by the local courts. Such terminology suggests that state courts have been applying a rule of in-

signee. Title Guaranty & Trust Co. v. Mortgage Commission, 273 N. Y. 415, 7 N. E. (2d) 841 (1937). This is not true, however, where a trust relationship exists. Fullerton v. National B. & T. Ins. Co., 100 N. Y. 76, 2 N. E. 629 (1885); *accord*, Domeyer v. O'Connell, 364 Ill. 467, 4 N. E. (2d) 830 (1936). Other jurisdictions, however, treat the assignment itself as an equity demanding subordination of the interest of the assignor. Georgia Realty Co. v. Bank of Covington, 19 Ga. App. 219, 91 S. E. 267 (1917); 3 POMEROY, EQUITY JURISPRUDENCE (4th ed. 1918) § 1203.

16. Matter of Title & Mortgage Guaranty Co. of Sullivan County, 275 N. Y. 347, 9 N. E. (2d) 957 (1937). Substantially similar doctrine appears in the early cases. Mechanics Bank v. Bank of Niagara, 9 Wend. 410 (N. Y. 1832).

17. Apparently this problem was not anticipated by the authors of the guaranty contracts. Many of the agreements, however, contained a clause that each share would be "equal and coordinate" with all other shares assigned or retained by the company. But without exception such language has been declared an insufficient expression of intent to accord parity participation to the guarantor. Pink v. Thomas, 282 N. Y. 10, 24 N. E. (2d) 724 (1939); Matter of Title & Mortgage Guaranty Co. of Sullivan County, 275 N. Y. 347, 9 N. E. (2d) 957 (1937).

18. Matter of Lawyers Title & Guaranty Co. (236 West Seventieth St.), 164 Misc. 292, 298 N. Y. Supp. 666 (Sup. Ct. 1937); Matter of New York Title & Mortgage Co. (Series N-9), 163 Misc. 196, 296 N. Y. Supp. 273 (Sup. Ct. 1936).

19. In several cases the decision has been based entirely upon the presumption of subordination. Matter of Bond & Mortgage Guaranty Co. (223 Second Ave.), 169 Misc. 196, 7 N. Y. S. (2d) 254 (Sup. Ct. 1937), *aff'd without opinion*, 255 App. Div. 765, 7 N. Y. S. (2d) 255 (1st Dep't 1938); Matter of Lawyers Title & Guaranty Co. (236 West Seventieth St.), 164 Misc. 292, 298 N. Y. Supp. 666 (Sup. Ct. 1937). In some cases, however, the decision has been based upon the presumption as reenforced by actual intent. Matter of Title & Mortgage Guaranty Co. of Sullivan County, 275 N. Y. 347, 9 N. E. (2d) 957 (1937); Matter of Lawyers Mortgage Co. (545 West End Ave.), 157 Misc. 813, 284 N. Y. Supp. 740 (Sup. Ct. 1936), *aff'd without opinion*, 272 N. Y. 554, 4 N. E. (2d) 733 (1936).

20. In Matter of Title & Mortgage Guaranty Co. of Sullivan County, 275 N. Y. 347, 9 N. E. (2d) 957 (1937), the presumption was derived from "special equities". See Title Guaranty & Trust Co. v. Mortgage Commission, 273 N. Y. 415, 7 N. E. (2d) 841 (1937).

21. Unmentioned in the early Supreme Court decisions, the "debtor-creditor" concept was first stressed by the Court of Appeals as a reason for subordinating the guarantor. Title Guaranty & Trust Co. v. Mortgage Commission, 273 N. Y. 415, 7 N. E. (2d) 841 (1937); Pink v. Thomas, 282 N. Y. 10, 24 N. E. (2d) 724 (1939). This reasoning would seem to be enlightening principally as a statement of the result of the local cases—that the guarantor is subordinated in the absence of contractual stipulation.

22. Pink v. Thomas, 282 N. Y. 10, 24 N. E. (2d) 724 (1939).

solvency administration in allocating the principal debtor's assets among its creditors.[23]

The frequent subordination of the guarantor resulting from the application of this rule is important in avoiding circuity of action where the guarantor is solvent.[24] But this justification vanishes where the insolvencies of mortgagor and guaranty company place public certificate holders in the class of general creditors in the guarantor's bankruptcy. In this situation, equality of participation in the mortgagor's[25] insolvency proceeding would allow the interest of the guarantor in the issue to become a part of the assets of its bankruptcy estate for division among all of its general creditors. But subordination in the mortgagor's bankruptcy of the certificates held by the insolvent guarantor reduces the amount of assets available for distribution in the guarantor's insolvency proceeding. And by holding back these assets from distribution to all the general creditors of the guarantor and awarding them to the public holders of the particular issue, the court in the mortgagor's bankruptcy in effect accords priority in the guarantor's insolvency proceeding to the holders of a single certificate issue over other general creditors of the guarantor[26] to the extent of the guarantor's interest in that issue.[27]

Confronted in the principal case with the ambiguous phraseology of the New York guarantor-interest opinions, the majority interpreted the state subordination rule as a local construction of guaranty contracts.[28] The court

23. The majority mentioned and dismissed a third possible category for the New York law—a rule attributing a certain legal result to a contract. See American Lumbermen's Mut. Cas. Co. v. Timms & Howard, Inc., 108 F. (2d) 497, 502 (C. C. A. 2d, 1939), holding that an insurance policy must be read as containing a statutory provision.

24. While New York expressly repudiated this reasoning as a basis for the subordination rule in Matter of Title & Mortgage Guaranty Co. of Sullivan County, 275 N. Y. 347, 9 N. E. (2d) 957 (1937), it has been adopted in other states. Kelly v. Middlesex Title Guaranty & Trust Co., 115 N. J. Eq. 592, 171 Atl. 823 (1934), *aff'd*, 116 N. J. Eq. 574, 174 Atl. 706 (1934); see also Preston v. Morsman, 75 Neb. 358, 106 N. W. 320 (1905). In these states, where the guarantor is insolvent, the public holders must share the security with the certificates held by the guaranteeing company. Kelly v. Middlesex Title Guaranty & Trust Co., *ibid.*

25. Although the principal case arose in the insolvency proceeding of a corporation holding property subject to the mortgage, the party holding the property securing the mortgage will, for purposes of convenience, be referred to as if it were always the mortgagor.

26. The RFC held a claim of $11,357,577.45. Claims on guaranteed mortgage certificates amounted to $50,857,852.86, and on guaranteed bonds issued by Prudence-Bonds to $58,833,179.79. Matter of Prudence Co., Inc., E. D. N. Y., May 26, 1939, p. 7.

27. Kelly v. Middlesex Title Guarantee & Trust Co., 115 N. J. Eq. 592, 171 Atl. 823 (1934), *aff'd*, 116 N. J. Eq. 574, 174 Atl. 706 (1934); *accord*, *In re* Rodewald, 24 F. Supp. 905 (S. D. Ill. 1938).

28. At least one other bankruptcy court has been faced with the problem of the instant case. *In re* Rodewald, 24 F. Supp. 905 (S. D. Ill. 1938). While the opinion in that case is not clear, apparently the court first decided that Illinois law, rather than Florida law, governed; and then, ignoring the Illinois law, granted equal participation to secured notes held by a partnership, its partners, and the public. Some of the publicly held notes were guaranteed. The opinion cites no authority and states no general principles. For an analogous principal-surety problem, see note 40 *infra*.

conceived itself bound by *Erie Railroad v. Tompkins*[29] to follow this state construction and interpreted the guaranty agreement as a contract between guarantor and assignee to subordinate the interest of the former in the event of reorganization or liquidation of the mortgage security.[30] Since these extra-bankruptcy priority contracts generally have been held operative in the federal courts through their equitable powers,[31] most cases have indicated that the intention to subordinate should be clear and the surrounding circumstances should be conducive to the application of equitable rules. The decision in the principal case, however, goes beyond this general policy, since the court determined intention by resorting to the New York presumption of guarantor subordination.

Although not clearly indicating the discretionary nature of the court's power to effectuate the extra-bankruptcy priority agreement, the majority did stress the desirability of according similar treatment to all creditors of New York mortgage-guaranty companies before any state or federal tribunal. While such an objective in bankruptcy suggests a marked extension in the policy of the *Tompkins* case,[32] the fact that investments in all of the state guaranty companies "were made under substantially identical conditions" influenced the majority.[33] As secondary factors also favoring subordination of the guarantor, the court pointed out that Prudence Realization Corporation, successor to the rights of the guarantor, took with full notice of the probable subordination;[34] and that the mortgaged property was held by the guarantor's wholly owned subsidiary, Amalgamated Properties, Incorporated.[35]

29. 304 U. S. 64 (1938). Since the *Tompkins* case it has been generally held that the federal courts must follow local construction of contracts. Ruhlin v. N. Y. Life Ins. Co., 304 U. S. 202 (1938); Shell Oil Co., Inc. v. Manley Oil Corp., 37 F. Supp. 289 (E. D. Ill. 1941).

30. The typical contract of this nature is between several creditors, subordinating the claims of one or more to the claims of the others upon the debtor's insolvency. Bank of America Nat. Trust & Savings Ass'n v. Erickson, 117 F. (2d) 796 (C. C. A. 9th, 1941); Bird & Son Sales Corp. v. Tobin, 78 F. (2d) 371 (C. C. A. 8th, 1935). Such agreements are usually employed by creditors to obtain new funds and credit for a debtor in poor financial condition.

31. Bird & Son Sales Corp. v. Tobin, 78 F. (2d) 371 (C. C. A. 8th, 1935); Searle v. Mechanics Loan & Trust Co., 249 Fed. 942 (C. C. A. 9th, 1918), *cert. denied*, 248 U. S. 592 (1918); see Note (1936) 100 A. L. R. 660.

32. The *Tompkins* case expressly excepted "matters governed by the Federal Constitution or by Acts of Congress" from its policy of following local law. The federal court's bankruptcy jurisdiction is based upon a Congressional act, which is in turn grounded in Constitutional authority. U. S. CONST., Art. I, § 8.

33. Such reasoning might be extended to any of the heretofore "federal" fields of law.

34. One possible answer is that other certificate holders and general creditors of the guarantor, who actually make up its successor corporation, did not take with notice of subordination. See dissent of Judge Frank in Geist v. Prudence Realization Corp., 122 F. (2d) 503, 507 (C. C. A. 2d, 1941).

35. But at the times of flotation of the participating certificates (apparently in the late twenties) and the later acquisition of an interest by the guarantor (May-Oct., 1932), the property was owned by a realty company seemingly unconnected with the guarantor.

The dialectic confusion of the state opinions, however, justifies interpreting them not only as construing contracts of guaranty, but as applying a rule of insolvent liquidation in allocating mortgage security among competing claims.[36] Support for this interpretation lies in the fact that the rights concerned in the guarantor-interest cases apparently do not freeze until distribution of the estate of the principal debtor. The fixing of rights at this time would seem to follow from the New York opinions, since neither the insolvency of the primary obligor, nor even the insolvency and liquidation of the guarantor,[37] invokes the rule of subordination. If the rule is not applied in these situations, the only occasion presenting the issue of guarantor participation is the liquidation of the primary obligor; and it becomes apparent that the rule may constitute a method of distributing that estate, for it is only at this juncture that all concerned rights are fixed. Further indication that this New York law is primarily a rule of insolvency administration lies in its use in statutory proceedings for the rehabilitation or liquidation of the guaranty companies and their mortgage issues, with little reliance on pre-depression precedent.[38]

If the New York rule is viewed as one of insolvency administration, the state guarantor-interest decisions cease to bind the federal court, and the usual principles of bankruptcy proceedings control. Under these bankruptcy rules, creditors are divided into classes according to the economic status of their claims,[39] and, as a corollary to this "fixed principle" of the *Boyd* case, creditors of the same economic class must be accorded equal treatment, subject to alteration by equitable factors.[40] Applying these principles to the

The later acquisition (Feb., 1933) by the guarantor's subsidiary, through foreclosure of a junior mortgage, came with no intimation of bad faith.

36. While the court in the instant case assumed the New York rule fell into one of two generic categories, contract construction or insolvency administration, it is possible that the court erred in assuming such a dichotomy existed.

37. Apparently the New York subordination rule is only applied when the guarantor holds certificates at the time of distribution of the security, and where these certificates are re-sold on the market or otherwise reach other holders, they are accorded parity participation under the usual "equal and coordinate" lien clause. Matter of Lawyers Title & Guaranty Co. (No. 424421), 165 Misc. 590, 1 N. Y. S. (2d) 264 (Sup. Ct. 1937) (guarantor's certificates assigned as security for a loan); Matter of Lawyers Mortgage Co. (8718 Ridge Blvd.), 284 N. Y. 371, 31 N. E. (2d) 492 (1940) (certificate issued to guarantor's subsidiary).

38. The state precedents cited in the New York guarantor-interest opinions usually dealt with priority of concurrent mortgages. Granger v. Crouch, 86 N. Y. 494 (1881). In none was there a holding on a guaranty situation.

39. Northern Pac. Ry. v. Boyd, 228 U. S. 482 (1913); Case v. Los Angeles Lumber Prod. Co., 308 U. S. 106 (1939). According to this rule, junior claims must either make a new contribution or be subordinated to full compensation of senior interests. See (1940) 49 YALE L. J. 1099.

40. These equitable principles, for example, prevent a surety, who has undertaken to pay creditors of the principal to a stated limit, from sharing on his subrogation claim in the assets of the principal until all partially protected debts have been paid in full. American Surety Co. v. Westinghouse Elec. Mfg. Co., 296 U. S. 133 (1935). On the general problem, see Comment (1940) 49 YALE L. J. 881; (1941) 50 YALE L. J. 892.

instant case, it becomes apparent that variation from the fundamental bankruptcy doctrine of equality must be predicated upon equitable considerations, since the guarantor and the public claimants hold investments with identical economic classification.

Several elements of the immediate situation favor according equality of participation to the certificates held by the guaranteeing company. It is only the circumstance of that company's choice to invest[41] in one of its own issues, rather than to distribute the entire issue to the public, which leads to its subordination in the principal case. Furthermore, the public holders of other issues of mortgage participation certificates and miscellaneous other creditors, in making their investment, relied upon the assets of the guaranteeing company, a part of which consisted of retained or reacquired shares.[42] From the point of view of these other general creditors of the guarantor, the participating certificates held by the company would be considered substituted value for general assets expended in their acquisition, a consideration rejected by the decision in the instant case.

This "insolvency-rule" interpretation of the New York law is based upon a policy of national similarity in bankruptcy remedy, as opposed to the majority's argument that creditors should receive the same treatment within a single state, whether liquidation occurs in a local or in a federal court. As pointed out in Judge Frank's dissent, uniformity of bankruptcy administration throughout the United States is, by express Constitutional provision,[43] made paramount to federal conformity with the rule of a particular state. This Constitutional mandate would seem to preclude a federal court from following state insolvency law in order to promote local uniformity, especially where the bankruptcy rule is directly contrary, as in the instant case.

It is possible that the majority in the principal case confused two distinct reasons for following the state rule and did not realize that adoption of either the "contract-construction" or the "insolvency-rule" approach would lead to a decision based upon equitable evaluation. For, in addition to construing the guaranty contract in terms of the New York case law as an extra-bankruptcy priority agreement, the court also asserted it was enforcing the state rule of subordination as determining the "real basis" of the parties' claims in the mortgagor's insolvency.[44] But in this proceeding, the claims of either the public certificate holders or the guarantor would appear to

41. Prudence intended to hold the reacquired certificates as investments. Affidavit of William T. Cowin, trustee of Prudence, Record on Appeal, p. 24, Geist v. Prudence Realization Corp., 122 F. (2d) 503 (C. C. A. 2d, 1941).

42. No figures are available for the Prudence situation. In general, a substantial part of the assets of these companies has been invested in retained or reacquired participating certificates. See (1938) 47 YALE L. J. 480, 483.

43. "The Congress shall have Power . . . to establish . . . uniform Laws on the subject of Bankruptcies throughout the United States . . ." U. S. CONST., Art. I, § 8.

44. A further statement indicates the majority was thinking in terms of discovering the basis of the parties' claims in bankruptcy. Referring to one possible categorization of the local law, it said: "It is still the difference between finding out what the contract claim is as opposed to adjusting priorities among unascertained claims." Geist v. Prudence Realization Corp., 122 F. (2d) 503, 506 (C. C. A. 2d, 1941).

find their "real basis" in the certificates held, with the guaranty contract an ancillary agreement binding only its signers and of no consequence in the relationship of either to the mortgagor.[45] Hence, it would appear that the court should isolate the problem of discovering the basis for the bankruptcy claims from the problem of the enforceability of the collateral priority contract. If that practice is adopted, the bankruptcy court, instead of finding the "real basis" of the claims in the priority contract as indicated in the majority opinion, would then follow the preferable procedure of considering the foundation of the claims before deciding upon their order of payment.

It would seem that the bankruptcy courts would afford greater protection to public investment in mortgage participation certificates by rejecting the New York presumption where the guarantor is insolvent, and adopting one of equality of participation for all holdings in the particular issue.[46] If accepted principles of bankruptcy administration are followed, the guarantor's claim will be subordinated only upon clear expression of intent by the contracting parties.

UNDISTRIBUTED PROFITS TAX: DIVIDENDS-PAID CREDIT IN TAX-FREE INTERCORPORATE LIQUIDATIONS*

THE Revenue Act of 1936[1] imposed upon all corporations subject to income tax a "surtax upon undistributed profits."[2] The history of the tax suggests that it was looked upon not only as a means of tapping sources of federal revenue theretofore lightly taxed but also as a measure of reform, in that it met the economists' argument that excessive corporate saving was a contributing cause of the depression.[3] A natural tax consequence of this saving

45. *In re* Rodewald, 24 F. Supp. 905 (S. D. Ill. 1938). A guaranty creditor does not thereby become a "secured creditor" in the principal's bankruptcy proceeding. Swarts v. 4th Nat. Bank of St. Louis, 117 Fed. 1 (C. C. A. 8th, 1902); *accord, In re* Noyes Bros., 127 Fed. 286 (C. C. A. 1st, 1903).

46. For a similar view of the state litigation, see (1938) 47 YALE L. J. 480; (1940) 14 ST. JOHN'S L. REV. 424.

* Helvering v. Credit Alliance Corp., 122 F. (2d) 361 (C. C. A. 4th, 1941), *cert. granted*, 10 U. S. L. WEEK 3176 (U. S. 1941).

1. 49 STAT. 1648 (1936).

2. Section 14. The surtax was included in the Revenue Act of 1938 but at much lower rates; it was allowed to lapse with the Act of 1939.

3. See generally BUEHLER, THE UNDISTRIBUTED PROFITS TAX (1937). On the history of this type of tax, see Martin, *Taxation of Undistributed Corporate Profits* (1936) 35 MICH. L. REV. 44; Comments (1936) 36 COL. L. REV. 1321, (1936) 50 HARV. L. REV. 332. The legislative hearings and reports are of little use in pursuing the wraith of Congressional intent. The surtax was originally proposed by the House as a substitute for all other corporate taxes; the Senate amended the House Bill and reintroduced the existing tax structure with an undistributed profits tax added. "The Conference Committee had the difficult task of reconciling . . . two diverse bills actuated by divergent views as to the proper attitude toward corporate wealth. . . .

was that tax assessments for individuals in the higher brackets were substantially lowered, since profits allowed to remain in a corporation were subject only to a relatively low rate of tax.[4] This revenue loss was aggravated through conscious manipulation by taxpayers who controlled closely held corporations.

The 1936 surtax was not the first attempt to tax profits retained by corporations. Since 1918 the Revenue Acts have included provisions imposing a penalty tax on corporations "improperly accumulating surplus."[5] These provisions have, however, been difficult to administer[6] and have failed to check the increasing use of the corporate form as a means of tax avoidance.[7] Consequently,[8] in 1934 Congress imposed a heavy tax on "undistributed profits" of personal holding companies without regard to the propriety of the accumulation.[9] In 1936 this tax was extended to all corporations.[10]

The old penalty tax on improperly accumulated surplus had been imposed on the entire net income of the offending corporation. The 1934 personal

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The House and Senate 1936 Bills were dissimilar in general aim, theory and in structure. The 1936 Act as finally enacted was to a considerable extent written in conference without any new statement of legislative intent—a fact which contributes in no small measure to the difficulty of interpretation of the Act." MERTENS, THE LAW OF FEDERAL INCOME TAXATION (1939 Cum. Supp.) 1397.

4. Under the Revenue Act of 1936 the tax rate on corporate incomes (apart from the surtax on undistributed profits) ranged up to 15% on corporate income over $40,000. § 13. Individual surtax rates went as high as 75%. § 12.

5. Revenue Act of 1918, § 220. INT. REV. CODE § 102 (1939). Another forerunner of the 1936 surtax is found in § 1206(2) of the Revenue Act of 1917 (40 STAT. 300, 334) which imposed a 10% tax on undistributed corporate profits where the income retained was not for actual employment in the reasonable needs of the business.

6. In suits brought under this section the Government must show not only that there has been an improper or unreasonable accumulation of surplus, but also that there has been a purpose to avoid individual surtax on the stockholders. United Business Corp. v. Commissioner, 62 F. (2d) 754 (C. C. A. 2d, 1933).

7. See Rudick, *Section 102 and Personal Holding Company Provisions of the Internal Revenue Code* (1939) 49 YALE L. J. 171, 217-21. Rudick lists a total of thirty cases brought under Section 102, seventeen of which were won by the Government. After repeal of the surtax on undistributed profits, the Treasury indicated that corporate returns beginning with 1938 would be closely examined with a view to uncovering violations of Section 102. See T. D. 4914, 1939-2 CUM. BULL. 108. It was suggested that the purpose of the proposed "drive" was to demonstrate once and for all the ineffectiveness of Section 102 and thus prepare the way for a reenactment of the general tax on undistributed profits. See Halperin, *T. D. 4914 and the Surtax on Corporations Improperly Accumulating Surplus* (1940) 18 TAXES 72. Whatever the reason, reports of the Board of Tax Appeals during 1941 have shown a substantial increase in cases brought under the section.

8. H. R. REP. No. 704, 73d Cong., 2d Sess. (1934); 1939-1 CUM. BULL. (Pt. 2) 562.

9. Revenue Act of 1934, § 351.

10. The Act of 1936 retained the tax on improperly accumulated surplus (§ 102) as well as the personal holding company tax (§ 351). Payment of the surtax under Section 14 did not relieve the corporate taxpayer from liability under the other sections. See XV-2 CUM. BULL. 72 (1935).

holding company tax introduced the new device of a credit for dividends paid,[11] which were to be deducted from corporate net income, and the remainder only taxed. This credit became the central feature of the undistributed profits tax. Section 27 was added to define when the credit was allowable.[12]

Section 27(f)[13] provided that amounts distributed in liquidation should, insofar as they were "properly chargeable to the earnings or profits accumulated since February 28, 1913," be treated as "taxable dividends paid" in computing the dividends-paid credit. Without this provision the Act would have led to an ingenious but inequitable paradox under which a corporation having paid out in liquidation all its assets including all its profits would still have been subject to the surtax on profits that were at best only metaphysically "undistributed."[14] This result would follow from the rule that corporate distributions in liquidation are not statutory dividends but a return of capital investment, and are taxable only as capital gains.[15] Since the credit was allowed only for "dividends," it was necessary to turn liquidating distributions into "dividends" for the purpose of Section 27. As the section was drafted, however, it automatically created two problems which were bound to provoke litigation.[16]

11. Revenue Act of 1934, § 351(b)(2)(C).

12. The general undistributed profits tax was discontinued in 1939. Section 27 of the Internal Revenue Code now applies to the surviving undistributed profits taxes levied on personal holding companies (§ 500), foreign personal holding companies (§ 331 *et seq.*) and on improper accumulation of surplus (§ 102).

13. Now INT. REV. CODE § 27(g) (1939).

14. *Cf.* Foley Securities Corp. v. Commissioner, 38 B. T. A. 1036 (1938), *aff'd*, 106 F. (2d) 731 (C. C. A. 8th, 1939), where the *A* Corporation had an operating deficit at the beginning of the taxable year, and income during the taxable year greater than the pre-existing deficit. It thereafter distributed to its stockholders almost its entire taxable income. The court held that a dividends-paid credit should be allowed only for that part of the distribution in excess of the deficit; for the balance the *A* Corporation was liable to surtax as on "undistributed profits." This case was brought under Section 351 of the Revenue Act of 1934. The Court of Appeals for the Second Circuit recently refused to follow the *Foley* case in Pembroke Realty and Securities Co. v. Commissioner, 122 F. (2d) 252 (C. C. A. 2d, 1941). But the Board subsequently followed the rule in the *Foley* case in Saxon Trading Corp., 45 B. T. A. 16 (1941).

15. INT. REV. CODE § 115(a) (1939): "The term 'dividend' . . . means any distribution made by a corporation to its shareholders . . . (1) out of its earnings or profits accumulated after February 28, 1913, or (2) out of the earnings or profits of the taxable year . . ." § 115(c): "Amounts distributed in complete liquidation of a corporation shall be treated as in full payment in exchange for the stock, and amounts distributed in partial liquidation of a corporation shall be treated as in part or full payment for the stock." Hellmich v. Hellman, 276 U. S. 233 (1928); M. E. Blatt Co. v. United States, 305 U. S. 267 (1938); see White v. United States, 305 U. S. 281, 288 (1938). See Darnell, *Corporate Liquidations and the Federal Income Tax* (1941) 89 U. OF PA. L. REV. 907; Comment (1938) 47 YALE L. J. 1146; MAGILL, TAXABLE INCOME (1939) 114-15.

16. Darnell, *Corporate Liquidations and the Federal Income Tax* (1941) 89 U. OF PA. L. REV. 907, 927, n. 106. Commentators were quick to point out the statutory

The first problem involves the limitation of the credit to that part of the distribution "properly chargeable to earnings or profits. . . ." "Earnings or profits" is a chameleon phrase which has more than one meaning in income taxation.[17] In some sections of the Revenue Acts[18] it has been interpreted to mean earned surplus as distinguished from capital accounts.[19] In its second, more technical meaning, the phrase connotes something different from corporate "net income." Thus elements of income not taxable to corporations as "income" may still be "earnings or profits," on distribution of which shareholders are taxed, under the statutory definition of a "dividend."[20] Furthermore, a line of cases beginning with *Commissioner v. Sansome*[21] established the rule that in certain tax-free corporate reorganizations, where one corporation distributed its assets to a successor, the earnings or profits of the first corporation were not distributed but passed intact to the successor in interest, and, when distributed to the shareholders of the second corporation, were still statutory dividends subject to tax as such. The 1936 Act codified this rule to some extent in Section 115(h):

> "The distribution . . . to a distributee by or on behalf of a corporation of its stock or securities or stock or securities in another corporation shall not be considered a distribution of earnings or profits of any corporation . . .
>
> (1) if no gain to such distributee from the receipt of such stock or securities was recognized by law . . ."

Under these circumstances the question may be raised whether distributions in a tax-free liquidation should be held "properly chargeable to earnings or profits."

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discrepancies which emerged. See *inter alia* Klein, *Liquidations under the Revenue Act of 1936* (1936) 14 TAXES 648, 650; Seidman, *The Undistributed Profits Tax—Suggested Changes in Law* (1937) 15 TAXES 79, 82; Seidman, *Some Problems Emerging from Tax-Free Intercorporate Liquidations under the 1936 Federal Income Tax Act* (1936) 6 BROOKLYN L. REV. 199, 206; Comments (1936) 36 COL. L. REV. 1321, 1332, (1936) 50 HARV. L. REV. 332, 339; MERTENS, LAW OF FEDERAL INCOME TAXATION (1939 Cum. Supp.) 1436, n. 93. Nevertheless, Congress has continued to reenact the sections involved in the problem in identical form.

17. See generally Paul, *Ascertainment of "Earnings or Profits"* (1937) 51 HARV. L. REV. 40. Reprinted in PAUL, SELECTED STUDIES IN FEDERAL TAXATION (2d Ser.) (1938).

18. *E.g.*, INT. REV. CODE §§ 113(b)(1)(D), 115(c), 115(g) (1939).

19. See Credit Alliance Corp., 42 B. T. A. 1020, 1027 (1940).

20. Charles F. Ayer, 12 B. T. A. 284 (1928). This was decided under the Revenue Act of 1921, but is "generally applicable under existing law." Paul, *supra* note 17, at 44.

21. 60 F. (2d) 931 (C. C. A. 2d, 1932), *cert. denied*, 287 U. S. 667 (1932); United States v. Kauffman, 62 F. (2d) 1045 (C. C. A. 9th, 1933); Murchison's Estate v. Commissioner, 76 F. (2d) 641 (C. C. A. 5th, 1935); Fain v. Commissioner, 76 F. (2d) 1008 (C. C. A. 5th, 1935), *cert. denied*, 296 U. S. 588 (1935); Harter v. Helvering, 79 F. (2d) 12 (C. C. A. 2d, 1935); Baker v. Commissioner, 80 F. (2d) 813 (C. C. A. 2d, 1936).

The second problem concerning the credit arises from subdivision (h) of Section 27.[22] This provision states a general exception to the dividends-paid credit by providing that it be disallowed where any part of a distribution is "not a taxable dividend in the hands of . . . the stockholders." Furthermore, Section 112(b)(6) provides with elaborate detail for the tax-free liquidation of a subsidiary corporation into its parent.[23] The three sections of the Act, by interrelation, seemed to result in contradictory imperatives: in a 112(b)(6) liquidation the credit is as clearly allowed by 27(f) as it is prohibited by 27(h).[24]

The problem has now received three hearings in different circuit courts of appeals. The Fifth Circuit ruled on the issue first in *Centennial Oil Company v. Thomas*.[25] It affirmed the District Court's holding that the subsidiary, liquidated under the provisions of 112(b)(6), was not entitled to the dividends-paid credit in any amount. The ground of decision was briefly stated to be that Section 27(h) limited Section 27(f) by way of exception. The court did not discuss the further problem presented by "properly chargeable to earnings or profits."[26] The same issue came before the Board of Tax Appeals in *Credit Alliance Corporation*.[27] The Board expressly refused to follow the *Centennial Oil* decision and allowed the credit. In the past year the Board has followed the *Credit Alliance* rule in a dozen other cases.[28]

22. INT. REV. CODE § 27(i) (1939).

23. To qualify under Section 112(b)(6) the distributee must have owned at least 80% of voting and non-voting (except where limited and preferred as to dividends) stock at the date of adoption of a plan of liquidation, must own at least 80% at the date of receipt of the property, and may not dispose of any stock between the date of adoption of a plan and the date of receipt of the property. The section also specifies the time within which the liquidation must be completed.

24. U. S. Treas. Reg. 94 Art. 27(f)-1 ruled that the dividends-paid credit was denied the distributing corporation in a 112(b)(6) liquidation.

25. 109 F. (2d) 359 (C. C. A. 5th, 1940) (Hutcheson, J., dissenting), *cert. denied*, 309 U. S. 690 (1940).

26. The court indicated its conception of the function of 27(f) in these words: "The philosophy of Subsection 27(f) is that in ordinary liquidations where there are accumulated profits, the profits could first be declared as a dividend and afterwards the remaining assets distributed in liquidation; and when both things are done in one transaction the same results shall be allowed to follow. The purpose of the undistributed profits surtax is to force distribution of profits to the stockholders so they may be taxed as dividends in the stockholders' hands." 109 F. (2d) 359, 360 (C. C. A. 5th, 1940).

27. 42 B. T. A. 1020 (1940). Two members dissented on the authority of the *Centennial Oil* case.

28. Kay Manufacturing Corp., 42 B. T. A. 1480 (1940) (mem.); Lane-Wells Co., 43 B. T. A. 463 (1941); Crown-Zellerbach Corp., 43 B. T. A. 541 (1941); California Brewing Ass'n, 43 B. T. A. 721 (1941); Little Gem Coal Co., 44 B. T. A. 755 (1941); Oliver Ditson Co., Inc., 3 C. C. H. 1941 Fed. Tax Serv. ¶ 7081-E (B. T. A. mem.); Desmond's Co., 3 C. C. H. 1941 Fed. Tax Serv. ¶ 7083-E (B. T. A. mem.); O'Donnell Oil & Securities Co., 3 C. C. H. 1941 Fed. Tax Serv. ¶ 7083-F (B. T. A. mem.); Asheville Citizen-Times Co., 3 C. C. H. 1941 Fed. Tax Serv. ¶ 7083-G (B. T. A. mem.); Biltmore Co., Transferee, 3 C. C. H. 1941 Fed. Tax Serv. ¶ 7083-H (B. T. A. mem.);

The Fourth Circuit Court of Appeals has recently affirmed the Board's position in *Helvering v. Credit Alliance Corporation*,[29] and the Second Circuit Court of Appeals has also sustained it in *Helvering v. Kay Manufacturing Corporation*.[30]

The Board's first argument in the *Credit Alliance* case follows the canon of statutory construction requiring that a more specific statutory provision override a more general one in case of conflict. Since Section 27(h) relates to all distributions and Section 27(f) only to those in liquidation, the latter should govern.[31] The Board also holds that allowing the credit carries out the Congressional policy expressed in the tax-free liquidation provisions of Section 112(b)(6). If the liquidation were to subject the subsidiary to the undistributed profits tax, Congressional intent would be thwarted. The Board then answers the argument that, even if the tax-free liquidation aspect of the transaction does not defeat the credit, the distribution is not "properly chargeable to earnings and profits" because of Section 115(h). That section, as it appeared in the 1936 Act,[32] related only to distributions by a corporation of "stock or securities"; in a 112(b)(6) liquidation the subsidiary distributes not "stock or securities" but all its assets, tangible and intangible. Therefore Section 115(h) seems inapplicable. Finally, the phrase "earnings or profits" as used in Section 27(f) must be taken to mean merely earned surplus as distinguished from paid-in surplus and other capital accounts.[33]

Hughes Tool Co., 3 C. C. H. 1941 Fed. Tax Serv. ¶7646-C (B. T. A. mem.); Western Cartridge Co., 3 C. C. H. 1941 Fed. Tax Serv. ¶7654-B (B. T. A. mem.); Lencul Corp., 3 C. C. H. 1941 Fed. Tax Serv. ¶7663-D (B. T. A. mem.); Central States Collieries, Inc., 3 C. C. H. 1941 Fed. Tax Serv. ¶7663-E (B. T. A. mem.).

Reed Drug Co., 44 B. T. A. 573 (1941) (distinguishing *Credit Alliance Corp.*; two members dissenting). See also Great Lakes Coca-Cola Bottling Co., 3 C. C. H. 1941 Fed. Tax Serv. ¶7437-A (B. T. A. mem.). In Little Gem Coal Co., 44 B. T. A. 755 (1941), the *Reed* case was strictly limited to its own facts, and, it was stated, "cannot be considered as impairing the authority of *Credit Alliance Corp.*"

29. 122 F. (2d) 361 (C. C. A. 4th, 1941).

30. 122 F. (2d) 443 (C. C. A. 2d, 1941).

31. The Board had previously held that 27(f) was limited by 27(g) which denied the credit in cases where the distributions were preferential. May Hosiery Mills, Inc., 42 B. T. A. 646 (1940), *aff'd.* 2 C. C. H. 1941 Fed. Tax Serv. ¶9571 (C. C. A. 4th, 1941) (Credit Alliance filed a brief *amicus curiae*).

32. The Revenue Act of 1938 added the words "or of property or money" after the phrase "or stock or securities in another corporation" to §115(h). The Board in the instant case, as well as the Second and Fourth Circuit Courts, reserved opinion on the result which would follow from this wording of the statute, and rejected the Government's argument that the insertion in the 1938 Act was merely a clarification and not an extension of the earlier form.

33. The Board rejected the further argument made by the Government that the Treasury Regulation (U. S. Treas. Reg. 94, Art. 27(f)-1) had been tacitly approved by Congress through reenactment of the sections in successive Revenue Acts. The Board stated that reenactment was entitled to little weight in the case of a tax which was shortly thereafter repealed. It is true that the undistributed profits tax was repealed; on the other hand Sections 27(f), 27(h), and 112(b)(6) remain in the Code. The fiction of Congressional approval by reenactment is best disregarded. Helvering v. R. J. Reynolds Tobacco

The opinions in the circuit courts of appeals add little to the arguments of the Board. Both opinions exclude the Board's demonstration on the logical level and stress the argument of Congressional policy. The Fourth Circuit Court of Appeals suggests that the statutory conflict could be eliminated by holding the parent-distributee liable for the undistributed profits surtax if it did not thereafter distribute them to its stockholders.[34] This apparently gratuitous dictum, though a sensible and equitable solution to the whole problem, unfortunately finds no support in the statute.[35]

In the *Credit Alliance* case neither the Board nor the Fourth Circuit Court of Appeals is wholly convincing in the attempt to demonstrate that statutory dissonance gives way to an inner harmony upon correct construction. The corpus of our income tax law has become so unwieldy that, more and more frequently, instances will occur where several sections clash. In such cases the solution must come from interstitial legislation by the courts; decision for the taxpayer or decision for the Government may be equally plausible under the language of the applicable sections of the Act. The court's conception of policy, though phrased in terms of a hypothetically discoverable Congressional intent, must dictate the decision actually arrived at.

Section 112 as a whole defines various types of corporate reorganization in which no gain or loss is "recognized." These provisions[36] are, strictly, tax-deferring rather than tax-exempting, since on final liquidation of the enterprise the stockholders are subject to a capital gains tax on the amount by which the liquidating distributions exceed the basis of the stock.[37] The reorganization sections, as construed, apply in cases where business exigencies require modification of corporate structure, and where a continuity of interest in the enterprise persists.[38] Section 112(b)(6) was new legislation in the

Co., 306 U. S. 110 (1939), seemed to lay down the rule that a regulation became binding when the section it construed was reenacted, but in Helvering v. Wilshire Oil Co., 308 U. S. 90 (1939), the rule was promptly avoided. For recent discussion see Brown, *Regulations, Reenactment and the Revenue Acts* (1941) 54 HARV. L. REV. 377; Feller, *Addendum to the Regulations Problem* (1941) 54 HARV. L. REV. 1311; Griswold, *A Summary of the Regulations Problem* (1941) 54 HARV. L. REV. 398.

34. Helvering v. Credit Alliance Corp., 122 F. (2d) 361, 365 (C. C. A. 4th, 1941).

35. See discussion *infra* pp. 329-30.

36. Described as unbelievably complicated in PAUL, STUDIES IN FEDERAL TAXATION (3d Ser.) (1940) 4.

37. *Id.* at 53-54.

38. The Supreme Court ruled in Gregory v. Helvering, 293 U. S. 465 (1935), that a literal compliance with the provisions of Section 112 was not enough to avoid the capital gains tax where an intent to avoid tax was discoverable. The Treasury regulations have codified the point decided in the *Gregory* case. "The Code recognizes as a reorganization the change (made in a specific way) from a business enterprise conducted by a single corporation to the same business enterprise conducted by a parent and a subsidiary corporation but not the creation of a temporary subsidiary as a device for the making of an ordinary dividend." (U. S. Treas. Reg. 101, Art. 112(g)-1; *id.* 103, § 19.112(g)-1). A recent case holding that for the purposes of the reorganization section a complicated intercorporate shuffle must be viewed as a whole, disregarding the "intermediate prestidigitation" is Morgan v. Helvering, 117 F. (2d) 334 (C. C. A. 2d, 1941) (*per* L. Hand, J.). "Unlike the transfer of property to a corporation upon its formation the reverse process of liquidation has received the legis-

1936 Act, and its insertion in the reorganization chapter undoubtedly manifests Congressional intent to encourage corporate simplification by eliminating the capital gains tax in situations where the enterprise as a whole continues. There is no persuasive reason for presuming that Congress intended to confer any other and greater benefit, *i.e.*, exemption of current earnings transferred from undistributed profits surtax.

In some situations it may be desirable for the enterprise to liquidate so as not to come under the provisions of Section 112(b)(6). In such a tax-free liquidation the basis of the property received is "the same as it would be in the hands of the transferor."[39] Where the cost of the assets to the subsidiary is less than the cost of the subsidiary's stock to the parent, so that on a *taxable* liquidation the parent would obtain as basis what it had paid for the stock, then liquidation will be so effected as not to fall within 112(b)(6). The capital gains tax paid on the liquidation may be offset not only by the stepped-up basis to the parent but by avoidance of the tax on domestic corporate dividends received.[40]

The result of this basis provision is to make 112(b)(6) liquidations unavailable for purposes of tax-exemption as distinguished from tax-deferment —for if the parent achieves a stepped-up basis on a tax-free liquidation, then the increment arising from the shift to the new basis becomes tax-free on final liquidation of the enterprise. The *Credit Alliance* rule has the effect of granting an exemption from undistributed profits surtax (insofar as current earnings are transferred) analogous to the exemption denied by the basis provision. It can be plausibly argued that the benefit intended to be conferred by Section 112(b)(6) is deferment only; the linking of 112(b)(6) with the basis provision indicates that the liquidation section should not be construed to exempt the property transferred from all tax. The conclusion is that the policy exemplified in Section 112(b)(6) will not square with the exemption from surtax of the current earnings transferred.

This argument falls if, as suggested by the Court of Appeals for the Fourth Circuit, these earnings are subject to surtax in the hands of the distributee.[41] But for them to be so taxable, they must become a part of the gross income of the parent-distributee, since the computation of undistributed profits surtax is based on the statutory net income of the taxpayer.[42]

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lative blessing of tax exemption most sparingly." Darnell, *Corporate Liquidations and the Income Tax* (1941) 89 U. OF PA. L. REV. 907. There are, however, cases implying that the reorganization provisions are to be liberally construed. See, *e.g.*, Commissioner v. Dana, 103 F. (2d) 359 (C.C.A. 3d, 1939).

39. INT. REV. CODE § 113(a)(15) (1939). The provision in the 1936 Act was identical.

40. See Seidman, *Some Problems Emerging from Tax-Free Intercorporate Liquidations under the 1936 Federal Income Tax Act* (1936) 6 BROOKLYN L. REV. 199; 2 C. C. H. 1941 Fed. Tax Serv. ¶¶ 733.05, 780.01; Johnson, *Tax-Free Liquidation: Loophole and Trap* (1937) 15 TAXES 3; Klein, *Liquidations under the Revenue Act of 1936* (1936) 14 TAXES 648.

41. See note 34 *supra* and parallel text.

42. Net income is defined as "the gross income computed under § 22, less the deductions allowed by § 23." INT. REV. CODE § 21 (1939). The surtax on undistributed

Gross income includes "gains . . . derived from any source whatever"[43] and, on distributions in liquidation, the gain is determined by the excess over the stockholder's basis.[44] But this gain "shall be recognized only to the extent provided in Section 112." Since in a 112(b)(6) liquidation no gain is recognized, there is no income to the distributee and therefore nothing on which the surtax may be imposed. In cases of liquidations not falling within Section 112(b)(6), where gain is recognized, it is easy to agree with the Court of Appeals for the Fourth Circuit that "there is nothing in the Act which says that the distributee is not subject to tax upon undistributed profits if it persists in the retention . . . of undivided profits."[45] But the question does not arise, since, in a taxable liquidation, the credit is obviously available to the liquidating subsidiary under Section 27(f).

Treasury regulations issued under Section 27(f) establish a *locus penitentiae* by ruling that if, in a 112(b)(6) liquidation, the parent-distributee paid to its stockholders before the end of the taxable year the earnings or profits received from the subsidiary, the dividends-paid credit would be allowed.[46] Although this interpretation clearly tends to effectuate the purpose of the Act, it may nevertheless rest on a doubtful statutory foundation. The rulings seem to have been based on the provision of Section 115(h) that earnings and profits of the subsidiary are not distributed in a 112(b)(6) liquidation but pass intact to the distributee. Both the Second and the Fourth Circuit Courts have interpreted the provision, as it appears in the 1936 Act, not to support the Government's contention that the liquidating distributions are not "properly chargeable to earnings or profits."

But, quite apart from the applicability of Section 115(h), the ruling seems incorrect. If the parent can receive a credit on distribution of the subsidiary's transferred earnings, it must be taxable when they are not distributed. But whether or not the earnings "pass intact," they do not become income to the parent and therefore do not become taxable to it. The *Sansome* case, codified in Section 115(h),[47] holds that the earnings or profits, retaining their character on a tax-free reorganization, are still within the statutory definition of dividends when ultimately distributed to stockholders of the reorganized corporation. The theory has nothing to do with the question of whether or not the earnings or profits are "income" to the successor corporation. The Treasury ruling is the converse of the suggestion

profits (§ 14 Revenue Act of 1936) defined "adjusted net income" as net income minus normal tax (§ 13) and various other credits, and "undistributed net income" as adjusted net income minus the dividends paid credit (§ 27). The surtax was levied on the net income. The amount of the tax was determined by the ratio between "undistributed" and "adjusted" net income.

43. INT. REV. CODE § 22(a) (1939).

44. Section 115(c) Revenue Act of 1936: "The gain or loss . . . shall be determined under Section 111, but shall be recognized only to the extent provided in Section 112." § 111(a): "The gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis . . ."

45. 122 F. (2d) 361, 365 (C. C. A. 4th, 1941).

46. U. S. Treas. Reg. 94, Art. 27(f)-1.

47. See Comment (1936) 36 COL. L. REV. 1321, 1337.

that the distributee be taxed, if the subsidiary is allowed the credit. The same principles apply in both cases.

In *Helvering v. Kay Manufacturing Corporation* the Court of Appeals for the Second Circuit, discussing the relationship between Sections 27(f) and 27(h) stated:

> "Having made this specific provision in favor of the liquidating corporation, it would be strange indeed if Congress intended to withdraw by paragraph (h) the benefit just granted by paragraph (f). . . . To read those words in paragraph (h) as modifying the language of paragraph (f) would deprive the latter of all utility."

In this connection it may be noted that Section 27(f) refers to all distributions in liquidation, complete and partial, not merely to the highly restricted type of 112(b)(6). Even if the credit is denied to the corporation liquidating under 112(b)(6), the section retains its utility and confers its benefit in all other liquidations. The purpose of 27(f) is realized if the section is held applicable where there has in fact been a taxable distribution of profits to stockholders outside the enterprise, and inapplicable where the tax on the distributions is avoided.

If one accepts the canon of construction followed by the Board, the credit should be allowed. In the realm of policy the court must weigh the Government's increasing need for revenue and the purpose of the undistributed profits surtax against an announced objective of encouraging certain business transactions. It is submitted that the reasons for denying the credit outweigh the reasons for allowing it.

RIGHTS OF WORKMEN AGAINST UNION OFFICIALS DURING COLLECTIVE BARGAINING NEGOTIATIONS

THE legal duties owed to workers by trade union officials in collective bargaining have remained undefined. The development of trade unions has created some institutional protection over the terms and tenure of employment;[1] but any individual worker must still rely on imperfectly controlled union leaders.[2] A share in job regulation should place upon union officers the responsibility of representing the interests of all employees in good faith.

1. Guild and state regulations have provided some protection for most previous generations of industrial craftsmen. The factory workman, without alternative sources of income or any guarantees of his livelihood, appeared in the nineteenth century industrial development. Thus trade unionism has reestablished, in a different form, the manual worker's former control over the terms of his employment. See FERGUSON AND BRUUN, A SURVEY OF EUROPEAN CIVILIZATION (1936) 252-53; HAMMOND AND HAMMOND, THE TOWN LABORER (2d ed. 1925) c. 2.

2. Apathy among the members and the practical necessity of retaining experienced bargainers inevitably limit any popular control of union officials. See WEBB AND WEBB, INDUSTRIAL DEMOCRACY (2d ed. 1902) Pt. I, cc. 1 & 2; WEBB AND WEBB, HISTORY OF

Yet, occasionally in any union the bargaining representatives may refuse to enforce equal treatment at work or reinstatement, or they may secure a discharge, for reasons which are entirely personal. And in some industries, such as building construction and food markets, where the labor supply is not normally attached to a single employer or is needed for immediate work on perishable commodities, the increased power of the union leaders controlling that labor supply has invited extensive corruption and tyranny.[3] Yet, widespread fear of the long-term effects of judicial intervention, together with the natural reluctance of the courts to interfere with intra-union affairs,[4] has hindered the establishment of adequate remedies for workmen against a union and its officials.[5]

The courts have adopted various legal concepts to describe the relationship between workers and the union officials engaged in bargaining with their employer. Two leading theories have developed from the attempted enforcement of collective agreements. Union leaders act as agents and usually need a specific authorization to bind their members to contracts with employers;[6] yet, the members and other workmen may sue as third party beneficiaries to enforce such agreements against the employer.[7] Intra-union disputes have developed several other rationales. A contract between member and union to follow all union rules has often been spelled out, largely for the purpose of protecting benefit rights and job tenure against arbitrary

TRADE UNIONISM (2d ed. 1920) 444-71; HOXIE, TRADE UNIONISM IN THE UNITED STATES (2d ed. 1923) c. 7.

3. In the extended discussions about corruption in American trade unions, this concentration in a few unions has been generally overlooked. See SEIDMAN, LABOR CZARS (1938).

4. In part judicial laissez-faire has probably been based upon a desire to avoid a controversial problem. But full autonomy has traditionally been thought necessary to allow voluntary unincorporated associations to carry out their own purposes, and under this theory trade unions have been handled as if they were religious associations or exclusive clubs. A striking example of the policy is found in Snay v. Lovely, 276 Mass. 159, 176 N. E. 791 (1931), where the court refused to correct an obvious error which had been made in good faith. See generally Chafee, *The Internal Affairs of Associations Not for Profit* (1930) 43 HARV. L. REV. 993.

5. Judicial intervention to correct abuses of trade union power is well established in cases involving expulsion of members from the union, and scattered decisions have given redress against racketeers and against violations of civil liberties. The best review of the subject is found in Comment (1935) 45 YALE L. J. 1248. Remedies to protect workmen can be given by injunction or damages. The choice between the union and the officials as defendants is not of primary importance: legally their duties will usually coincide, and in fact the union treasury will make most payments.

6. Ahlquist v. Alaska-Portland Packers' Ass'n, 39 F. (2d) 348 (C. C. A. 9th, 1930); A. R. Barnes and Co. v. Berry, 169 Fed. 225 (C. C. A. 6th, 1909), *aff'g* 157 Fed. 883 (S. D. Ohio 1908). See note 13 *infra*. This requirement of authorization depends on a construction of the union rules in each case.

7. Yazoo and Miss. Val. R. R. v. Sideboard, 161 Miss. 4, 133 So. 669 (1931), is a leading case. The various rationales employed in this situation are reviewed in Rentschler v. Missouri Pac. R. R., 126 Neb. 493, 253 N. W. 694 (1934), 95 A. L. R. 1, 10 (1935); see also Witmer, *Collective Labor Agreements in the Courts* (1938) 48 YALE L. J. 195.

expulsions from the union.[8] Further control over the officials has been rarely provided on the analogy of corporate stockholders' suits.[9] More important is the extension, to protect workmen against unjustified union interference, of the inalienable rights guaranteed by the Constitution: free speech,[10] a fair hearing before expulsion,[11] and free access to work offered.[12] These rights implied by law are more easily adapted to a new situation than those based on supposed private agreements.

Collective bargaining by union officials for their members readily suggests the agency analogy, and the agent's duties of good faith and obedience have often provided the means of enforcing obligations of union leaders.[13] Yet, the protection of workmen under an agency rationale is incomplete and easily abused. The union officials' negotiations as agents could not create

8. The contract rationale is most explicitly developed in Krause v. Sander, 66 Misc. 601, 122 N. Y. Supp. 54 (Sup. Ct. 1910). Since this theory could provide redress only where there has been some defect in following the procedure prescribed by the union rules, constitutional guarantees were soon invoked to provide protection for the worker's rights where the union rules did not do so. See notes 10-12 *infra*. But the contract rationale is still constantly repeated as the basic theory of intra-union rights, and the occasional enforcement of contractual rights sometimes produces serious difficulties. See note 17 *infra*.

9. The problem of limiting ultra vires activities of union officials has not been seriously explored. A famous series of English cases has forbidden appropriation of the union's funds to unauthorized purposes; the most important is Osborne v. Amalgamated Society of Railway Servants, [1910] A. C. 87. The argument is completely demolished in WEBB AND WEBB, HISTORY OF TRADE UNIONISM (2d ed. 1920) 608-31.

10. Spayd v. Ringing Rock Lodge, 270 Pa. 67, 113 Atl. 70 (1921), holding that a union cannot expel a member for signing a petition opposing the union's legislative program. See Witmer, *Civil Liberties and the Trade Union* (1941) 50 YALE L. J. 621.

11. Gilmore v. Palmer, 109 Misc. 552, 179 N. Y. Supp. 1 (Sup. Ct. 1919), where a rule providing for trial and expulsion without a hearing was held invalid; *accord*, Yockel v. German-American Bund, 20 N. Y. S. (2d) 774 (Sup. Ct. 1940).

12. Bogni v. Perotti, 224 Mass. 152, 112 N. E. 853 (1916) (against a jurisdictional strike). See also Erdman v. Mitchell, 207 Pa. 79, 91, 94, 56 Atl. 327, 331, 333 (1903) (against a jurisdictional strike); Vegelahn v. Guntner, 167 Mass. 92, 97, 44 N. E. 1077 (1896) (against picketing).

13. In at least one important instance the annulment of an agreement as unauthorized by the membership has brought collective negotiations closer to popular control. In 1906-07, during the Typographical Union's long struggle for the eight-hour day and against the open shop, a popular rebellion in the Pressmen's Union brought to power a more militant group led by George L. Berry, pledged to carry out a similar program. A compromise agreement, signed by the former officials of the Pressmen, was denied specific performance in court as unauthorized by the members. A. R. Barnes and Co. v. Berry, 157 Fed. 883 (S. D. Ohio 1908), *aff'd*, 169 Fed. 225 (C. C. A. 6th, 1909); see PERLMAN AND TAFT, HISTORY OF LABOR IN THE UNITED STATES 1896-1932 (1935) 59.

The requirement of specific authorization under the agency analogy has also served to define and limit the liability of the members for torts committed by the union officers. Lawlor v. Loewe, 235 U. S. 522 (1915); Sweetman v. Barrows, 263 Mass. 349, 161 N. E. 272 (1928).

Under the analogous notion of a fiduciary duty owed by the union officials to the members, a receivership has been set up in a few cases to oust racketeers from control of local unions. See for example Chalghian v. Int. Brotherhood of Teamsters, 114 N. J. Eq. 497, 169 Atl. 327 (Ch. 1933).

any rights for non-unionists, nor perhaps for those members who voted against authorizing the agreement, against either employers or the officials themselves. In the enforcement of collective agreements against employers, the agency theory has been abandoned by the courts because of this failure to provide redress for all employees.[14] The same limitation on the safeguards provided by the officers' duties as agents in collective bargaining would exclude many workmen in particular need of protection. In *Young v. Canadian Northern Railway Company*,[15] for example, a collective agreement provided standard terms for "employees"; but the majority union's officials refused to enforce the seniority rights listed for a member of a rival minority union. A more serious disadvantage to the agency rationale in trade union affairs lies in the fact that many authorizations to the officials are never meant seriously as binding instructions. In the informal proceedings of union meetings resolutions promising support are often passed hurriedly and without any real consideration. Even in a vote to strike, the purpose may be to strengthen the bargainers' hand and precipitate a showdown.[16] Union officials are not employees, but leaders with a wide discretion. Judicial enforcement of any apparent instructions affords hostile judges an opportunity to intervene at the instance of minorities under employer influence and curtail an official's needed freedom of action. The incomplete protection which the agency rationale gives to union members does not justify such a threat to a union's legitimate activities.

Three other traditional business categories are even less appropriate for regulating intra-union affairs. The usual contract implied between a union and its members provides protection only for those union members who are injured by the official's clear violation of a written rule. Any extension of implied contractual relations within a union would involve the creation of inflexible duties derived from informal agreements.[17] The workers' eventual status as third party beneficiaries, after the collective agreement is signed, does not establish a duty of good faith upon the officials as promisees during negotiations. The corporate analogy offers redress against delinquent officers only for injuries to the whole union. In short, all analogies derived from business relations must be unrealistic when applied to trade unions, because each assumes a well-defined private agreement.

14. See note 7 *supra*. But see Mueller v. Chicago and North Western Ry., 194 Minn. 83, 259 N. W. 798 (1935).

15. [1929] 4 D. L. R. 452 (Man. K. B.), [1930] 3 D. L. R. 352 (Man. C. A.), [1931] A. C. 83 (P. C.).

16. The courts have properly refused to pass on the legal significance of a strike vote. See Burke v. Monumental Division, 273 Fed. 707 (D. Md. 1919), and Burke v. Monumental Division, 286 Fed. 949 (D. Md. 1922), *aff'd*, 298 Fed. 1019 (C. C. A. 4th, 1924), *rev'd*, 270 U. S. 629 (1926).

17. When local unions have shifted their national affiliation, the contractual enforcement of the first national's rule against dissolving a local has produced an extraordinary situation: the new C. I. O. local has almost all the members, and the old A. F. of L. local is left with nothing but funds and a valid closed shop contract. M and M Wood Working Co. v. NLRB, 101 F. (2d) 938 (C. C. A. 9th, 1939); Lumber and Sawmill Workers' Union v. Int. Woodworkers of America, 197 Wash. 491, 85 P. (2d) 1099 (1938).

On the other hand, the creation of new duties between strangers permits a flexible adaptation to the needs of the collective bargaining situation. The original tort duty to preserve the physical security of limb and land has expanded rapidly to safeguard the enjoyment of intangibles, especially contractual relations in modern business. Similarly, for the manual worker an undisturbed access to existing work has been guaranteed — on the constitutional level,[18] or under the property label, or simply as a vested relationship.[19] Constitutional guarantees could hardly be invoked directly to justify judicial supervision of the usual processes of collective bargaining.[20] But any employment relationship is protected under tort law from "malicious" interference.[21] With the widespread establishment of collective bargaining, the protection of job tenure from unfair union interference finds new applications. It required only a minor extension of this doctrine for the courts to recognize the right to continued union membership against arbitrary expulsion.[22] This well-established right of workmen to job security against malicious interference by union officials should logically include all collective negotiations affecting continued job terms and tenure. The customary dependence of this rationale upon an existing employment relation[23] might prevent inclusion of the reinstatement opportunities of those already discharged; but the traditional vagueness of legal "malice" has hindered the development of definite limitations on its protection to present employees.

18. Bogni v. Perotti, 224 Mass. 152, 112 N. E. 853 (1916), is actually a square holding. A small local sought an injunction against jurisdictional strikes by the Hodcarriers Union, which was seeking to absorb the local; but a Massachusetts statute (Mass. Laws 1914, c. 778) forbade an injunction unless some property right was endangered, and specifically stated that the right to go to work was not a property right. The court held that access to work was such a property right that a statutory provision attempting to take it away was unconstitutional. The plaintiff local whose "property" was thus threatened and protected was a branch of the I. W. W. See also note 12 *supra*. The influence of this doctrine has declined: see Mr. Justice Butler, dissenting in Senn v. Tile Layers Protective Union, 301 U. S. 468, 483 (1937).

19. See Grand Int. Brotherhood of Locomotive Engineers v. Mills, 43 Ariz. 379, 399-401, 31 P. (2d) 971, 979 (1934).

20. But see note 29 *infra*.

21. "By the weight of authority, the unjustified interference of third persons is actionable although the employment is at will," Truax v. Raich, 239 U. S. 33, 38 (1915). In that case the right was protected against invasion by the state, but cases involving interference by third parties have been cited interchangeably. Lucke v. Clothing Cutters and Trimmers' Assembly, 77 Md. 396, 26 Atl. 505 (1893); Berry v. Donovan, 188 Mass. 353, 74 N. E. 603 (1905); Vegelahn v. Guntner, 167 Mass. 92, 99-100, 44 N. E. 1077, 1078 (1896).

22. Eschman v. Huebner, 226 Ill. App. 537 (1922), an extreme case of persecution of a member by the officials for personal reasons; Brennan v. United Hatters, 73 N. J. L. 729, 65 Atl. 165 (1906). For discussion of the stake in union membership, as a property right, see Fleming v. Moving Picture Machine Operators, 16 N. J. Misc. 502, 509, 1 A. (2d) 850, 853 (Ch. 1938), *aff'd*, 124 N. J. Eq. 269, 1 A. (2d) 386 (1938).

23. Although non-union men discharged under a closed-shop agreement have often received redress, workers unable to secure employment in the same situation usually have no legal rights. They cannot attack the agreement, Hoban v. Dempsey, 217 Mass. 166, 104 N. E. 717 (1914); nor can they secure admission to the union, Mayer v. Journeymen Stonecutters' Association, 47 N. J. Eq. 519, 20 Atl. 492 (1890).

An important advantage in the "malice" concept is that it limits judicial intervention to those cases in which the official has been motivated by personal reasons. Thus, no redress will be granted where there is reason to believe that the interests of the union will be served by the discharge of a member. Furthermore, the evidentiary difficulties of proving malice will sanction intervention by the courts only where the unjustifiable interference with employment is unmistakable.

A few reported decisions point toward this approach. First, collective bargaining terms established in good faith have been held privileged to injure some workmen in carrying out union policy. A variety of agreements have been justified on this principle: rearrangements abridging existing railroad seniority rights;[24] closed shop contracts, now increasingly classified as bona-fide rather than malicious;[25] most strikingly, provisions for the abolition of underpaid jobs to protect standard trade union rates.[26] An occasional remark in these cases suggests that bad faith might change the result.[27] Secondly, a few seniority decisions have granted relief to workmen deprived of job status by the union's agreement. The definite and long-term character of seniority ratings originally encouraged the courts to review the union's interpretation of its rules, on the traditional contract theory.[28] By a significant change in later cases the seniority right has been made incidental to a broader judicial supervision over the fairness of collective bargaining proceedings. Thus, seniority determinations by an arbitration board have been annulled for lack of notice to the workman concerned. The interference-with-employment rationale was invoked here,[29] and it reappears in two cases

24. Donovan v. Travers, 285 Mass. 167, 188 N. E. 705 (1934); Hartley v. Brotherhood of Ry. and Steamship Clerks, 283 Mich. 201, 277 N. W. 885 (1938).

25. See, for examples, F. F. East Co. v. United Oystermen's Union, 21 A. (2d) 799 (N. J. Eq. 1941); Williams v. Quill, 277 N. Y. 1, 12 N. E. (2d) 547 (1938), *appeal dismissed*, 303 U. S. 621 (1938). See 1 TELLER, LABOR DISPUTES AND COLLECTIVE BARGAINING (1940) §§ 97-99, 170; (1940) 49 YALE L. J. 754.

26. O'Keefe v. Local 463 of United Ass'n of Plumbers, 277 N. Y. 300, 14 N. E. (2d) 77, 117 A. L. R. 817, 823 (1938). In this case a company had repeatedly paid its employees below union rates; finally the union withdrew those men from their jobs and furnished the company with new plumbers who would not accept the lower wages. The displaced workmen were held to have no redress, as the union's action was a reasonable measure to protect its own welfare. See also Rhea Manufacturing Co. v. Industrial Commission, 231 Wis. 643, 650, 285 N. W. 749, 752 (1939).

27. See Hartley v. Brotherhood of Ry. and Steamship Clerks, 283 Mich. 201, 207, 277 N. W. 885, 887 (1938); O'Keefe v. Local 463 of United Ass'n of Plumbers, 277 N. Y. 300, 309, 14 N. E. (2d) 77, 80 (1938); Grand Int. Brotherhood of Locomotive Engineers v. Marshall, 119 S. W. (2d) 908, 911 (Tex. Civ. App. 1938).

28. Robinson v. Dahm, 94 Misc. 729, 159 N. Y. Supp. 1053 (Sup. Ct. 1916); see also Gregg v. Starks, 188 Ky. 834, 224 S. W. 459 (1920). The broad language of one important early case seems to say that a seniority rating is a vested individual right which the union cannot take away; see Piercy v. Louisville and Nashville Ry., 198 Ky. 477, 484-85, 248 S. W. 1042, 1045-46 (1923). And see Gleason v. Thomas, 117 W. Va. 550, 186 S. E. 304 (1936).

29. "The right to earn a livelihood and to continue in employment unmolested by efforts to enforce void enactments should . . . be entitled to protection," Griffin v. Chicago Union Station Co., 13 F. Supp. 722, 724 (N. D. Ill. 1936), *aff'd sub nom.* Nord

overruling regular collective negotiations. In *Bucko v. Murray*[30] a New York court has recently granted a temporary injunction against an allegedly unfair referendum provided by the collective agreement. Taking a broad ground, the court distinguished privileged bona-fide agreements; "but labor organizations are not permitted to act in bad faith or through malice or ill will nor may they be actuated by malice or a desire to injure employees, whether the latter be members of the union or not."[31] A further step is the remedy in damages against the union or the officials. In *Order of Railway Conductors v. Jones*,[32] a railroad agreed to the union's seniority recommendations, and discharged a conductor. The trial showed that the union was really seeking unfairly to eliminate the man, and the court upheld his right to damages from the union for such interference with the employer's will.[33] Since frequent intervention in several types of intra-union disputes has left legitimate union activities largely unscathed, organized labor's distrust of any supervision by the courts now seems unrealistic.

The effective application of this weapon could perhaps be useful in helping to dislodge the corrupt officials entrenched in a few unions. If an active minority is already restless, public disclosure and punishment of official tyranny may provide an opportunity to revive popular control. On the other hand, outsiders do not generally appreciate the frequent loyalty of union members even to the most venal leaders,[34] and indiscriminate external intervention may consolidate support of a dishonest union administration. Changes of regime imposed from outside will not usually correct the causes of abuses in American trade unions.

In different situations where the question of the relation of a workman to union officials has been raised, the various loose analogies to business and personal relations have proved useful. It must be remembered that a trade union's internal affairs present a unique problem. Yet, by careful development of available concepts where these correspond to industrial realities, it should be possible for courts to extend legal protection to victimized individuals without interfering with necessary trade union activities.

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v. Griffin, 86 F. (2d) 481 (C. C. A. 7th, 1936); see also Estes v. Union Terminal Co., 89 F. (2d) 768 (C. C. A. 5th, 1937).

30. 170 Misc. 902, 11 N. Y. S. (2d) 402 (Sup. Ct. 1939), *injunction dissolved, judgment for defendants* (1939), see 283 N. Y. 634, 28 N. E. (2d) 35, 36 (1940), *judgment aff'd mem.*, 258 App. Div. 867, 16 N. Y. S. (2d) 537 (1st Dep't 1939), *aff'd mem.*, 283 N. Y. 634, 28 N. E. (2d) 35 (1940).

31. *Id.* at 904, 11 N. Y. S. (2d) at 404.

32. 78 Colo. 80, 239 Pac. 882 (1925).

33. The possibility of a right to damages against the union officials was suggested in Young v. Canadian Northern Ry., [1930] 3 D. L. R. 352, 364, (Man. C. A.) (concurring opinion), cited *supra* note 15: "It may be that his rights are so plain and the bias of the committee so evident that he has a cause of action against them, if a legal duty to aid him could be held to exist."

34. Of course in these situations the officials have been prudent enough to ensure popular support by securing substantial gains for their members. See, for example, SEIDMAN, LABOR CZARS (1938) 17-20.

THE TAXATION OF INVESTMENT TRUSTS AS ASSOCIATIONS*

IT is a well established rule[1] of federal income taxation that a "strict" trust whose function is to conserve its res until liquidation is taxable in the same category as an individual,[2] whereas a "business" trust, "a medium for the conduct of a business and sharing its gains," is taxable as an "association."[3] Like several other business organizations corporate in substance but non-corporate in form,[4] the business trust is a device commonly employed to minimize corporate taxes.[5]

The need for differentiating between strict and business trusts is made apparent by two recent decisions of the Circuit Court of Appeals for the Second Circuit. According to the terms of the trust agreements before the court in *Commissioner v. Chase National Bank*[6] the grantor, an investment corporation, made up "units" consisting of sixteen shares of the common stock of thirty specified corporations, and deposited this portfolio of carefully selected securities with a bank as trustee, the bank delivering to the grantor certificates of interest in the securities. The trust shares were then sold to the general public by the depositor-grantor. The Commissioner of Internal Revenue classified the trusts as associations and taxable as such under Section 801(a) of the Revenue Act of 1934.[7] The Circuit Court, however, affirmed the decision of the Board of Tax Appeals[8] that these were strict trusts not taxable as associations. On almost identical facts[9] in

* Commissioner v. Chase Nat. Bank of City of N. Y., 122 F. (2d) 540 (C. C. A. 2d, 1941); Commissioner v. North American Bond Trust, 122 F. (2d) 545 (C. C. A. 2d, 1941).

1. Morrissey v. Commissioner, 296 U. S. 344 (1935); Hamilton Depositors Corp. v. Nicholas, 111 F. (2d) 385 (C. C. A. 10th, 1940); Sears v. Hassett, 111 F. (2d) 961 (C. C. A. 1st, 1940); United States v. Trust No. B. I. 35, 107 F. (2d) 22 (C. C. A. 9th, 1939); Ittleson v. Anderson, 67 F. (2d) 323 (C. C. A. 2d, 1933); Continental Bank & Trust of N. Y. v. United States, 19 F. Supp. 15 (S. D. N. Y. 1937).

2. 53 STAT. 66 (1939), 26 U. S. C. § 161 (1934).

3. 53 STAT. 469 (1939), 26 U. S. C. § 3797 (Supp. 1939).

4. See Morrissey v. Commissioner, 296 U. S. 344, 360 (1935); Equitable Trust Co. v. Magruder, 37 F. Supp. 711, 714 (D. Md. 1941); Investment Trust of Mutual Investment Co., 27 B. T. A. 1322, 1330 (1933), *aff'd*, 71 F. (2d) 1009 (C. C. A. 2d, 1934); Dean, *Federal Taxation of Trusts as Associations* (1940) 14 TEMP. L. Q. 333; Warren, *The Reduction of Income Taxes Through The Use of Trusts* (1936) 34 MICH. L. REV. 809.

5. For a complete discussion of tax avoidance by the use of the business trust, see Jones, *Trusts: Instrumentalities For Avoiding Taxes* (1938) 27 GEO. L. J. 18; Silbert, *Voluntary Trusts and Federal Taxation* (1937) 17 B. U. L. REV. 1; Warren, *loc. cit. supra* note 4.

6. 122 F. (2d) 540 (C. C. A. 2d, 1941).

7. 48 STAT. 771 (1934), 26 U. S. C. § 1696 (1934).

8. Chase Nat. Bank of the City of N. Y., Trustee, 41 B. T. A. 430 (1940). This decision is discussed in Dean, *supra* note 4, at 341-42.

9. In the *North American* case the investment corporation, as grantor of the trust, selected eligible bonds (the corpus in the *Chase* case consisted of stocks) which were deposited with the trustee. Certificates of interest were issued by the trustee to the depositor, which were then sold to the public.

the companion case decided on the same day, *Commissioner v. North American Bond Trust,*[10] the same court reversed the Board of Tax Appeals[11] and held the trust taxable as an association. The court distinguished these cases on the ground that the depositor in the *Chase* case, in creating additional interests in the trust corpus for sale to investors, was obliged to deposit new stock "units" made up of exactly the same number of shares in the same corporations as those deposited in the original units. On the other hand, the terms of the agreement in the *North American* case provided that the depositor in making up new units was not confined to bonds of the same corporations as those that had been selected for the original bond units.[12] These new bonds were commingled with the original deposits, so that all certificate holders, both old and new, shared equally in the new pool of original bonds, plus whatever new bonds the depositor had selected. From this distinction the court concluded that the depositor in the latter case was empowered to "vary the existing investments of all certificate holders at will . . . and in this way to take advantage of the market variations to improve the investments even of the first investors."[13]

There have been three clearly marked stages in the development of the principles which determine whether a particular trust is to be taxed as an association.[14] The first stage appeared in *Crocker v. Malley,*[15] which held the decisive test to be the degree of control exercised by the beneficiaries over the management of the trust. The second stage was marked by *Hecht v. Malley,*[16] in which the Supreme Court rejected the control test and held a trust to be an association when its trustees were "associated together in much the same manner as the directors in a corporation for the purpose of carrying on business enterprises."[17] The latest stage of this evolution was reached in *Morrissey v. Commissioner,*[18] which held an association to be a "common effort . . . for the conduct of a business enterprise"[19] in a quasi-corporate form.[20] Precedent for the decisions in the instant cases stemmed from this

10. 122 F. (2d) 545 (C. C. A. 2d, 1941).

11. Record, p. 166, Commissioner v. North American Bond Trust, 122 F. (2d) 545 (C. C. A. 2d, 1941).

12. Commissioner v. North American Bond Trust, 122 F. (2d) 545, 546 (C. C. A. 2d, 1941).

13. *Ibid.*

14. For a more complete study of the evolution of these principles, see Dean, *supra* note 4, at 335-37; (1937) 26 ILL. B. J. 127.

15. 249 U. S. 223 (1919).

16. 265 U. S. 144 (1924).

17. *Id.* at 161.

18. 296 U. S. 344 (1935).

19. *Id.* at 357. The requirement that an association must consist of persons associated in a common effort receives a detailed analysis in Equitable Trust Co. v. Magruder, 37 F. Supp. 711, 715 (D. Md. 1941), where it is stated: "The substance of the distinction between a nontaxable trust, and a . . . business trust . . . lies in the intrinsic nature of the enterprise and the relation of the several associates thereto, rather than in . . . technical distinctions." See also Dean, *supra* note 4, at 347-48.

20. This case also propounded five subordinate criteria to be used in determining whether the trust had a corporate structure. These were: (1) title to the property held

decision, which established the rule that a trust is taxable as an association when two essential factors are present. First, the entity must be a common enterprise for the transaction of business for profit.[21] Secondly, the structural characteristics of the specific trust must be analogous to those of a corporation.[22] In both principal cases the formal provisions of the trust agreements include all the salient corporate elements: continuity of interests,[23] centralized management,[24] limited liability,[25] and transferable shares.[26]

The Treasury regulations[27] promulgated pursuant to the *Morrissey* decision[28] attempt to distinguish between "association" and "trust" on the basis of these two factors. An association is an organization "whether . . . created by an agreement, a declaration of trust, a statute, or otherwise,"[29] which, like a corporation, continues notwithstanding a change in member-

by the trust; (2) centralized management by the trustees; (3) continuity of trustees as a self-perpetuating body; (4) transferable beneficial interests; (5) limited liability. Recent cases demonstrate a general adoption of these criteria as controlling on the question of quasi-corporateness. Lewis & Co. v. Commissioner, 301 U. S. 385 (1937); Commissioner v. Rector & Davidson, 111 F. (2d) 332 (C. C. A. 5th, 1940); Hamilton Depositors Corp. v. Nicholas, 111 F. (2d) 385 (C. C. A. 10th, 1940); Wellston Hills Syndicate Fund v. Commissioner, 101 F. (2d) 924 (C. C. A. 8th, 1939). See (1936) 20 MINN. L. REV. 445; *cf.* Commissioner v. Vandegrift Realty and Investment Co., 82 F. (2d) 387 (C. C. A. 9th, 1936); Commissioner v. Gibbs-Preyer Trusts Nos. 1 & 2, 117 F. (2d) 619, 623 (C. C. A. 6th, 1941).

21. Morrissey v. Commissioner, 296 U. S. 344, 357 (1935).

22. *Id.* at 359.

23. In both principal cases the trust agreements provided that the death or incapacity of a certificate holder would not terminate the trust, that the trust was not to be liquidated for twenty years, and that there would always be a trustee to administer the agreements. See Hamilton Depositors Corp v. Nicholas, 111 F. (2d) 385, 387 (C. C. A. 10th, 1940), where the court said "the fact that management is shared between the trustee and the corporation [depositor] does not destroy continuity or centralization of management."

24. The depositor directs the management of these trusts and occupies the position of a board of directors, the activities of which are restricted by the trust agreement, which is analogous to a corporate charter. The trustees, like corporate officers, act as administrators of the will of the depositor.

25. Commissioner v. Chase Nat. Bank of City of N. Y., 122 F. (2d) 540, 542 (C. C. A. 2d, 1941); Record, p. 65, Commissioner v. North American Bond Trust, 122 F. (2d) 545 (C. C. A. 2d, 1941); *cf.* Best v. Helvering, 92 F. (2d) 491 (App. D. C., 1937), holding a trust taxable as an association despite the fact that there was no limited liability.

26. *Id.* at 542, 544; Commissioner v. North American Bond Trust, 122 F. (2d) 545, 547 (C. C. A. 2d, 1941).

27. U. S. Treas. Reg. 86, Art. 801-1 to 801-3.

28. Morrissey v. Commissioner, 296 U. S. 344, 354-55 (1935). The court said: "Where Revenue Act merely provided that the term 'corporation' should include 'associations,' . . . the Treasury Department was authorized to supply rules for the enforcement of the Act within the permissible bounds of administrative construction," and the Department could clarify or enlarge the regulations "so as to meet administrative exigencies or conform to judicial decision." See also Murphy Oil Co. v. Burnet, 287 U. S. 299, 303-07 (1932).

29. U. S. Treas. Reg. 86, Art. 801-2.

ship, and whose affairs are conducted by a group acting in a representative capacity. "It includes . . . an 'investment' trust (whether of the fixed or the management type) . . ."[30] The term, trust, according to the terms of these regulations, refers to an "ordinary"[31] trust, in which the trustees merely protect and conserve the corpus until such time as it can most advantageously be liquidated, as distinguished from an arrangement designed to afford a medium for a profit-seeking activity accruing to the benefit of the shareholders. Such an entity is said to be a substitute for a voluntary association to obtain corporate advantages without their attending disadvantages.

This "ordinary" or "traditional" type of trust, referred to in both the *Morrissey* case and the Treasury regulations, is generally understood to be one in which the grantor conveys property to the trustee to be conserved for the benefit of named persons.[32] The agreements in both of the principal cases provide for the creation of the "corpus" only upon the purchase of beneficial interests from the "grantor." In addition, there is a continual augmentation of the trust res by further deposits of securities purchased with funds furnished by "beneficiaries" drawn from the general public. Furthermore, the admitted purpose in creating these trusts was not the ordinary one, but rather, in the words of the court itself, "to provide investors with a means for acquiring an undivided beneficial interest in . . . securities and to enable them to participate in a relatively wide-spread investment."[33] An enterprise with 67,000 beneficiaries and which had received $662,000 in dividends during the taxable year is palpably different from the "ordinary" trust referred to in the *Morrissey* case and the Treasury regulations.

It is true that the chief function of these "trust administrators" was the conservation of the underlying securities, but this protective function alone does not make a strict trust of a business enterprise. It is characteristic of all investment companies that its managers, like the depositor in the instant cases, first select securities for the small investor and then devote constant attention to the preservation of the quality of these investments. In the investment company, as in these trusts, goods and services are sold by the managing experts to the general public.[34] The fact that these certificate holders are in reality stockholders of an investment company is further demonstrated by their power to take advantage of a favorable fluctuation

30. *Ibid.*

31. *Id.*, Art. 801-3.

32. *Cf.* United States v. Davidson, 115 F. (2d) 799 (C. C. A. 6th, 1940); Commissioner v. Kelley, 74 F. (2d) 71 (C. C. A. 1st, 1934); Commissioner v. Morriss Realty Co. Trust No. 2, 68 F. (2d) 648 (C. C. A. 7th, 1934); Blair v. Wilson Syndicate Trust, 39 F. (2d) 43 (C. C. A. 5th, 1930).

33. Commissioner v. Chase Nat. Bank of City of N. Y., 122 F. (2d) 540, 541 (C. C. A. 2d, 1941).

34. Brooklyn Trust Co. v. Commissioner, 80 F. (2d) 865, 868 (C. C. A. 2d, 1936). The court said: "The large investment . . . in . . . securities required active management. To keep such a fund invested in securities to the best advantage was to engage in business in the fullest sense." See Stanley Securities Co. v. United States, 38 F. (2d) 907 (Ct. Cl. 1930), *cert. denied*, 282 U. S. 845 (1930).

in the market price of the constituent stocks.[35] The certificate holder is entitled to surrender his trust shares to the trustee in exchange for his proportionate share of the underlying securities, which then can be sold on the market, or he can sell his freely transferable trust certificate directly on the open market.[36] The depositor in the *Chase* case could at any time eliminate constituent securities no longer qualified to preserve the sound investment character of the stock units. In 1933 alone the trustee, at the direction of the depositor, disposed of stocks in the portfolio valued at $600,000 in the course of these so-called "weeding-out activities."[37] Thus, even though there was no purchase of new securities to improve the investment as in the *North American* case, there was a sale of unproductive securities which obviously improved the existing investment of the certificate holders. Moreover, the depositor in making up new portfolios was authorized to limit his selection of stocks to those original corporations which had yielded a return lucrative enough to have been retained as constituent corporations. These activities were in response to market fluctuations, as were the purchases of new bonds in the *North American* case, and they were designed to improve the character of the *Chase* investment.

Furthermore, it may well be that in view of the *Morrissey* decision an investment trust is to be classified as an association even if its only activities are the collection of income and its distribution to the beneficiaries.[38] The Supreme Court in that case held the trust to be taxable as an association even after it had disposed of the trust property in exchange for shares in

35. See dissent of Judge Augustus Hand in Commissioner v. Chase Nat. Bank of City of N. Y., 122 F. (2d) 540, 544 (C. C. A. 2d, 1941); Investment Trust of Mutual Investment Co., 27 B. T. A. 1322, 1329 (1933), *aff'd,* 71 F. (2d) 1009 (C. C. A. 2d, 1934).

36. During the taxable year some 3,000,000 outstanding certificates of interest were surrendered to the trustee of the Chase trusts in exchange for shares of the underlying securities, while only 138 certificates were surrendered to the trustee of the North American Bond Trust.

37. 122 F. (2d) 540, 543 (C. C. A. 2d, 1941). On the other hand, in the *North American* case, where the court based its decision largely upon the fact that the depositor was empowered to vary the investment, none of the constituent bonds were eliminated, nor were any new bonds purchased, during the taxable year.

38. See dissent in Commissioner v. Chase Nat. Bank of City of N. Y., 122 F. (2d) 540, 544 (C. C. A. 2d, 1941); see also Kettleman Hills Royalty Syndicate No. 1 v. Commissioner, 116 F. (2d) 382 (C. C. A. 9th, 1940), holding a trust taxable as an association if the administrator of trust makes "business judgments;" Fidelity-Bankers Trust Co. v. Helvering, 113 F. (2d) 14 (App. D. C. 1940), *cert. denied,* 310 U. S. 649 (1940); Investment Trust of Mutual Investment Co., 27 B. T. A. 1322, 1329 (1933); (1936) 84 U. OF PA. L. REV. 666, n. 14. But *cf.* Higgins v. Commissioner, 61 Sup. Ct. 475 (U. S. 1941), holding that personal management of taxpayer's own investments in securities does not constitute "carrying on a business" within a statute permitting deduction of expenses incurred in computing taxable net income; Cleveland Trust Co. v. Commissioner, 115 F. (2d) 481 (C. C. A. 6th, 1940), *cert. denied,* 61 Sup. Ct. 809 (U. S. 1941); but see Dean, *supra* note 4, at 341-43. See also (1936) 20 MINN. L. REV. 835, 837, posing question of "whether it was actually the intent of Congress to tax such a device, the sole purpose of which is to provide diversified investment for those with limited capital, as an association."

a corporation. Mr. Chief Justice Hughes stressed the fact that confining trust activities to the collection and distribution of income "did not alter the character of the organization. . . . It was not a liquidating trust; it was still an organization for profit."[39]

The criteria propounded by the Supreme Court in the *Morrissey* case[40] and elaborated by the Treasury regulations have the merits of directness and simplicity, but their efficacy has been limited by lower court construction. The basis of the *Morrissey* decision would seem to have been undermined by judicial emphasis upon the minutiae of the trust agreements, rather than upon the overall effect of the trust's activities. Emphasis upon the latter aspects of each case would prevent trusts, such as the one in the *Chase* case, from relying upon purely formal distinctions to avoid sharing the corporate tax burden with trusts which are inherently alike.

STATE INJUNCTIONS AGAINST EMPLOYEES SUING IN FEDERAL COURTS UNDER EMPLOYERS' LIABILITY ACT*

By abrogating the common law defense of the fellow servant rule,[1] introducing the doctrine of comparative negligence,[2] and abolishing the common law defense of assumption of risk,[3] the Employers' Liability Act enlarged the rights of injured employees of railroads operating in interstate commerce.[4] Early decisions under the Act required employee-litigants to sue in the state of the railroad's incorporation,[5] often an extremely costly requirement since the railroad might have its home in a state far distant from that in which the accident occurred. The Amendment of 1910 was consequently added to the Act;[6] it included a venue provision that an action might be brought:

39. Morrissey v. Commissioner, 296 U. S. 344, 361 (1935).

40. The principles propounded in the *Morrissey* decision were applied in two recent cases in which investment trusts were held to be taxable as associations. Hamilton Depositors Corp. v. Nicholas, 111 F. (2d) 385 (C. C. A. 10th, 1940); Continental Bank & Trust Co. of N. Y. v. United States, 19 F. Supp. 15 (S. D. N. Y. 1937). These trusts were identical with the trusts in the principal cases in all material respects, except that funds realized upon elimination of constituent securities could be reinvested. However, reinvestment of itself should not be the controlling factor, for in the *North American* case the trustee could not reinvest any funds; yet the trust was held taxable as an association.

* Baltimore & Ohio R. R. v. Kepner, 62 Sup. Ct. 6 (U. S. 1941).

1. 53 STAT. 1404, 45 U. S. C. § 54 (Supp. 1939).

2. 35 STAT. 66 (1908), 45 U. S. C. § 53 (1934).

3. 53 STAT. 1404, 45 U. S. C. § 54 (Supp. 1939).

4. 53 STAT. 1404, 45 U. S. C. § 51 (Supp. 1939).

5. Cound v. Atchison, T. & S. F. Ry., 173 Fed. 527 (W. D. Tex. 1909); see Trapp v. Baltimore & Ohio R. R., 283 Fed. 655, 656 (N. D. Ohio 1922).

6. 53 STAT. 1404, 45 U. S. C. § 56 (Supp. 1939).

> "in the district of the residence of the defendant, or in which the cause of action arose, or in which the defendant shall be doing business at the time of commencing such action."

To protect state jurisdiction once obtained under this mandate, Congress inserted a proviso that actions originating in state courts could not be removed to the federal courts.

The employee who chooses to sue in the courts of a state other than that in which the accident occurred is often met by equitable *forum non conveniens* proceedings brought by his employer to confine him to courts within the state, and perhaps even within the district, where the accident occurred. Such a situation arose in the recent case of *Baltimore & Ohio Railroad v. Kepner*[7] where an employee injured in an accident in Ohio brought suit under the Employers' Liability Act in the United States District Court for the Eastern District of New York. The Railroad asked the Common Pleas Court of Hamilton County, Ohio, where it operated a part of its system, to enjoin the employee from prosecuting his suit in the federal court, alleging that by suing at a place more than seven hundred miles from his residence and from the place of the accident, the employee would cause it great inconvenience and unwarranted expense. The Railroad relied on the equity power of courts to restrain persons within their jurisdiction from prosecuting suits which would be unduly harassing or oppressive to defendants. The Court of Common Pleas, denying the injunction, held that the equity power of *forum non conveniens* did not extend to suits brought in federal courts under the Employers' Liability Act. Its decision was affirmed by the Supreme Court of Ohio[8] and subsequently by the Supreme Court of the United States.[9]

Resolution of the problem confronting the Court in the *Kepner* case demands, first of all, a summary of existing inter-court relationships. Since 1793 federal courts have been virtually prohibited by statute from enjoining proceedings in state courts.[10] A parallel limitation prevails in the converse situation where a state court attempts to enjoin a federal court proceeding. In the first case to come before it, the Supreme Court of the United States formulated the rule that state courts are without power to issue such injunctions.[11] Despite the rule, however, many courts have effectually blocked proceedings in the courts of other sovereignties by the simple expedient of enjoining the litigants rather than the courts themselves. In support of this action, they have fallen back on the familiar propositions that equity acts

7. 62 Sup. Ct. 6 (U. S. 1941).

8. Baltimore & Ohio R. R. v. Kepner, 137 Ohio St. 409, 30 N. E. (2d) 982 (1940) (Chief Justice Weygandt dissenting).

9. 62 Sup. Ct. 6 (U. S. 1941) (Stone, C. J., Roberts and Frankfurter, JJ., dissenting).

10. 1 STAT. 334 (1793), 28 U. S. C. § 379 (1934), as amended by 36 STAT. 1162 (1911), 28 U. S. C. § 279 (1934) (allowing injunctions in bankruptcy cases). *Accord*, Toucey v. New York Life Ins. Co., 10 U. S. L. WEEK 4025 (U. S. 1941); Kline v. Burke Construction Co., 260 U. S. 226 (1922).

11. M'Kim v. Voories, 7 Cranch. 279 (U. S. 1812). See POMEROY, EQUITY JURISPRUDENCE (2d ed. 1919) § 2062.

in personam and that, while courts may not stay proceedings in courts of another sovereignty, they have jurisdiction over persons within their territorial limits.[12]

Federal courts, with a single exception,[13] have refrained from enjoining litigants from suing under the Employers' Liability Act in other federal courts.[14] They reason that the right to sue in federal courts is given by Congress under its power to regulate interstate commerce. In proceeding under this general power, Congress may incidentally burden such commerce as, for example, by authorizing suits in any district court where the defendant does business.

There are no federal decisions recognizing a state court's injunction, issued because of inconvenience, unnecessary expense, or hardship, against an employee proceeding in a federal court under the Employers' Liability Act.[15] In the case of *Southern Railway v. Painter*,[16] the District Court interpreted the state court's decree against the employee restraining him from continuing his suit in the federal court of his choice as being in effect an injunction against the federal court proceeding itself and therefore invalid. The Circuit Court of Appeals for the Eighth Circuit concluded that the state court had exceeded its authority and affirmed the decision.[17] The court discussed the nature of the dual court system and indicated that federal courts must be free to decide cases within their jurisdiction without interference from state courts. Having invalidated the injunction, the court said that it was not worthy of full faith and credit, and went on to enjoin the Railroad from further exercise of its alleged rights under the injunction. But in reversing this decision, the Supreme Court of the United States held that federal courts are not able to issue counter injunctions to stay litigation in state courts even though intended to support prior jurisdiction in the federal court.[18] Presented simultaneously as they were, the *Kepner* and *Painter* cases throw the problem of injunctions against litigants suing under the Employers' Liability Act into sharp relief.

12. Cole v. Cunningham, 133 U. S. 107 (1890); Steelman v. All Continent Co., 301 U. S. 278 (1937); Kern v. Cleveland, C. C. & St. L. Ry., 204 Ind. 595, 185 N. E. 446 (1933).

13. Baltimore & Ohio R. R. v. Bole, 31 F. Supp. 221 (N. D. W. Va. 1940). But *cf.* Baltimore & Ohio R. R. v. Clem, 36 F. Supp. 703 (N. D. W. Va. 1941). This single exception is specifically overruled in Baltimore & Ohio R. R. v. Kepner, 62 Sup. Ct. 6 (U. S. 1941).

14. Chesapeake & Ohio Ry. v. Vigor, 90 F. (2d) 7 (C. C. A. 6th, 1937); *cf.* Southern Ry. v. Cochran, 56 F. (2d) 1019 (C. C. A. 6th, 1932); *accord*, Chicago, M. & St. P. Ry. v. Schendel, 292 Fed. 326 (C. C. A. 8th, 1923).

15. *Cf.* Bryant v. Atlantic Coast Line R. R., 92 F. (2d) 569 (C. C. A. 2d, 1937); Rader v. Baltimore & Ohio R. R., 108 F. (2d) 980 (C. C. A. 7th, 1940), *cert. denied*, Baltimore & Ohio R. R. v. Rader, 309 U. S. 682 (1940).

16. 10 U. S. L. WEEK 4032 (U. S. 1941) (opinion of District Court for Eastern District of Missouri not reported).

17. Southern Ry. v. Painter, 117 F. (2d) 100 (C. C. A. 8th, 1941).

18. 10 U. S. L. WEEK 4032 (U. S. 1941). The employee litigant is thus forced to appeal a state court's erroneous decree that he may not proceed in the federal court. *Cf.* Bryant v. Atlantic Coast Line R. R., 92 F. (2d) 569 (C. C. A. 2d, 1937).

The Court's decision in the *Kepner* case, allowing employees the free choice of federal forums conferred on them by the terms of the Employers' Liability Act, merits approval. It eliminates the confusion of injunctions and cross injunctions inevitably arising in the *Painter* situation. It accords, moreover, with the position maintained by the federal courts that the matter of a litigant's convenience is legislative and beyond the judicial province.[19] Federal jurisdiction under the Employers' Liability Act is mandatory,[20] and if proceedings may be enjoined on grounds of inconvenience, federal courts are placed in the awkward position of being forced to take a jurisdiction which they cannot assume without ignoring another court's decree. The decision removes the likelihood that such a dilemma will occur.

Nor can convincing argument for issuing injunctions against litigants proceeding in distant federal courts under the Employers' Liability Act be found in state decisions. Decisions that state courts may enjoin litigants from prosecuting suits under the Act in courts of other states rest on the premise that the jurisdictional limitations of the 1910 Amendment do not affect the state's equitable functions.[21] But to conclude thus runs counter to both the meaning and the purpose of the Amendment. State legislatures cannot confine causes of action arising under the Employers' Liability Act to their own courts.[22] These courts should not be able to require what sovereign states cannot.

In relation to the *Kepner* situation, the state cases are further weakened by the fact that injunctions against litigants proceeding in federal courts are often refused by state courts which liberally grant decrees to prevent litigants from continuing actions in other state courts.[23] The difference in treatment is rationalized by the argument that a state court's jurisdiction is only permissive, whereas a federal court's jurisdiction is mandatory[24] But

19. Second Employers' Liability Cases, 223 U. S. 1 (1912); Schendel v. McGee, 300 Fed. 273 (C. C. A. 8th, 1924); Connelly v. Central R. R. of New Jersey, 238 Fed. 932 (S. D. N. Y. 1916).

20. Second Employers' Liability Cases, 223 U. S. 1 (1912); Wood v. Delaware & H. R. R., 63 F. (2d) 235 (C. C. A. 2d, 1933); Norris v. Illinois Cent. R. R., 18 F. (2d) 584 (D. Minn. 1925).

21. Kern v. Cleveland, C. C. & St. L. R. R., 204 Ind. 595, 185 N. E. 446 (1933); Reed's Adm'x v. Illinois Cent. R. R., 182 Ky. 455, 206 S. W. 794 (1918); *cf. Ex parte* Crandall, 52 F. (2d) 650 (S. D. Ind. 1931). The Supreme Court's first decision on this matter will soon be forthcoming in Miles v. Illinois Cent. R. R. (Tenn. Sup. Ct. Jan. 10, 1941), *cert. granted,* 10 U. S. L. WEEK 3157 (U. S. 1941).

22. Payne v. Knapp, 197 Iowa 737, 198 N. W. 62 (1924); Peterson v. Chicago, B. & Q. Ry., 187 Minn. 228, 244 N. W. 823 (1932); *cf.* Atchison, T. & S. F. Ry. v. Sowers, 213 U. S. 55 (1909).

23. Kern v. Cleveland, C. C. & St. L. Ry., 204 Ind. 595, 185 N. E. 446 (1933) (state court enjoined employee from proceeding in Missouri court); McConnell v. Thomson, 213 Ind. 16, 8 N. E. (2d) 986, 113 A. L. R. 1429, 1444 (1937) (state court refused to enjoin employee from proceeding in federal court in Missouri).

24. Baltimore & Ohio R. R. v. Kepner, 137 Ohio St. 409, 30 N. E. (2d) 982 (1940); McConnell v. Thomson, 213 Ind. 16, 8 N. E. (2d) 986, 113 A. L. R. 1429, 1444 (1937); *cf.* Rader v. Baltimore & Ohio R. R., 108 F (2d) 980 (C. C. A. 7th, 1940), *cert. denied,* Baltimore & Ohio R. R. v. Rader, 309 U. S. 682 (1940).

the argument is not convincing because, under the Employers' Liability Act, a state court is duty bound to take jurisdiction except where the local statutory or common law doctrine of *forum non conveniens* is contrary.[25]

Assertions by state courts that they may enjoin suits under the Employers' Liability Act in another state court on some basis of *forum non conveniens* convey an erroneous impression. The decisions do not bear out the expressed sentiment. There is a noticeable reluctance toward granting such injunctions, manifested by the setting of severe, if not impossible, requirements. This aversion is translated into terms such as undue hardship, clear invasion of rights, oppression, and fraud; inconvenience alone does not suffice.[26] In addition to their unwillingness to enjoin, state courts have further demonstrated their disfavor toward the application of *forum non conveniens* to Employers' Liability Act cases by disregarding foreign injunctions issued against them.[27] Moreover, one court issuing an injunction against proceedings in a distant state court has itself made the injunction proceedings meaningless by awarding only nominal damages to the railroad where the employee violated the injunction.[28]

If the language of the 1910 Amendment to the Employers' Liability Act is not plain and clear, but is sufficiently ambiguous to warrant construction of its meaning, other materials are available. The legislative history of the Act reveals that Congress was seeking to extend, from time to time, the

25. Both the duty and the common law exception are stated in Second Employers' Liability Act Cases, 223 U. S. 1, 57 (1912), where it was said that a state court must entertain jurisdiction of Employers' Liability Act cases "when its ordinary jurisdiction as prescribed by local laws is appropriate to the occasion . . . and (it is) accustomed to exercise that jurisdiction." By negative implication this language permits courts to refuse jurisdiction under the Act where local law allows them discretionary power in this situation. *Cf.* Hoffman v. Foraker, 274 U. S. 21 (1927); Walton v. Pryor, 276 Ill. 563, 115 N. E. 2 (1917); see 2 ROBERTS, FEDERAL LIABILITIES OF CARRIERS (2d ed. 1929) 1843.

In Douglas v. New Haven R. R., 279 U. S. 377 (1929), a procedural statute of New York was interpreted to allow her courts discretion to refuse jurisdiction of suits by non-residents against foreign corporations. This statute is, however, unique.

But the exception to the Employer's Liability Act which the Supreme Court allows to state courts because of local law is far different from either requiring these same courts to submit to injunctions from other forums or allowing them to enjoin litigants suing elsewhere.

26. Baltimore & Ohio R. R. v. Inlow, 64 Ohio App. 134, 28 N. E. (2d) 373 (1940); Chicago, M. & St. P. Ry. v. Wolf, 199 Wis. 278, 226 N. W. 297 (1929); Chicago, M. & St. P. Ry. v. McGinley, 175 Wis. 565, 185 N. W. 218 (1921); Missouri-Kansas-Texas R. R. v. Ball, 126 Kan. 745, 271 Pac. 313 (1928); Mobile & Ohio R. R. v. Parrent, 260 Ill. App. 284 (1931); Southern Pacific Co. v. Baum, 39 N. M. 22, 38 P. (2d) 1105 (1934); *cf.* Baltimore & Ohio R. R. v. Clem, 36 F. Supp. 703 (N. D. W. Va. 1941); see Lancaster v. Dunn, 153 La. 15, 18, 95 So. 385, 388 (1922).

27. Kepner v. Cleveland, C. C. & St. L. Ry., 322 Mo. 299, 15 S. W. (2d) 825 (1929); Peterson v. Chicago, B. & Q. Ry., 187 Minn. 228, 244 N. W. 823 (1932); Taylor v. Atchison, T. & S. F. Ry., 292 Ill. App. 457, 11 N. E. (2d) 610 (1937); *cf.* Lindsey v. Wabash Ry., 61 S. W. (2d) 369 (Mo. App. 1933).

28. New York, C. & St. L. R. R. v. Meek, 210 Ind. 322, 1 N. E. (2d) 611 (1936).

rights and privileges of employees.[29] By the Amendment of 1910, Congress intended that the employee-litigant under the Act should be unrestricted in his choice of forum within the limitations of its venue provisions.[30]

But railroad litigants resorting to the *forum non conveniens* doctrine to circumvent the Act have attempted to restrict this choice. The abundance of this litigation may indicate that employees have been so completely liberated that they may harass railroads by choosing distant or friendly forums. But even assuming this to be true, the solution is not to be found in injunction litigation which is not productive of substantial justice, depending as it does on strategic disposition of property and financial invulnerability. Therefore, despite the unquestionable strength of the equitable *forum non conveniens* doctrine, the Supreme Court has correctly decided in *Baltimore & Ohio Railroad v. Kepner* that state courts may not enjoin litigants suing in federal courts under the Employers' Liability Act.

BUYER'S RECOVERY OF INVALIDATED PROCESSING TAX UNDER ORIGINAL AAA*

WHEN parties to a contract for the sale of goods expect a possible change in the taxes on such goods, it is often stipulated in the contract which party shall bear the risk of any change. Widespread use of such stipulations occurred with reference to the processing taxes imposed by the original AAA.[1] That statute empowered the Secretary of Agriculture to impose

29. The first Employers' Liability Act [34 STAT. 232 (1906)] was declared unconstitutional in Howard v. Illinois Cent. R. R., 207 U. S. 463 (1908). The second Employers' Liability Act [35 STAT. 65 (1908), 45 U. S. C. § 51 *et seq.* (1934)], was substantially the same as the first, but added that the employee injured or killed by accident and guilty of contributory negligence should not be held to be negligent, and did not assume the risk where the common carrier had violated the Safety Appliance Act [27 STAT. 531 (1893), 45 U. S. C. § 1 *et seq.* (1934)]. The constitutionality of the second act was sustained in Second Employers' Liability Cases, 223 U. S. 1 (1912). The statute of limitations has been extended from one [35 STAT. 66 (1908)] to two [36 STAT. 291 (1910)] and now to three years [52 STAT. 1404, 45 U. S. C. § 56 (Supp. 1939)]. The relief from assumption of risk has been expanded [53 STAT. 1404, 45 U. S. C. § 54 (Supp. 1939)].

30. The words of the statute are clear and expansive. The legislative history further buttresses them. See SEN. REP. No. 432, 61st Cong., 2d Sess. (1910); 45 CONG. REC. 3996 (1910) (Messrs. Clay and Bailey); *id.* at 4034 (Mr. Borah: "The bill enables the plaintiff to find the corporation at any point or place or state where it is actually carrying on business, and there lodge his action, if he chooses to do so."); *id.* at 4051 (Messrs. Paynter and Bailey); *id.* at 4093 (Mr. Paynter); *id.* at 4158 (Messrs. Garrett and Clayton to the effect that all laws and parts of laws in conflict with the act in question are repealed by the doctrine of implication).

*United States v. American Packing & Provision Co., 122 F. (2d) 445 (C. C. A. 10th, 1941).

1. 48 STAT. 31 (1933), 7 U. S. C. §§ 601–22 (1934), *amended*, 49 STAT. 750 (1935), declared unconstitutional in United States v. Butler, 297 U. S. 1 (1936).

levies on the processing of various commodities and to increase or decrease them within certain limits.[2] Processors, therefore, adopted a form of contract which provided that the sale price included the processing tax as then determined by the Secretary. It was further agreed that the sale price should be increased or decreased in case of any change in the taxes.[3] The obvious effect of this tax clause was to guarantee to the processor a margin of profit independent of variations in the amount of tax he might be required to pay. Conversely, the buyer was faced with the risk of having to pay an additional amount over the agreed price;[4] a decrease in the tax, however, would redound to his benefit.

When the processing tax was invalidated,[5] many processors became enriched by the amount which they would otherwise have had to pay the Government. Buyers, therefore, relying on the contract provisions as giving them a right to such funds, sought to recover them.[6] Procedurally, they either brought suit directly[7] or interposed this claim when sued by the processor for the contract price.[8] In general two counts were stated, one in contract under the "up and down" provisions of the tax clause and the other seeking quasi-contractual relief in the nature of a count for money had and received. The only variable factors involved the actual enrichment of the seller and the financial loss of the buyer.

2. 48 STAT. 35, 39 (1933), 7 U. S. C. §§ 609(b), 615 (1934), *amended*, 49 STAT. 763–65 (1935).

3. The following is typical of the tax provisions in contracts between processor and buyer: "Taxes: The price named in this contract includes all taxes as at present determined by the Secretary of Agriculture. . . . Under said Agricultural Adjustment Act it is provided that said taxes may be changed from time to time, and it is therefore understood and agreed that if, after the date of this contract, said present taxes are increased . . . then in such event the amount of such increase or increases shall be added to the price named in this contract . . . and correspondingly, if any reduction or reductions are hereafter made in said present taxes affecting the price named in this contract, then the seller agrees to adjust the price named herein and allow to the buyer the amount of such reduction or reductions." See Johnson v. Igleheart Bros., 95 F. (2d) 4, 6 (C. C. A. 7th, 1938), *cert. denied*, 304 U. S. 585 (1938), 33 ILL. L. REV. 354.

4. For cases interpreting this phase of the contracts, see United States v. Cowden Manufacturing Co., 312 U. S. 34 (1941); United States v. Glenn L. Martin Co., 308 U. S. 62 (1939); Telescope Folding Furniture Co. v. United States, 90 Ct. Cl. 635 (1940); Batavia Mills, Inc. v. United States, 85 Ct. Cl. 447 (1937).

5. United States v. Butler, 297 U. S. 1 (1936).

6. There are approximately thirty reported cases where buyers have sought to recover the amount of the processing taxes.

7. Moundridge Milling Co. v. Cream of Wheat Corp., 105 F. (2d) 366 (C. C. A. 10th, 1939); Johnson v. Igleheart Bros., 95 F. (2d) 4 (C. C. A. 7th, 1938), *cert. denied*, 304 U. S. 585 (1938), 33 ILL. L. REV. 354; Johnson v. Sauer Milling Co., 148 Kan. 861, 84 P. (2d) 934 (1938).

8. Consolidated Flour Mills v. Ph. Orth Co., 114 F. (2d) 898 (C. C. A. 7th, 1940); Sparks Milling Co. v. Powell, 283 Ky. 669, 143 S. W. (2d) 75 (1940); Mattingly v. Smith Milling Co., 183 Miss. 505, 184 So. 635 (1938); Lucas v. Panos, 190 Wash. 402, 68 P. (2d) 617 (1937).

Whatever the findings of fact in any particular case, however, the processor invariably prevailed.[9] On the contractual count, it was held without exception that the "up and down" clause was not intended to cover the contingency that the tax might be held unconstitutional.[10] In dismissing the count for quasi-contractual relief, the courts relied primarily on two grounds. First, it was held that the processor had not been enriched in such a way as to entitle the buyer of processed goods to recover. Authority was found in the rule formulated in earlier cases[11] that a buyer could not succeed in such cases unless the tax was stated separately from the remainder of the price. This rule barred restitution whenever the tax was "absorbed" or "buried" in a composite price, regardless of any actual enrichment resulting to the seller.[12] In the second place, the buyer was denied relief where he failed to show that he had borne the burden of the tax, again regardless of the seller's enrichment.[13] This rule was based on the equities of the case.[14] The buyer, it was argued, could not complain that the seller's gain was

9. The processor was held obligated to make a refund in only two cases. In Brown v. Salter, 59 Ga. App. 579, 1 S. E. (2d) 468 (1939), the plaintiff, a grower of peanuts, on proof that the processor had deducted the tax from the market price paid to the grower, was permitted to recover this amount as unpaid purchase money. In Denison Peanut Co. v. McCraw's, Inc., 127 S. W. (2d) 499 (Tex. Civ. App. 1939), the processor had expressly agreed to make a refund in event the tax were held invalid.

10. The only two cases in which the parties expressly contracted with reference to the constitutionality of the tax are Brown v. Salter, 59 Ga. App. 579, 1 S. E. (2d) 468 (1939) cited *supra* note 9, and Casey Jones, Inc. v. Texas Textile Mills, Inc., 87 F. (2d) 454 (C. C. A. 5th, 1937) (agreement to refund if the Supreme Court invalidated the tax within ninety days of passage of title on the goods). In view of the widespread doubts as to the validity of the tax, the omission of any express stipulation regarding this eventuality was held to indicate an intention that the "up and down" clause did not cover it. See Moundridge Milling Co. v. Cream of Wheat Corp., 105 F. (2d) 366, 370 (C. C. A. 10th, 1939).

11. Texas Co. v. Harold, 228 Ala. 350, 153 So. 442 (1933); Wayne County Produce Co. v. Duffy-Mott Co., 244 N. Y. 351, 155 N. E. 669 (1927); Kastner v. Duffy-Mott Co., 125 Misc. 886, 213 N. Y. Supp. 128 (Sup. Ct. 1925); *cf.* Lash's Products Co. v. United States, 278 U. S. 175 (1929).

12. See Wayne County Produce Co. v. Duffy-Mott Co., 244 N. Y. 351, 353, 155 N. E. 669 (1927): "This is not a case where the item of the tax is absorbed in a total or composite price to be paid at all events. In such a case the buyer is without remedy, though the annulment of the tax may increase the profit to the seller." *Accord,* Christopher v. Hoger & Co., Inc., 160 Misc. 21, 289 N. Y. Supp. 105 (Munic. Ct. 1936). See also Note (1938) 115 A. L. R. 667.

13. Consolidated Flour Mills Co. v. Ph. Orth Co., 114 F. (2d) 898 (C. C. A. 7th, 1940); Johnson v. Igleheart Bros., 95 F. (2d) 4 (C. C. A. 7th, 1938), *cert. denied,* 304 U. S. 585 (1938); Johnson v. Sauer Milling Co., 148 Kan. 861, 84 P. (2d) 935 (1938); Johnson v. Scott County Milling Co., 21 F. Supp. 847 (E. D. Mo. 1937); Tager v. Wool Ray Prod. Corp., 160 Misc. 19, 289 N. Y. Supp. 541 (Munic. Ct. 1936).

14. Johnson v. Igleheart Bros., 95 F. (2d) 4, 9 (C. C. A. 7th, 1938), *cert. denied,* 304 U. S. 585 (1938); Tager v. Wool Ray Prod. Corp., 160 Misc. 19, 289 N. Y. Supp. 541 (Munic. Ct. 1936); *cf.* United States v. Jefferson Electric Co., 291 U. S. 386, 402 (1934).

unjust when he himself had been able to shift the burden along to his vendees. Either one of these grounds individually was sufficient to defeat the buyer's action, although in virtually all cases both were found present. Apart from these considerations, moreover, many cases failed because the processor had not yet recovered the tax from the Government and, thus, according to the courts, had not become enriched.[15] In other cases,[16] the Government had taxed away 80% of the processor's enrichment under the provisions of the so-called "windfall" tax.[17]

After the case law on the subject had become established and refined through a considerable body of precedent, the United States, as buyer of processed commodities, brought similar suits to recover alleged overpayments to processors. Like private purchasers, the United States had bought under contracts providing that the sale price included all federal taxes and that the price would be adjusted to meet any change in such taxes.[18] Unlike most private buyers, however, it was able to prove conclusively that it had absorbed the tax passed on to it by the processor.[19] Despite this difference, the Court of Claims in two cases held that the United States stood in no better position than any other purchaser.[20] In a third case the court conceded that "some equitable remedy" might be available, but held that it had not been invoked.[21] In the most recent case, however, the Circuit Court of Appeals for the Tenth Circuit permitted the Government to recover in

15. Hodgman Rubber Co. v. Dumaine, 93 F. (2d) 165 (C. C. A. 1st, 1937); Mattingly v. Smith Milling Co., 183 Miss. 505, 184 So. 635 (1938); Ph. Orth Co. v. New Richmond Roller Mills Co., 232 Wis. 491, 287 N. W. 713 (1939).

16. Johnson v. Scott County Milling Co., 21 F. Supp. 847 (E. D. Mo. 1937); Crete Mills v. Smith Baking Co., 136 Neb. 448, 286 N. W. 333 (1939).

17. INT. REV. CODE § 700 (1939). The constitutionality of this statute has been upheld. White Pkg. Co. v. Robertson, 89 F. (2d) 775 (C. C. A. 4th, 1937); Louisville Prov. Co. v. Glenn, 18 F. Supp. 423 (W. D. Ky. 1937); Union Pkg. Co. v. Rogan, 17 F. Supp. 934 (S. D. Cal. 1937). By §§ 901–17 of the Revenue Act of 1936, refunds to processors who paid the tax are made conditional upon a showing that the processor did not directly or indirectly shift the tax to his vendees. These provisions are discussed in Comment (1937) 50 HARV. L. REV. 477.

18. The typical tax clause in the United States contracts read as follows: "Prices bid herein include any Federal tax heretofore imposed by the Congress which is applicable to this bid. If any sales tax, processing tax, adjustment charge, or other taxes or charges are imposed or changed by the Congress . . . and are paid by the contractor . . . then the prices named in this bid will be increased or decreased accordingly . . ." See Brief for the United States, p. 7, United States v. American Packing & Provision Co., 122 F. (2d) 445 (C. C. A. 10th, 1941).

19. The supplies bought under these contracts were for the use of the United States and not for resale. It is, therefore, obvious that the Government must absorb the tax. See United States v. Hagan & Cushing Co., 115 F. (2d) 849, 852 (C. C. A. 9th, 1940) (dissenting opinion).

20. Kansas Flour Mills v. United States, 92 Ct. Cl. 390 (1941), *cert. granted*, 61 Sup. Ct. 1085 (U. S. 1941); Ismert-Hinke Milling Co. v. United States, 90 Ct. Cl. 27 (1939).

21. United States v. Hagan & Cushing Co., 115 F. (2d) 849 (C. C. A. 9th, 1940).

quasi-contract.[22] In arriving at this decision, the court distinguished all cases where the buyer was a private party on the ground that the United States had been able to prove that it would have borne the tax. The case, however, splits with the weight of authority in holding that a separation of tax and price is not an absolute requisite to recovery. Since the tax due on the goods was subject to exact mathematical computation,[23] the contract provision that the price included all taxes was held to be prima facie evidence that the buyer had put the seller in funds to pay the tax. The court, therefore, concluded that the vendor "had obtained money from the Government under such circumstances that in equity and good conscience it should be returned."[24]

To reach its decision in favor of the Government the court had to hurdle the obstacles which have developed to block recovery by buyers. In suits based on principles of unjust enrichment, the obligation of the party enriched does not arise from any express contract, but is imposed by law.[25] Imposition of the obligation depends on an initial finding by the court that a benefit has been conferred.[26] Even for an economist concentrating solely on economic data it is difficult in the usual case to determine with accuracy which party has been enriched and by how much.[27] The mere fact, moreover, that one party can show economically that another has been enriched at his expense does not ipso facto decide the case. Legal barriers may defeat the action regardless of the economic proof. If the payments are found to have been made under a mistake of law, the rule is frequently applied that they may not be recovered back.[28] Moreover, the rule requiring statement of taxes

22. United States v. American Packing & Provision Co., 122 F. (2d) 445 (C. C. A. 10th, 1941).

23. Although the tax was primarily computed on the basis of the raw commodity, such as wheat, the AAA authorized the Secretary of Agriculture to establish conversion factors so that the tax could be computed in terms of the processed article, such as flour. 48 STAT. 37 (1933), 7 U. S. C. § 610(c) (1934).

24. 122 F. (2d) 445, 449 (C. C. A. 10th, 1941). The court admits that its reasoning and conclusion are inconsistent with the reasoning and conclusion in Kansas Flour Mills v. United States, 92 Ct. Cl. 390 (1941), *cert. granted,* 61 Sup. Ct. 1085 (U. S. 1941), and Ismert-Hinke Milling Co. v. United States, 90 Ct. Cl. 27 (1939). The court also recognizes that there may be a distinction in the pleadings in United States v. Hagan & Cushing Co., 115 F. (2d) 849 (C. C. A. 9th, 1940), but adheres to the views expressed in the dissenting opinion in that case.

25. KEENER, QUASI-CONTRACTS (1893) 1–20; WOODWARD, QUASI-CONTRACTS (1913) § 3; Corbin, *Quasi-Contractual Obligations* (1912) 21 YALE L. J. 533; Lewisohn, *Contract Distinguished from Quasi-Contract* (1914) 2 CALIF. L. REV. 171.

26. RESTATEMENT, RESTITUTION (1937) §§ 1, 48.

27. Some courts seem to have taken an opposite view. See Rieder v. Rogan, 12 F. Supp. 307 (S. D. Cal. 1935) (judicial notice taken that under modern accounting systems it is possible to trace in even the most complex organizations the approximate cost of every item going into the making of the whole product); United States v. Jefferson Elect. Co., 291 U. S. 386, 402 (1934) ("If the taxpayer has borne the burden of the tax, he can readily show it. . . .").

28. Johnson v. Igleheart Bros., 95 F. (2d) 4 (C. C. A. 7th, 1938), *cert. denied,* 304 U. S. 585 (1938); Heckman v. I. S. Dawes & Son, 12 F. (2d) 154 (App. D. C.

as a separate item outside the actual purchase price may block recovery by buyers, despite obvious equities in their favor.

While the mistake-of-law rule has no plausible justification,[29] there are logical and practical arguments for requiring separation of tax and price. Since the *sine qua non* of the quasi-contractual action is a total failure of consideration or purpose,[30] it must clearly appear that the party asking for restitution has paid a definite amount for a specific purpose. Where only a single composite price is stated to a purchaser, the latter is said to be paying only the amount demanded for the goods and is not reimbursing the seller for any tax.[31] As a practical matter, moreover, the economic forces determining price in a competitive economy are so many and so intricate that it is virtually impossible to break down the price into component parts and to determine what portion represents the amount of the tax.[32] In the usual case, therefore, a statement by the seller of the amount of tax which he is passing on is almost a necessity.

As a decisive factor in the processing tax cases, however, application of the separate tax item rule seems clearly unwarranted. Although the tax was not separately itemized, the parties had expressly agreed that the amount had been included in the sale price.[33] The fact, moreover, that under the

1926); Noll Baking & Ice Cream Co. v. Sparks Milling Co., 304 Ill. App. 624, 26 N. E. (2d) 425 (1940); Southern Biscuit Co. v. Lloyd, 174 Va. 299, 6 S. E. (2d) 601 (1940).

29. See KEENER, QUASI-CONTRACTS 85-91; RESTATEMENT, RESTITUTION (1937) 179-81; SEAVEY AND SCOTT, NOTES ON RESTATEMENT OF RESTITUTION (1937) 35-38. In Wayne County Produce Co. v. Duffy-Mott Co., 244 N. Y. 351, 355, 155 N. E. 669, 670 (1927), the court reasons that the "quality of the mistake [fact or law] did not prevent the defendant from recovering the money from the Government. It cannot absolve from the duty of disposing of the money thus recovered as good conscience shall dictate."

30. RESTATEMENT, RESTITUTION (1937) § 48; KEENER, QUASI-CONTRACTS 34 *et seq.*

31. Lash's Products Co. v. United States, 278 U. S. 175 (1929), has often been cited as authority for this proposition. At 176, the court says: "The purchaser does not pay the tax. He pays or may pay the seller more for the goods because of the seller's increased obligation, but that is all. . . . The amount added because of the tax is to get the goods and for nothing else." Since, however, this case involved the interpretation of a technical ruling by the Treasury, its authority is questionable.

32. Besides the difficulty in allocating the various items making up total price, the problem is further complicated by changes in supply and demand curves following the imposition of a tax. Resulting changes in production and prices introduce new elements which must be considered in judging the shifting of a tax. See Johnson, *AAA Refunds: A Study in Tax Incidence* (1937) 37 COL. L. REV. 910.

33. There are four commonly-used methods of shifting the economic burden of a tax: (1) the seller may merely include the tax in a total or composite price; (2) the seller may follow the method used by processors—composite price but statement that tax is included; (3) the seller may represent that a certain fraction of the price represents the tax; (4) the seller may separate price and tax completely. The last two methods are to all intents identical in legal effect. United States v. Jefferson Elect. Co., 291 U. S. 386 (1934). But see Cupples Co. v. Mooney, 25 S. W. (2d) 125 (App. St. L. 1930) (price under contract stating 1/41 of price to be federal excise tax held composite). The second method is different from the last two only in that the exact amount

"up and down" clause the processor had agreed to reimburse the buyer in case of reduction of the tax was strong indication that the former had actually passed on the tax.[34] In addition, there was never any doubt about the amount due under any contract. The tax could be computed directly on the finished product as sold by the processor.[35] In substance, therefore, the result was the same as though the seller had taken the formal step of separately itemizing the taxes. While these considerations were present in all processing tax cases, the separate tax item rule was uniformly invoked as a ground for denying recovery. Even where the Government was plaintiff and other objections to recovery were absent, courts failed to abandon the rule.[36] The more realistic approach in the *American Packing Company* case sensibly modifies the rule by giving presumptive effect to the tax clause.

Even if the buyer is able to surmount the separate tax rule, however, he must do more than prove that the seller has been enriched. In the processing tax cases, the buyer has been required to prove in purely economic terms that he has sustained a loss as a result of the seller's enrichment.[37] Where the buyer has himself shifted the burden of the tax to his vendees, the courts hold that recovery must be denied. In comparable cases prior to the processing tax, however, the question of the buyer's actual loss does not seem to have arisen. On the contrary, where recovery has been granted, it was considered sufficient that the buyer had proved that the tax had been passed to him in the form of a separate item and that the seller had escaped its payment.[38] How the buyer obtained the funds to pay this item was not a factor in the decisions. Besides lack of precedent, the inclusion of this factor in the processing tax cases involves a logical inconsistency. In determining the seller's enrichment, courts have taken the legalistic position that a tax cannot be passed on unless separately itemized.[39] The buyer, on the other hand, is forced to frame his case on an economic level by the requirement of proof that he has not shifted the tax burden. To be consistent,

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of the tax passed on does not appear in the contract. Where, however, the amount of the tax on each unit sold is mathematically certain, as in the case of a sales or excise tax, the distinction between the second method and the last two fails. United States v. American Packing and Provision Co., 122 F. (2d) 445 (C. C. A. 10th, 1941).

34. The "up and down" clause might also evidence an intent of the parties to treat the tax as a separate and distinct item in the transactions. United States v. Hagan-Cushing Co., 115 F. (2d) 849, 852 (C. C. A. 9th, 1940) (dissenting opinion).

35. See note 23 *supra*.

36. United States v. Hagan-Cushing Co., 115 F. (2d) 849 (C. C. A. 9th, 1940); Kansas Flour Mills v. United States, 92 Ct. Cl. 390 (1941), *cert. granted*, 61 Sup. Ct. 1085 (U. S. 1941); Ismert-Hinke Milling Co. v. United States, 90 Ct. Cl. 27 (1939).

37. See cases cited *supra* note 12.

38. Wayne County Prod. Co. v. Duffy-Mott Co., 244 N. Y. 351, 155 N. E. 669 (1927) (federal excise tax); Solomon Tobacco Co. v. Cohen, 184 N. Y. 308, 77 N. E. 257 (1906) (import duty); Friend v. Rosenwald, 124 App. Div. 226, 108 N. Y. Supp. 701 (1st Dep't 1908) (import duty).

39. Golding Bros. v. Dumaine, 93 F. (2d) 162 (C. C. A. 1st, 1937); Heckman & Co. v. I. S. Dawes & Son, 12 F. (2d) 154 (App. D. C. 1926); *cf.* Lash's Products v. United States, 278 U. S. 175 (1929).

the same rule should apply to the purchaser's loss as to the seller's gain. If the legalistic position is adopted, it should be held as a matter of law that the buyer has not passed on the tax to his vendees where he has sold at a single composite price.

Despite the logical inconsistency, however, the economic proof demanded of the buyer has practical justification. To permit recovery without clear evidence of loss would operate merely to transfer the seller's enrichment to the buyer. Where the Government is the buyer, it can readily prove its assumption of the burden of the tax. In the typical case, however, the processor has passed the tax directly along to the buyer of processed commodities. The latter in turn distributes the burden among the mass of consumers in the form of higher prices.[40] Furthermore, the windfall tax applies to buyers as well as processors.[41] Unless the buyer had proved his absorption of the tax, he would subsequently be forced to disgorge the lion's share of his recovery. The consequent circuity is perhaps a strong inducement for the courts to deny restitution.[42]

Although the windfall tax has not been emphasized as an important factor in the cases, a situation might well arise where it would be the crucial issue. If the buyer could otherwise establish his right to restitution, the seller might nevertheless contend that payment to the Government under the terms of the statute had discharged his entire obligation to the buyer.[43] The decision of Congress, however, to tax away the major portion of the enrichment is not a legislative determination that it is entirely eliminated.[44] Since the windfall tax applies to only 80% of any enrichment, the buyer should be allowed to recover the remaining 20%.[45] On the contractual count,

40. Studies made of the economic effects of the processing taxes show that consumer expenditures for agricultural commodities during the period when the taxes were in effect increased by approximately the amount of the taxes collected. See NOURSE, THREE YEARS OF THE AAA (1937) 401–12.

41. INT. REV. CODE § 700(2) (1939).

42. See Ph. Orth Co. v. New Richmond Roller Mills Co., 232 Wis. 491, 498–99, 287 N.W. 713, 717 (1939). In addition, recovery without proof of absorption would encourage multiple actions by enriching the buyer in relation to his vendees. See (1941) 30 KY. L. J. 118.

43. The argument would be predicated upon the assumption that the windfall tax was intended to effect a complete disposal of the funds collected by processors under the invalid statute, to the exclusion of any private claims. Where the United States is plaintiff-buyer, the further argument might be made that, having two alternative remedies, it should not be permitted to bring suit after choosing to act under the windfall tax statute.

44. The figure of 80% was apparently arrived at through a compromise in Congress. The subcommittee of the Committee on Ways and Means recommended a 90% rate, while other representatives suggested 75%. In the discussions, it was intimated that a 100% tax would be confiscatory. See *Hearings before Committee on Finance on H. R. 12395*, 74th Cong., 2d Sess. (1936) 868; H. R. REP. No. 2475, 74th Cong., 2d Sess. (1936) 11. See also Comment (1937) 50 HARV. L. REV. 477.

45. In none of the cases where the seller's payment of the windfall tax was relied upon as a ground to defeat the action did the buyer raise the question of the

the objection would remain that the "up and down" clause in the contract was not intended to cover the contingency of unconstitutionality. It has been suggested, on the other hand, that the provisions of the windfall tax in effect constitute a 20% reduction in the processing tax and that the processor is obligated to make a refund under the terms of the contract.[46] On quasi-contractual grounds, restitution might be blocked by the rules formulated in the usual processing tax cases. If, however, the buyer could avoid the composite price rule and prove that he sustained a loss, his recovery of 20% would be facilitated.

A "windfall" tax, therefore, does not eliminate the enrichment problem represented in the processing tax cases. In absence of more effective legislation, quasi-contractual principles should be geared to yield results in conformity with economic fact. The buyer should be required to prove in economic terms that he has absorbed the tax and has not shifted it to his vendees.[47] Since private buyers have opportunity to pass along the tax, the burden of proof properly falls more heavily on them. Both the Government and private parties, however, should be permitted to show by whatever means possible that the seller shifted the tax to them. Separate itemization of the tax should be eliminated as a condition precedent to recovery. Recognition of these considerations in the *American Packing Company* case points the way toward sounder treatment of similar enrichment issues.

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remaining 20%. The reason probably is that such cases also failed on the mistake-of-law rule, the composite-price rule, or because the buyer had failed to allege his absorption of the tax. See cases cited *supra* note 14.

46. (1938) 33 ILL. L. REV. 354, 356, n. 15.

47. The statute relative to refunds of processing taxes by the United States imposes this burden on processors. Revenue Act of 1936, §§ 901–17. Suits under that statute indicate that the requirement of proof is difficult, but not insuperable. See Hornbuilt Prod., Inc. v. Commissioner, 119 F. (2d) 797 (C. C. A. 3d, 1941); H. T. Poindexter & Sons v. United States, 40 F. Supp. 787 (D. Mo. 1941); *cf.* Luzien's, Inc. v. Nee, 106 F. (2d) 130 (C. C. A. 8th, 1939).