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CONTRIBUTORS OF LEADING ARTICLES IN THIS ISSUE

JOSEPH WARREN is professor of law at the Harvard Law School. He has published a large number of articles in various legal periodicals.

WILLIAM C. BOLLAND is a member of Lincoln's Inn and an editor of the Selden Society Year Books, on which he has published a great deal of material. He is also Sanders Reader of Law in Cambridge University.

JOHN E. KIRSHMAN has been since 1919 professor of finance at the University of Nebraska. Among his published works are the following articles: *Interest Rates and Security Prices*; *Speculation and Security Prices*, and a book entitled *Principles of Investment*.

EDWARD C. WITTE was from 1917-1922 Secretary of the Industrial Commission of Wisconsin and since then has been Chief of the Wisconsin Legislative Reference Library. He has published numerous articles and is the author of the section on the "Law of Conspiracy" in Commons and Andrews, *Principles of Labor Legislation* (1916 and 1920).

ELCANON ISAACS is a member of the Cincinnati Bar. Among his published articles are the following: *An Analysis of Doing Business* (1925) 25 COL. L. REV. 1018; and *The Federal Protection of Foreign Corporations* (1926) 26 COL. L. REV. 263.

THE RESPONSIBILITY OF A BANK FOR MISAPPROPRIATION BY
A FIDUCIARY¹

The difficult situation in which New York banks are placed when handling fiduciary accounts is again called to attention by the ruling in *Cahan v. Empire Trust Co.*² In this case an agent with authority to draw on his principal's bank account drew checks payable to himself and deposited them in his individual account with the defendant bank, which then collected them from the drawee bank. He subsequently dissipated his account. In an action by his principal against the defendant bank judgment was rendered against the defendant for the amount of the checks with interest. The court said,³ ". . . we hold the *form*⁴ of the check should be taken as evidence that the agent is engaged upon ventures of his own, and as to his authority to conduct the same the bank must assume the risk of investigation". On the facts, however, since, in addition to the form of the check, there was the deposit to the agent's personal account, it is probably unfair to say that the case holds more than that a check drawn by an agent on his principal's account payable to himself and deposited in his own private account is sufficient notice of possible misappropriation to put the bank in which it is deposited upon inquiry.

This holding is directly contra to *Havana Cent. Ry. v. Knickerbocker Trust Co.*,⁵ in which the New York Court of Appeals held the bank receiving the deposit not liable.⁶ The result of these cases is that, as to a principal who can meet the jurisdictional requirements of the federal courts, New York banks collect and pay out at their peril the proceeds of any such check presented for deposit, but may do so without peril if these jurisdictional requirements cannot be met. The federal rule makes it necessary for a New York bank, to be safe, to investigate every such

¹ "Fiduciary" includes a trustee under any trust, expressed, implied, resulting or constructive, executor, administrator, guardian, conservator, curator, receiver, trustee in bankruptcy, assignee for the benefit of creditors, partner, agent, officer of a corporation, public or private, public officer, or any other person acting in a fiduciary capacity for any person, trust or estate." Uniform Fiduciaries Act, sec. 1., (1923) 9 Uniform Laws Annotated, 99.

² (1926, C. C. A. 2d) 9 Fed. (2d) 713.

³ *Ibid.* at 718.

⁴ Italics ours.

⁵ (1910) 198 N. Y. 422, 92 N. E. 12, reversing the Appellate Division in (1909, 1st Dept.) 135 App. Div. 313, 119 N. Y. Supp. 1035.

⁶ The same plaintiff, getting into the federal court on the ground of diverse citizenship, then sued the drawee bank. The Circuit Court of Appeals denied recovery. *Havana Cent. Ry. v. Knickerbocker Trust Co.* (1913, C. C. A. 2d) 204 Fed. 546, writ of certiorari denied (1914) 234 U. S. 755, 34 Sup. Ct. 673.

check presented, or to investigate whether the principal can properly sue in the federal courts.

The majority of the cases hold that a depository of fiduciary funds need not inquire into the authority of the fiduciary to make the deposit, even if made to the personal account of the fiduciary; nor is it necessary to inquire for what purposes the withdrawals by the fiduciary are made, whether by checks payable to the fiduciary personally, or as fiduciary, or to third persons.⁷ The bank is responsible, however, when the fiduciary draws on the fiduciary account, or his own account containing fiduciary funds, in order to pay his personal indebtedness to the bank.⁸

In these general rules no distinction has been drawn among the various types of fiduciaries. Nor have the cases seemed to make any distinction; and the Uniform Fiduciaries Act (now adopted by eight states⁹) expressly lumps all fiduciaries into one class.¹⁰ The various cases, however, in which the majority rule has not been followed have generally been those in which the fiduciary has had the least power of control over the fiduciary funds. Thus, it may be that it is proper to distinguish, on the one hand, between a trustee (executor, administrator, guardian, etc.), who has legal title to the fund with power of control, and, on the other hand, an agent or coporate officer, who has neither legal nor equitable title and has authority only to draw on the account, or to employ it in a certain way, for his principal. That such a distinction *may* exist is apparently recognized in the *Cahan*¹¹ case, and the opinions in the *Bishoff*¹² and *Whiting*¹³ cases faintly suggest it. At

⁷ See cases collected in COMMENTS (1923) 32 YALE LAW JOURNAL, 377, note 2. See generally McCollom, *Liability of Banks Receiving Checks To a Trustee's Order For Deposit in His Individual Account* (1911) 11 COL. L. REV. 428; Thulin, *Misappropriation By Fiduciary* (1918) 6 CALIF. L. REV. 171; NOTES (1913) 13 COL. L. REV. 727; *Commissioners' Note* (to Uniform Fiduciaries Act) (1923) 9 Uniform Laws Annotated, 108.

⁸ *Bishoff v. Yorkville Bank* (1916) 218 N. Y. 106, 112 N. E. 759; *Ward v. City Trust Co.* (1908) 192 N. Y. 61, 84 N. E. 585; *Allen v. Puritan Trust Co.* (1912) 211 Mass. 409, 97 N. E. 916.

⁹ See (1923) 9 Uniform Laws Annotated, Supplement, 1925, at 12.

¹⁰ *Supra* note 1.

¹¹ " . . . we shall, so far as possible, avoid decisions dealing with defalcations by executors and trustees who had 'title' to the funds they misapplied; we shall regard primarily cases arising out of acts by agents . . . or officers of corporations, both of whom act by procuration and have no title to the funds with which they deal. We do not assert that the legal principles involved in these two classes of wrongdoing are basically different; we but seek to avoid unnecessary prolixity." *Supra* note 2, at 715. In the case of an ordinary bank deposit, the depositor is a creditor and the bank a debtor. "Title" means no more than this here.

¹² "The title to the funds was in the executor, and he possessed the full control and disposition of them." *Bishoff v. Yorkville Bank*, *supra* note 8, at 110.

¹³ "The executor was the owner. Whether he deposited in his own name

any rate the cases have dealt more severely with banks accepting such checks from agents¹⁴ and corporate officers¹⁵ than from trustees and others having legal title.¹⁶ And in the few cases holding banks liable for collecting such checks drawn by trustees, the trustees have generally been of an official nature—sheriffs, commissioners, etc.—whose trusts by their character precluded any justification for depositing the fund in a private account.¹⁷ It may seem odd, at first blush, to cause a bank to scrutinize more carefully the acts of an agent than those of a trustee. However, an agent has less “title” to the fund than a trustee and hence, ordinarily, less control over it, so that any unusual exercise of control lends itself more readily to suspicion. It is believed that this distinction should not be of controlling importance in the general problem of the bank’s responsibility; but it has been suggested as a possible means of reconciling some of the cases.

That a fiduciary¹⁸ may draw cash from his principal’s¹⁹ account

or with the addition of the name of the estate, the title was unchanged.” *Whiting v. Hudson Trust Co.* (1923) 234 N. Y. 394, 406, 138 N. E. 33, 37.

¹⁴ *Farmers’ Loan & Trust Co. v. Fidelity Trust Co.* (1898, C. C. A. 9th) 86 Fed. 541; cf. *Anderson v. Kissam* (1888, C. C. S. D. N. Y.) 35 Fed. 699.

¹⁵ *Wagner Trading Co. v. Battery Park Nat. Bank.* (1920) 228 N. Y. 37, 126 N. E. 347; *Underwood, Ltd. v. Bank of Liverpool* [1924] 1 K. B. 775. In each of these cases the corporate officer indorsed to himself and deposited in his own account checks received by the corporation and drawn to its order as payee. In New York such cases are considered as different from a drawing by a corporate officer to his own order and a deposit to his own private account. “They do not reach a case where the instrument has been collected according to its tenor for the account of the very person who is named there as payee.” *Whiting v. Hudson Trust Co.*, *supra* note 13, at 406. But the difference does not seem substantial, for an indorsement by an officer to himself seems no more than a drawing by an officer to his own order; in each case the bank has equal notice that corporate funds are being deposited in a personal account. Under this analysis the *Wagner* case, *supra*, would seem inconsistent with the *Havana* case, *supra* note 5. In *Santa Marina Co. v. Canadian Bank of Commerce* (1918, C. C. A. 9th) 254 Fed. 391, the court reached a contrary result from the New York rule in the *Wagner* case. If agents and corporate officers are to be regarded as identical for the purpose of these cases (and they seem to be), this holding is inconsistent with *Farmers’ Loan & Trust Co. v. Fidelity Trust Co.*, *supra* note 14, decided by the same court. Cf. (1924) 4 BOSTON U. L. REV. 265.

¹⁶ But by statute in New York every executor, administrator, guardian, or testamentary trustee who deposits in his own name funds received from the estate of a deceased person shall be guilty of a misdemeanor. N. Y. Surro. Ct. Act, 1920, ch. 928, sec. 231.

¹⁷ *Bank of Hickory v. McPherson* (1912) 102 Miss. 852, 59 So. 934 (commissioner); *United States Fidelity & Guaranty Co. v. Peoples Bank* (1913) 127 Tenn. 720, 157 S. W. 414 (guardian); see (1913) 27 HARV. L. REV. 176.

¹⁸ Either trustee or agent. See *supra* note 1.

¹⁹ “‘Principal’ includes any person to whom a fiduciary as such owes an obligation.” Uniform Fiduciaries Act, sec. 1, *supra* note 1.

without suspicion is generally admitted.²⁰ There are so many reasons why cash may be legitimately needed that the likelihood of misappropriation is too remote to justify the practical business inconvenience of inquiry by the banks. The legitimate reasons, however, for the transfer of such funds into the fiduciary's individual account are relatively few.²¹ This, no doubt, explains the different treatment accorded by some courts to a drawing of cash and a drawing for deposit in the fiduciary's private account; some believe that such a transfer for deposit in a personal account should constitute notice, as contrasted with no notice in a drawing of cash.²² This difference indicates that the responsibility of the bank cannot be predicated on what it did alone, but rather on what it did together with what it knew or should have known.²³

As the situation now exists in New York a bank accepting a check from a fiduciary "should have known", *i.e.*, is put upon inquiry, (1) when a corporate officer has indorsed checks payable to the corporation for deposit in his personal account,²⁴ (2) when the bank accepts a fiduciary check in satisfaction of a personal debt owed to it by the fiduciary,²⁵ and (3) under the federal rule, when the check has been drawn by an agent or corporate officer on his principal's account to his own order for

²⁰ See *Farmers' Loan & Trust Co. v. Fidelity Trust Co.*, *supra* note 14, at 544, stating that, "When an agent draws a draft in the name of his principal, and receives from a bank the money therefor, the presumption, in the absence of any showing to the contrary, is that he receives the money in the same capacity in which he draws the draft; that is to say as agent."

"The drawee bank, it would seem, can pay cash with safety to the payee officer, as can also an intermediate bank." Thulin, *op. cit. supra* note 7, at 178, see also p. 177; and (1905) 19 HARV. L. REV. 68.

²¹ (1905) 19 HARV. L. REV. 68.

²² Thus, it might seem that a fiduciary could draw cash at the paying teller's window and deposit it to his individual account at the receiving teller's window without liability attaching to the bank. Thulin, *op. cit. supra* note 5, at 178. In a large bank where the paying and receiving teller are not in "privity" with one another such a result might be possible, although if the bank had knowledge of the complete transaction this formula would not relieve it of responsibility. *Cf. Lowndes v. City Nat. Bank* (1909) 82 Conn. 8, 72 Atl. 150.

²³ Since the form of the check would be identical whether cashed or deposited in the individual account (unless endorsed "for deposit"—which is not the most usual practice), the form of itself would not seem enough to put the bank in the position of "should have known." And from this it follows that the intimation by the New York court in the *Havana* case, *supra* note 5, at 430, that "the depository [drawee bank] may be liable to the depositor" is fallacious, for the drawee bank can have no evidence of misappropriation other than that presented by the form of the check, and only if endorsed "for deposit" would it be put upon inquiry.

²⁴ *Supra* note 15.

²⁵ *Supra* note 8.

deposit in his personal account.²⁶ Referring to situation (1) Cardozo, J., has said,²⁷ "The cases imposing liability in such circumstances lay down, however, a strict and at times a hard rule, and are not to be extended. . . . The transactions of banking in a great financial center are not to be clogged and their pace slackened by over-burdensome restrictions." It may well be questioned whether the requirement to investigate at its peril is not overburdensome in situation (3), as well as in situation (1). For it is estimated that eighty-five per cent of the country's business is transacted by checks²⁸ and that large New York banks handle over thirty millions of dollars in checks daily.²⁹ Under this pressure of business³⁰ it is banking practice to examine the face of a collection item only for the amount and the name of the drawee; not noticing³¹ the names of the drawer and payee and their relationship to one another. In so doing the bank relies on its indorser to make good any loss.

It may be argued that the bank should do this at its peril, and assume the risk in situations (1) and (3) above.³² It is submitted, however, that this practice of the banks is forced upon them by the ever increasing use of checks by the public. In view of this functional habit of the banks and its practical inescapability under modern business conditions it seems unsound policy to put upon the banks the risk of misappropriation in receiving for deposit in the private account of an agent or corporate officer a check drawn by such an agent or officer on the principal's or corporation's account payable to himself,³³ or a check drawn by

²⁶ *Cahan v. Empire Trust Co.*, *supra* note 2.

²⁷ *Whiting v. Hudson Trust Co.*, *loc. cit. supra* note 13.

²⁸ Moulton, *Money and Banking* (1916) Part II, 37.

²⁹ *Ibid.* 102.

³⁰ In addition to checks as here discussed, there is a large volume of notes, drafts and other instruments made payable at banks, which present similar questions for determination.

³¹ Unless the check is for a very large sum.

³² Or in other words, that reliance by the bank on the indorser warrants holding the bank liable in situations (1) and (3) and forcing it to look to the indorser for its relief. The bank, however, cannot be certain of the integrity of all its depositors. The principal or the corporation can be more certain of his/its agent's or officer's honesty, or at least has a greater opportunity to be so than the bank. Since both the principal or corporation and the bank have to trust the same man, it seems fair to place the loss, if any, on the one who has had the better chance to form a judgment before placing that trust in the individual, to wit, on the principal or corporation. "Those for whom he acts must ever find their protection in his integrity." *Goodwin v. American National Bank* (1881) 48 Conn. 550, 568. See also the dissenting opinion in *Farmers' Loan & Trust Co. v. Fidelity Trust Co.*, *supra* note 14.

³³ Likewise if made payable to bearer, cash or to the bank in which deposited.

a third person payable to the principal or corporation and endorsed to himself by the agent or officer. The great expenditure of time necessary to scrutinize minutely all checks for such details and to make inquiry seems prohibitive.³⁴

That the problem involved here is one of business or public policy³⁵ is admitted by the court in the *Cahan* case.³⁶ Approaching the issue from this angle, the Uniform Fiduciaries Act³⁷ has, and wisely, it is submitted, taken the opposite view from that of the Circuit Court of Appeals in the *Cahan* case.³⁸

TAXATION OF GIFTS IN CONTEMPLATION OF DEATH

To prevent evasion of the inheritance tax laws it was necessary to amend them so as to tax all gifts made in contemplation of death. This gave rise to great difficulties, since it is almost impossible to determine accurately the subjective state of mind of a donor. Thus there has grown up a large body of decisions dealing with the kinds of conduct on the part of a donor which the courts find material in determining his state of mind.

A number of earlier cases limited taxable gifts in contemplation of death to gifts *causa mortis*,¹ but this view has been disapproved, "contemplation of death" being held to be much more inclusive than *causa mortis*. A gift *inter vivos* is taxable if the evidence shows it to have been made in contemplation of death.² "In con-

³⁴ In the instant case the court rightly says (at 718): "At bottom, the question here depends upon whether the form of such drafts as those at bar gives clear enough notice that the agent is not acting in the principal's interest." It is submitted that the answer is that it does not, under existing banking conditions, even though the agent is depositing in his private account. Cf. *supra* note 21.

³⁵ It may be said that it is good public policy to place the loss on the bank, which will probably insure against it and thus distribute it over the community as a whole. But it is equally practicable to put the burden of insurance on the principal to require a bond of the fiduciary. In fact corporate officers, executors and administrators, and official trustees of any kind usually are under bond. It seems the better policy to require principals to seek protection in this manner.

³⁶ *Supra* note 2, at 719.

³⁷ *Supra* note 1, sec. 9.

³⁸ "The object of the [Uniform Fiduciaries] Act is to relieve persons dealing with a fiduciary from the heavy responsibility of a constructive inquiry into the good faith of the fiduciary. In practice such inquiries are impossible in the ordinary course of banking and commercial transactions; and there is involved a risk which should be eliminated, except in cases of knowledge of fraud or personal advantage to the payee or recipient." (1922) 8 A. B. A. JOUR. 641.

¹ *In re Edgerton's Estate* (1898, 3d Dept.) 35 App. Div. 125, 54 N. Y. Supp. 700; *In re Hendrick's Estate* (1914, 1st Dept.) 163 App. Div. 413, 148 N. Y. Supp. 511.

² *In re Bottomley's Estate* (1920, N. J. Prerog.) 111 Atl. 605; cf. *Chambers v. Lamb* (1921) 186 Calif. 261, 199 Pac. 33.

temptation of death" does not refer to a general expectation that death will occur at some time, but to an apprehension of impending peril.³ It is evident, therefore, that the mere fact that the donor was aged will not be of great consequence.⁴ On the other hand, if the donor was suffering from a serious disease at the date of his gift, it is strong evidence that he contemplated death.⁵ This evidence would be rebutted by showing that he was ignorant of his disease,⁶ or thought it to involve little danger.⁷

Plans which the donor had made for the future are of primary importance in determining his state of mind. If he was about to undergo an operation at the time of the transfer, it is justifiable to assume a fear of death;⁸ but if he was making plans for extensive improvements to his premises,⁹ or for an extended trip or

³ *In re Baker's Estate* (1903, 4th Dept.) 83 App. Div. 530, 82 N. Y. Supp. 390; *Conway's Estate v. State* (1918, Ind. App.) 120 N. E. 717; *People v. Danks* (1919) 289 Ill. 542, 124 N. E. 625.

⁴ In many cases there has been no tax even though the donor was well advanced in age. *In re Desserts' Estate* (1913) 154 Wis. 320, 142 N. W. 647 (aged 86); *In re Spaulding's Estate* (1900, 4th Dept.) 49 App. Div. 541, 63 N. Y. Supp. 694 (aged 88); *In re Romney's Estate* (1922) 60 Utah, 173, 207 Pac. 139 (aged 86); *In re Bullard's Estate* (1902, 3d Dept.) 76 App. Div. 207, 78 N. Y. Supp. 491 (aged 83); *Appeal of Hillenmeyer* (1925) 2 U. S. Board of Tax App. 1322 (aged 72); see Ashcraft, *Federal Estate Tax on Gifts in Contemplation of Death* (1924) 6 ILL. L. QUART. 253; Gleason & Otis, *Inheritance Taxation* (1922, 3d ed.) 119.

⁵ *Rosenthal v. People* (1904) 211 Ill. 306, 71 N. E. 1121; *People v. Porter* (1919) 287 Ill. 401, 123 N. E. 59; *People v. Danks* (1919) 289 Ill. 542, 124 N. E. 625; *People v. Taverner* (1921) 300 Ill. 373, 133 N. E. 211; *Abstract Title & Guaranty Co. v. State* (1916) 173 Calif. 691, 161 Pac. 264; *State v. Pabst* (1909) 139 Wis. 561, 121 N. W. 351; *In re Price's Estate* (1909, Surro.) 62 Misc. 149, 116 N. Y. Supp. 283; *In re Thompson's Estate* (1914, Surro.) 85 Misc. 291, 147 N. Y. Supp. 157; *In re Birdsall's Estate* (1897, Surro.) 22 Misc. 180, 49 N. Y. Supp. 450; *In re Hall's Estate* (1923, N. J. Prerog.) 119 Atl. 669; *In re Bottomley's Estate* (1920, N. J. Prerog.) 111 Atl. 605; *In re Dupignac's Estate* (1924, N. J. Prerog.) 125 Atl. 119; *Kunhardt v. Bugbee* (1925, N. J.) 130 Atl. 660; *Shwab v. Doyle* (1920, C. C. A. 6th) 269 Fed. 321; *In re Beyer's Estate* (1920, 1st Dept.) 190 App. Div. 802, 180 N. Y. Supp. 396; *Williams v. Guile* (1889) 117 N. Y. 343, 22 N. E. 1071; *In re Fitzgibbon's Estate* (1919, Surro.) 106 Misc. 130, 173 N. Y. Supp. 898; *In re Hodges' Estate* (1914, Surro.) 86 Misc. 367, 148 N. Y. Supp. 424; *In re Clapp's Estate* (1917, Surro.) 167 N. Y. Supp. 1082; *In re Einstein's Estate* (1921, Surro.) 114 Misc. 452, 186 N. Y. Supp. 931; *Edwards' Estate* (1921) 1 Penn. D. & C. Rep. 497.

⁶ *Meyer v. United States* (1925) 60 Ct. of Claims, 474.

⁷ *People v. Kelley* (1905) 218 Ill. 509, 75 N. E. 1038; *Spreckels v. Stato* (1916) 30 Calif. App. 363, 158 Pac. 549; *In re Mahlstedt's Estate* (1901, 2d Dept.) 67 App. Div. 176, 73 N. Y. Supp. 818; *In re Cornell's Estate* (1901, 3d Dept.) 66 App. Div. 162, 73 N. Y. Supp. 32; *Vaughan v. Riordan* (1921, W. D. N. Y.) 280 Fed. 742; *Fidelity Trust Co. v. Lucas* (1925, W. D. Ky.) 7 Fed. (2d) 146.

⁸ *Merrifield's Estate v. People* (1904) 212 Ill. 400, 72 N. E. 446; *Estate of Reynolds* (1915) 169 Calif. 600, 147 Pac. 268.

⁹ *Rea v. Heiner* (1925, W. D. Pa.) 6 Fed. (2d) 389.

vacation,¹⁰ it would not seem probable that the donor was anticipating death at the same time. The same is true where he was looking forward to matrimony.¹¹

If evidence can be obtained of a motive for the transfer other than a contemplation of death, a strong case is made out against the taxability of the transfer. Thus where the gift was made to a member of the donor's family so that he might learn to manage the property,¹² or was made so that the donor might no longer be troubled with the care of the property,¹³ it was not taxed. If a transfer is made in pursuance of a plan decided upon some time previously when there was no danger of death, it is likely to be held not to have been made in contemplation of death.¹⁴

Other acts of the transferor, done about the same time that he made the transfer, may give clues to his state of mind and have evidential value. In cases where the donor made his will at the time of the transfer, the courts have found that death was contemplated;¹⁵ but where no will was made until some later date the contrary inference has been drawn.¹⁶ Where the *res* transferred was stock and the transferor retained one share in order to keep his voting power, the court decided that there was no contemplation of death.¹⁷

It seems almost certain that the legislative purpose in taxing gifts made in contemplation of death is to prevent loss of revenue through intentional evasion of the inheritance tax; and yet it is contemplation of death and not intent to evade the tax that is made the test of taxation. Indeed, the tax on such a gift seems not to be collectible until after the donor's death, inasmuch as a true inheritance tax would not have been collectible prior thereto. It should be observed, however, that taking by gift *inter vivos*

¹⁰ *Spreckels v. State*, *supra* note 7; *Meyer v. United States*, *supra* note 6; *Rea v. Heiner*, *supra* note 9; *Vaughan v. Riordan*, *supra* note 7.

¹¹ *In re Minor's Estate* (1919) 180 Calif. 291, 180 Pac. 813; *Polk v. Miles* (1920, D. Md.) 268 Fed. 175.

¹² *Kelly v. Woolsey* (1918) 177 Calif. 325, 170 Pac. 837.

¹³ *McDougald v. Wulzen* (1917) 34 Calif. App. 21, 166 Pac. 1033; *In re Desserts' Estate*, *supra* note 4. So also where a wife transferred her property so that her husband would no longer be burdened with its care. *Meyer v. United States*, *supra* note 6.

¹⁴ *In re Kueter's Estate* (1922) 45 S. Dak. 341, 187 N. W. 625; *In re Crary's Estate* (1900, Surro.) 31 Misc. 72, 64 N. Y. Supp. 566; *Appcal of Hillenmeyer*, *supra* note 4; *Fidelity Trust Co. v. Lucas*, *supra* note 7.

¹⁵ *People v. Danks*, *supra* note 5; *Rosenthal v. People*, *supra* note 5; *In re Snyder's Estate* (1925, Calif. App.) 235 Pac. 54; *In re Hall's Estate*, *supra* note 5; *In re Dupignac's Estate*, *supra* note 5; *Estate of Reynolds*, *supra* note 8. Also dissenting opinion in *In re Mahlstedt's Estate*, *supra* note 7. Where the transferor, a doctor, was seen examining himself with a stethoscope just prior to the transfer, the gift was held in contemplation of death. *In re Dee's Estate* (1913 Surro.) 148 N. Y. Supp. 423.

¹⁶ *Commonwealth v. Fenley* (1920) 189 Ky. 480, 225 S. W. 154.

¹⁷ *In re Mahlstedt's Estate*, *supra* note 7.

is not in fact taking by inheritance, since the subject matter vests at once in the donee's possession and enjoyment. Such gifts cause the donor to run the risk of poverty and lack of support and filial care during his remaining years just as other gifts do. As long as the statutes lay a tax only on gifts made in contemplation of death, there is no escape from the necessity of introducing evidence of the donor's state of mind. At the same time, the inference that the courts will draw from such bits of evidence must always be very uncertain.

IS AN ELECTION THE EXERCISE OF A POWER?

In re Vanatta's Estate, decided recently,¹ offers an excellent illustration of the need for clear analysis and discriminating use of terms. Jacob Vanatta had provided in his will that his widow, Julia Vanatta, was to receive the income from the estate during her life, subject to certain provisions in favor of his sister. It was further provided that she might elect in writing during her life time to take absolutely and in lieu thereof one half of the estate remaining after the provisions made for the sister had been satisfied and after his debts had been paid. And the executor was authorized and directed to convey to her such portion if she should so elect.

Soon after the death of her husband, Julia Vanatta elected to take half of the estate, and in writing directed the executor to convey it to her. This election was complied with by the executor, and eventually his administration account was settled.

Subsequently, new assets of the estate of Jacob Vanatta were discovered, consisting of some shares of stock which had either been forgotten or had been thought worthless. In the meantime, Julia Vanatta had died leaving a will. The case arose out of a contest between the residuary legatees under her will, who claimed one half of the newly discovered assets, and the residuary legatees of Jacob Vanatta, who claimed all. Counsel for the latter claimed, among other things, that Julia Vanatta's estate was not entitled to take any of these assets on the theory, apparently, that she had been the donee of a power under her husband's will, and subject to the rule that powers cannot be exercised after the death of the donee.²

Perhaps influenced by this line of argument, the court, in explaining its decision, saw fit to deny that Julia Vanatta had a power. The court said, speaking of the brief for the residuary legatees of Jacob Vanatta:

"This brief seems to have been based upon a misconception of the rights of the widow under the will, and without making a

¹ Prerogative Court of New Jersey, Jan. 8, 1926, 131 Atl. 515.

² *Chambers v. Tulane* (1852) 9 N. J. Eq. 146.

proper distinction between a 'power' and an 'election'. In my judgment, the right given to the widow under the will is not a power but a right to elect between two alternative provisions under the will."

The court correctly held that half of the new assets should go to the legatee of Julia Vanatta. To reach this result it was entirely unnecessary to deny that a legal power was conferred upon the widow by the will of Jacob. Such a power was created, a power that could not be exercised after Julia's death; but she properly exercised it before her death in a manner that affected the whole of Jacob's estate including undiscovered assets.

As has been said, "The lawyer's world is full of powers".³ It may correctly be said that any human being who can by his acts produce changes in the legal relations between himself and others, or between third persons, has a legal power or powers.⁴ It is a fundamental error, therefore, to seek to define legal powers generally with reference to the object upon which they operate, or with reference to their being created by certain persons, or in some particular manner. The essence of the power is capacity to change legal relations. "Whenever a power exists there is at least one other human being whose legal relations will be altered if the power is exercised."⁵

The court says that Julia Vanatta did not have a power, but had a "right to elect". Is not an election always the exercise of a power?⁶ Election in its legal sense has been defined as "the choice of one of two rights or things, to each one of which the party choosing has an equal right, but both of which he cannot have."⁷ Or, again, as the "making an act of choice between two or more courses of conduct, 'implying' that the act was done under such circumstances that the choice is binding."⁸

Without adopting either of these definitions or attempting to create a new one, it is clear that an election is the making of a choice between alternatives by an overt manifestation of will, a manifestation that may consist of words or of other conduct. It is also clear that if a choice is between alternatives that have nothing to do with legal relations, such a choice is not the exercise of a legal power. Thus, of an evening one may make a

³ Cook, *Hohfeld's Contributions to the Science of Law* (1919) 28 YALE LAW JOURNAL, 721, 725.

⁴ Corbin, *Legal Analysis and Terminology* (1919) 29 YALE LAW JOURNAL, 163, 168.

⁵ Cook, *op. cit. supra* note 3, at 725.

⁶ The exercise of mere physical strength is of course not involved in this discussion.

⁷ See *Bliss v. Geer* (1880) 7 Ill. App. 612, 617.

⁸ See *Usher v. Waddingham* (1892) 62 Conn. 412, 428, 26 Atl. 538, 541. The present court's definition is "the choice between two or more courses of action, rights, or things by one who cannot enjoy the benefit of both."

choice between going to the theatre and staying at home; and we may make a choice between including such a case under the term "election" and not so including it. Such a choice does not either extinguish or create any legal relation, and is therefore not the exercise of a legal power. Such a choice does not affect societal action; and ordinary judicial usage does not include it within the term "election".

Let us consider certain other specific instances frequently involving litigation and affecting societal action:

(1) If an offer is made by A to B, the latter has a choice between accepting and not accepting. Sometimes he is said to have an "option", but it is not usual to use the term "election". It is clear, however, that the making of the choice may affect the legal relations of the parties. Manifestation of acceptance creates contractual relations and may also even affect "property" interests. Not accepting, however, may take various forms, not all of which would affect the legal relations of the parties. Rejection, one of these forms, would extinguish B's power of acceptance, and thus be itself the exercise of a legal power. A conditional acceptance would extinguish B's power of acceptance and would at the same time create such a power in A. Mere silence, however,—one form of not accepting—would not in itself affect the legal relations of the parties. In case of an offer to him, B has a choice among more than two alternative courses of conduct, some of which will not affect legal relations.⁹

(2) In the case of a contract induced by fraud or a contract with an infant, one of the parties has a choice, specifically pointed out, between disaffirmance and ratification. He may "elect" between them. Disaffirmance will undo such legal relations as the original transaction may have created and will make a subsequent ratification inoperative. Ratification will create legal relations that the original transaction failed to create, and will make a subsequent disaffirmance inoperative. Disregarding other possible alternative courses of conduct, either of these two would be the exercise of a power.¹⁰

(3) A contract may in express terms provide for an election between alternatives by one of the parties. If the promisee has

⁹ Coke put this case: "If I give unto you one of my horses in my stable, there you shall have the election." Quoted in Byrne, *Law Dictionary*. Here the act of election would pass title to the horse chosen. But observe that the donee would be equally privileged to choose none of the horses.

¹⁰ Thus in *Law v. Law* [1905] 1 Ch. 140, 158, the court said: "He deliberately made his election [to ratify], and by that election he is bound." In *Clough v. London & N. W. Ry.* (1871) L. R. 7 Exch. 26, 34, the court said: "the contract continues valid till the party defrauded has determined his election by avoiding it." The same power of "election" exists upon the happening of a condition subsequent. See *Oakes v. Insurance Co.* (1883) 135 Mass. 248, 249.

the choice of two performances by the other party, his notice of election would be a condition precedent to his enforceable right. Like other such conditions, it would be an operative fact that affects legal relations. If it is the promisor who is given the choice between two performances, either performance would operate as a discharge of his duty; but by a definite election of one alternative he would lose his power of discharging his duty by performing the other.¹¹

(4) In leases it is frequently provided that the lessor may re-enter and terminate the lease in case of some specified breach by the lessee. The term "election" is not commonly used in such a case.¹² The re-entry by the lessor (or other specified act of termination) would be the exercise of a power, extinguishing the property interest of the lessee and re-vesting it in the lessor. But a forbearance to re-enter would not have such an effect, and it seems would not change the legal relations of the parties. Probably the term "election" should not be extended to cover such cases, except where the lease clearly gives the choice between terminating the lease and doing an act that would thereafter prevent such termination ("waive" the condition).¹³ Of course, "election" may be, and doubtless has been, used loosely to include a choice between alternatives, one of which is a mere forbearance to change any legal relations. This usage should be disapproved in case an effort at reducing the term to scientific exactness of meaning is to be made. At present such an effort seems to be unnecessary.¹⁴

(5) In the case of a bankrupt tenant, his trustee in bankruptcy may elect to terminate the lease or to continue it as an

¹¹ See Dyer, fol. 18, pl. 104 (1537), putting the case where the lessee might elect between paying the rent in pepper and paying in saffron.

¹² But see Ewart, *Waiver Distributed* (1917) 69: "he has, upon the happening of the breach, a right to elect whether the tenancy is to continue or to end."

¹³ In *Clough v. L. & N. W. Ry.*, *supra* note 10, at 34, the court said: "If with knowledge of the forfeiture, by the receipt of rent or other unequivocal act, he shows his intention to treat the lease as subsisting, he has determined his election forever, and can no longer avoid the lease."

¹⁴ It seems undesirable to say, for example, that a person may "elect" between committing a tort or a crime and not committing it, or between performing a contract and breaking it. Very likely the term "election" should be used only in cases where the person making the choice has the legal privilege of choosing either alternative. This idea was expressed in *Termes de la Ley* as follows: "Election is where a man is left to his own free will to take or do one thing or another, which he pleases." This is repeated in Burrill, *Law Dictionary*; Stroud, *Law Dictionary*; and in *Bierce v. Hutchins* (1907) 205 U. S. 349, 27 Sup. Ct. 524. In this last case, Mr. Justice Holmes further says: "the characteristic fact is that one party has a choice independent of the assent of anyone else. But if a man owns property he has no election to transfer it to another. He cannot make the transfer unless the other assents."

asset of the estate. His choice will depend upon its value as an asset. As in case (4) above, the trustee's manifestation of his election to terminate would revest the property interest in the lessor, and would affect the contractual relations of the parties. His manifestation of an election not to terminate would leave the property interest unaffected, but would destroy the power to terminate.¹⁵

(6) An injured party is frequently said to have an "election" of remedies. In certain tort cases, the injured party may elect between trover and replevin or between trover and indebitatus assumpsit. An unpaid seller of goods may sometimes elect between an action for the price and an action for damages. There has been some conflict as to just what conduct constitutes an "election" in such cases; but there is no doubt that an "election", when held to exist, actually affects the legal relations of the parties, both to each other and to the officers of society. The property interest in a chattel, the right to payment, and the right to judgment are all affected.¹⁶ The choice is between specified alternatives, and the making of the choice affects legal relations irrespective of which one is chosen.

Where a partner was induced by fraud to sell his share in the partnership and the other partners later sold out in exchange for shares of stock that greatly increased in value, the defrauded partner had a choice among many remedies. Some of the possibilities were rescission, trover, replevin, damages, and a decree that the shares of stock should be held in trust.¹⁷

(7) Under some statutes a widow may elect to take either her distributive share, or the homestead for life free of her husband's debts. Her choice of the homestead creates in her specific property rights, and limits the rights of the creditors against the executor to the value of the remaining estate, excluding the homestead. On the other hand, a choice of the distributive share instead of the homestead gives her a definite right against the executor but no property rights in the homestead.¹⁸

There are many more possible examples,¹⁹ but it is believed that these suffice to show that the making of an "election" is generally the exercise of a legal power. The use of the term can be (although perhaps it should not be) extended to include cases where the choice of one or more of the alternatives would not affect legal relations. Wherever the making of an "election" does in fact affect legal relations, we should not hesitate to describe it as

¹⁵ *In re Sherwood, Inc.* (1913, C. C. A. 2d) 210 Fed. 754.

¹⁶ See Corbin, *Waiver of Tort* (1910) 19 YALE LAW JOURNAL, 221, 239.

¹⁷ *Falk v. Hoffman* (1922) 233 N. Y. 199, 135 N. E. 243.

¹⁸ *In re Lund's Estate* (1899) 107 Iowa, 264, 77 N. W. 1048.

¹⁹ See, for further examples, Bigelow, *Estoppel* (5th ed. 1890) ch. 21, "Election"; Bouvier, *Law Dictionary*, "Election."

the exercise of a power, even though the profession may have been accustomed to the word "power" only in certain special cases like "power of appointment" and "power of attorney".

In the *Vanatta* case, the widow by her expression of will materially affected the legal relations of herself, her husband's executor, and her husband's distributee. The fact that this made it the exercise of a power created by Jacob Vanatta's will does not prevent the widow's "election" from being operative as an exercise of power with respect to any assets, even including stocks uninventoried because forgotten or thought to be of no value.²⁰

WHEN DO CONTROVERSIES OVER THE LEGAL OPERATION OF A
STATUTE BECOME JUSTICIABLE?

The recent case of *New Jersey v. Sargent* (1926) 46 Sup. Ct. 122, presents the problem of how the conflicting rights of the State and Federal governments in navigable water courses should best be brought before the court. The State of New Jersey filed an original bill in equity in the United States Supreme Court to obtain a judicial decision as to whether certain parts of the Federal Water Power Act of 1920¹ were unconstitutional. The state's contention was that the sections of the Act giving the Federal government control of the building of dams in navigable streams (through a licensing technique) infringed upon the rights of the state to control watercourses for power purposes.² No evidence was produced to show that the Federal government had issued or was about to issue any license under the Act; or that the state had made any appropriations for the building of dams. A motion to dismiss the bill was granted on the ground that no justiciable controversy was set forth for the court to pass upon.

Under the prevailing procedure in the federal courts, the instant decision is sound, as there seems to be no way in which the court could have taken jurisdiction of the instant case unless

²⁰ Her "election" was clearly the exercise of a legal power, even within the definitions of "power" quoted by the court in the instant case.

¹ 41 Stat. at L. 1063. For a detailed discussion of the scope of the Act see Shields, *The Federal Power Act* (1925) 73 U. PA. L. REV. 142. The Act creates a Federal Power Commission and provides for the improvement of navigation, the development of water power, the use of the public lands thereto, and repeals section 18 of the River and Harbor Appropriation Act of 1917.

² A similar proceeding was started by the State of New York but was not pressed for argument. Later a working construction was reached by conference between the New York Water Commission and the Federal Power Commission. 73 U. PA. L. REV. 142, 156, note 31; Sherman, *Conflicting Federal and State Jurisdiction Over Water Power* (1925) N. Y. S. B. A. 120-131.

it could be brought within the general equity power of the court to enjoin threatened injuries. But the injury threatened seemed too remote to justify invoking this power.³ From a functional viewpoint, however, the situation is decidedly unsatisfactory. As it now stands neither the State nor the Federal government can be certain of its rights and powers without taking some affirmative step under the Act that is in itself wrongful, or that immediately threatens injury; until then there is no justiciable controversy.⁴ If either party should err in judging the scope of the Act, the monetary loss, not to mention the time and effort wasted by legislatures and commissions would be tremendous. Such waste as an incident to determining the constitutionality of an act seems needless in view of the recent developments of the declaratory judgment.⁵ State declaratory judgment statutes have enlarged the scope of "justiciable controversies" thereby enabling parties to know in advance of action upon assumed rights, the legal consequences of their proposed acts.⁶

To obtain a declaratory judgment the court must be satisfied that an actual controversy exists between the parties to the suit.⁷

³ 2 Willoughby, *Constitutional Law* (1910) secs. 739, 744; *Texas v. Interstate Commerce Commission* (1921) 258 U. S. 158, 42 Sup. Ct. 261; *Massachusetts v. Mellon* (1922) 262 U. S. 447, 43 Sup. Ct. 597; *Muskrat v. United States* (1910) 219 U. S. 346, 31 Sup. Ct. 250.

⁴ Mr. Justice Van Devanter (in instant case, 46 Sup. Ct. 122, 125): "But whether they [sections of the Act] are thus invalid cannot be made the subject of judicial inquiry until they are given or are about to be given some practical application and effect. Naturally this will be after they become part of an accepted license, and after some right, privilege, immunity or duty asserted under them becomes the subject of actual controversy." It should be observed that there was in this case an "actual controversy" as to the rights, privileges, powers, and immunities created by the Act of Congress. These are no different in kind from such legal relations created by a "license"; but they pertain to state officers rather than to a private citizen.

⁵ For a list of the nineteen states which now render declaratory judgments, see COMMENTS (1926) 35 YALE LAW JOURNAL, 473, note 1. For an outline of the growth of the movement, see Sunderland, *The Declaratory Judgment* (1917) 16 MICH. L. REV. 69; Borchard, *The Declaratory Judgment—A Needed Procedural Reform* (1918) 28 YALE LAW JOURNAL, 1, 105; COMMENTS (1920) 29 *ibid.* 545; Borchard, *State Legislation on Declaratory Judgments* (1924) 18 AM. POL. SC. REV. 305.

⁶ "Declarations have in recent State cases been successfully sought in the following classes of cases: The construction of wills, trust deeds, statutes and ordinances and the powers of statutory public bodies thereunder; the powers and privileges conferred by corporate charters or by-laws; the construction of contracts, either before or after breach, including leases and the legal relations of the parties thereto; and the trial of claims to the enjoyment of property, real or personal." COMMENTS (1926) 35 YALE LAW JOURNAL, 477.

⁷ " . . . jurisdiction will never be assumed unless the tribunal appealed to is satisfied that an actual controversy, or the ripening seeds of one, exists between parties all of whom are sui juris and before the court,

If one of the parties to the action should do some act which would put an end to the actual controversy, there is nothing left to be decided, and on appeal the case would of course be dismissed.⁹ Nor could the declaratory judgment statute oblige or authorize a declaration of legal relations where the rights of the parties would not be finally decided.⁹ And it follows that where the party suing has no actual interest there would be no more relief for him under a declaratory judgment statute than there is under non-statutory procedure.¹⁰

There is, however, a line of cases,¹¹ exemplified by the instant case, which seem proper for decision under a declaratory judgment act. In the instant case there is an actual controversy in the sense that both the State and the Federal governments claim conflicting interests as regards the management and control of certain watercourses. They are already asserting and denying certain rights, powers, and privileges. There is a potential further and more acrimonious controversy in the sense that certainly in the near future, one of the parties or perhaps both,

and that the declaration sought will be a practical help in ending the controversy. . . ." Von Moschzisker, C. J., in *Petition of Keriker* (1925, Pa.) 131 Atl. 265, 271.

⁸ These are moot cases and of course the result would be the same even though a declaration were sought under a declaratory judgment statute. *San Mateo County v. Southern Pac. Ry.* (1885) 116 U. S. 138 (suit to enjoin collection of a tax; tax having been paid pending appeal); *Singer Co. v. Wright* (1891) 141 U. S. 696 (same); *Dakota Co. v. Glidden* (1882) 113 U. S. 222 (claim compromised pending appeal). And the same result would obtain where the event rendering the cases moot occurs by the mere lapse of time. *Mills v. Green* (1895) 159 U. S. 651, 16 Sup. Ct. 132 (election which was sought to be enjoined held before court heard appeal); *Jones v. Montague* (1904) 194 U. S. 147, 24 Sup. Ct. 611 (same); *Richardson v. McChesney* (1910) 218 U. S. 487, 31 Sup. Ct. 43 (same); *Atherton Mills v. Johnston* (1922) 259 U. S. 13, 42 Sup. Ct. 422 (father sued to enjoin discharge of son, but son was over the age affected by Labor Law before the appeal was heard). It appears that the controversy between the New York Water Commission and the Federal Power Commission had ceased. See note 2, *supra*.

⁹ *Gordon v. United States* (1864) 117 U. S. 697 (final decision lay with Treasury Department and Congress); See *Hayburn's Case* (1792, U. S.) 2 Dall. 409, 411.

¹⁰ *Lord v. Veazie* (1850, U. S.) 8 How. 251 (pending appeal one party to the suit acquired the other's interest); *Cleveland v. Chamberlain* (1861, U. S.) 1 Black, 419 (same); *Wood Paper Co. v. Heft* (1869, U. S.) 8 Wall. 333 (same). Nor could the court render a declaratory judgment where the parties to the suit were not the proper ones. *Cherokee Nation v. Georgia* (1831, U. S.) 5 Pet. 1; *Stearns v. Wood* (1914) 236 U. S. 75, 35 Sup. Ct. 229.

¹¹ *Massachusetts v. Mellon*, *supra* note 3; *Texas v. Interstate Commerce Commission*, *supra* note 3; cf. *Pennsylvania v. West Virginia* (1922) 262 U. S. 553, 43 Sup. Ct. 658 (although the court took jurisdiction in this case there was a strong dissenting opinion by Mr. Justice Brandeis. Had his view prevailed the case would seem a fit one for a declaratory judgment).

will do some act either consistent or inconsistent with the Act. Grave uncertainty involving property interests hangs over both parties. A declaratory judgment of those interests would be binding and final. A declaratory judgment act would therefore save much of the expense and the wasted effort incident to testing constitutionality under present methods. The Federal Act recommended by the American Bar Association should be passed, for although it confers jurisdiction only on the lower federal courts it would in many cases resolve the issue before it became necessary to act upon one's own interpretation of his rights and to incur the expense and loss now incident to the creation of a so-called "justiciable controversy".¹² Such an act would not confer a new kind of jurisdiction, since our courts admittedly have jurisdiction to determine controversies and to prevent wrongs before the injurious act occurs in many cases. It would merely make it unnecessary for an injurious act to be so immediately impending. The difference would be merely one of degree.

THE STATUTORY RESPONSIBILITY OF DIRECTORS FOR PAYMENT OF DIVIDENDS OUT OF CAPITAL

There are statutes in practically every state¹ which make unlawful the payment of dividends out of capital;² and directors who violate them are made jointly and individually responsible to the creditors of the corporation to the extent of the dividend,³ or for the debts of the corporation,⁴ or for the loss caused by such declaration.⁵ Some make the directors responsible to the corporation as well,⁶ and others make such act a misdemeanor.⁷ But whether the responsibility thus imposed is absolute, irrespective of fault, or whether it is dependent on bad faith or negligence is a question upon which most of the statutes are silent; and since clear cut holdings on this precise point are rare, a review of this important problem seems warranted.

It was well settled at common law that directors who acted in good faith and without negligence were not responsible for

¹² The American Bar Association has urged the passage of a Federal Declaratory Judgment Act at recent meetings. See (1922) 8 A. B. A. JOUR. 554.

¹ See *infra* notes 22, 23, 24, 25.

² For the meaning of "capital", and "surplus profits" in this connection see Clark, *Corporations* (3d ed. 1916) 422 *et seq*; 2 Cook, *Corporations* (8th ed. 1923) 1896 *et seq*; NOTES (1919) 7 CALIF. L. REV. 183; *Paying Dividends out of Capital* (1908) 44 CAN. L. JOURN. 94.

³ E.g. Massachusetts, *infra* note 24; Idaho, *infra* note 25.

⁴ E.g. Colorado, *infra* note 23; Oregon, *infra* note 22.

⁵ E.g. New Jersey, *infra* note 22; New York, *infra* note 25.

⁶ E.g. New York and California, *infra* note 25; Ohio, *infra* note 24.

⁷ E.g. New York, Cahill's Cons. Laws, 1923, ch. 41, sec. 664; Connecticut and Maine, *infra* note 24.

losses which resulted from their acts,⁸ although there was much confusion over the degree of care which should be required of them in the performance of their duties.⁹ Some courts have held them responsible only for fraud or for negligence which was so gross as to amount to fraud;¹⁰ and directors have, therefore, been excused for bona-fide errors of judgment, no matter how reckless and absurd they might appear when measured by the standards of ordinary business prudence. Other courts have adopted the more stringent standard of requiring the director to use such care and prudence as business men generally exercise in managing their own affairs.¹¹ Still other decisions have taken the intermediate position of requiring the same degree of care as a reasonably prudent man would use under the same circumstances.¹² These same tests of general responsibility were apparently invoked when actions were brought against directors for a wrongful declaration of dividends. Where they were guilty of fraud or were negligent, the directors were held accountable;¹³ but where these elements were lacking they were absolved from responsibility.¹⁴

In England,¹⁵ the situation was dealt with by the Companies Act of 1862, which provided that "no dividend shall be payable except out of profits"¹⁶ and which empowered the court in wind-

⁸ Clark, *op. cit. supra* note 2, at 646; 3 Cook, *op. cit. supra* note 2, at 2855 *et seq.*; 2 Thompson, *Corporations* (1895) 2997; 2 Lindley, *Companies* (6th ed. 1902) 523; 2 Morawetz, *Private Corporations* (2d ed. 1866) 528; *Godbold v. Branch Bank* (1847) 11 Ala. (N.S.) 191; *Spering's Appeal* (1872) 71 Pa. 11; *Hodges v. New England Screw Co.* (1850) 1 R. I. 312; *Scott v. Depeyster* (1832, N. Y.) 1 Edw. Ch. 513; *Watt's Appeal* (1875) 78 Pa. 370; *Booth v. Dexter Steam Fire Engine Co.* (1897) 118 Ala. 369, 24 So. 405.

⁹ Dwight, *Liability of Corporate Directors* (1907) 17 YALE LAW JOURNAL, 33.

¹⁰ *Spering's Appeal*, *supra* note 8.

¹¹ *Hun v. Cary* (1880) 82 N. Y. 65; *Hanna v. Lyon* (1904) 179 N. Y. 107, 71 N. E. 778; *General Rubber Co. v. Benedict* (1915) 215 N. Y. 18, 109 N. E. 96; *Horn Silver Mining Co. v. Ryan* (1889) 42 Minn. 196, 44 N. W. 56; *Shea v. Mabry* (1878, Tenn.) 1 Lea, 319; See 3 Thompson, *op. cit. supra* note 8, at 3000.

¹² See *Stone v. Rottman* (1904) 183 Mo. 552, 573, 82 S. W. 76, 82; *Carrington v. Basshor Co.* (1912) 118 Md. 419, 84 Atl. 746; *Briggs v. Spaulding* (1891) 141 U. S. 132, 11 Sup. Ct. 924; see 1 Morawetz, *op. cit. supra* note 8, at 527.

¹³ *Gratz v. Redd* (1843, Ky.) 4 B. Mon. 178 (here the directors paid dividends before paying interest on borrowed money, knowing that there weren't sufficient funds.)

¹⁴ Cf. *Lexington and Ohio Ry. v. Bridges* (1847, Ky.) 7 B. Mon. 556. In *Blythe v. Enslin* (1923) 209 Ala. 96, 95 So. 479, where no statute was mentioned, the court held that when the dividend was declared because of bad judgment and not bad faith, the directors were not responsible.

¹⁵ For a general discussion of the English cases, see 1 Lindley, *op. cit. supra* note 8, at 523 *et seq.*, 603 *et seq.*; *Paying Dividends out of Capital*, *supra* note 2.

ing-up proceedings to compel a director who had been "guilty of any misfeasance or breach of trust in relation to the company" to repay misapplied funds.¹⁷ Under this and subsequent similar acts, directors were held responsible when dividends were knowingly,¹⁸ or negligently¹⁹ declared out of capital, but not when the directors had used reasonable care in such payments.²⁰

In America, some of the statutes clearly indicate that an absolute responsibility was not intended, but others are most obscure; and there have been relatively few cases interpreting them. In spite of the differences in the wording of these statutes, a classification into four general groups is possible. The statutory responsibility may be imposed:²¹ (1) upon directors who "knowingly" declare and pay such dividends;²² (2) upon directors "assenting to" them;²³ (3) upon directors who "vote for" or "declare" them;²⁴ (4) upon directors "under whose administration" such dividends are declared.²⁵

¹⁶ (1862) 25 & 26 Vict., ch. 89, Table A, rule 73.

¹⁷ (1862) 25 & 26 Vict., ch. 89, sec. 165.

¹⁸ *Re National Funds Assurance Co.* (1878) 10 Ch. Div. 118; *Flitcroft's Case* (1882) 21 Ch. Div. 519.

¹⁹ *Leeds Estate Building Co. v. Shepherd* (1887) 36 Ch. Div. 787; *Re Oxford Building Society* (1886) 35 Ch. Div. 502.

²⁰ *Stringer's Case* (1869) L. R. 4 Ch. 475 (bad debts owed by the Confederacy were included as assets); *Re London and General Bank* (1894, Ch.) 72 L. T. R. 227 (under a similar section in the Winding Up Act of 1890, ch. 63, sec. 10); *Dovey v. Cory* [1901, H. L.] A. C. 477; *Prefontaine v. Grenier* [1907, P. C.] A. C. 101.

²¹ Practically all the statutes provide that a director who causes his dissent to be entered on the records of the corporation shall be absolved.

²² Ark. Crawford and Moses Digest, 1921, ch. 38, sec. 1729; Del. Rev. Code, 1915, ch. 65, sec. 1949 ("wilful or negligent violation"); Fla. Rev. Gen. Sts. 1920, Div. 4, Tit. 3, sec. 4119 ("knowingly"); Kan. Rev. Sts. 1923, ch. 17, sec. 609; Iowa, Comp. Code, 1919, Tit. 17, ch. 1, sec. 5352 ("knowingly consenting"); Mich. Comp. Laws (Cahill) 1922, ch. 173, sec. 9053, sub. sec. 70; Mo. Rev. Sts. 1919, ch. 90, Art. 1, sec. 9761; N. J. Comp. Sts. 1911, Corporations, sec. 30, p. 1617 ("wilful or negligent"); Or. Gen. Laws, 1920, Tit. 34, ch. 3, sec. 6873; R. I. Gen. Laws, 1923, Tit. 24, ch. 248, sec. 3506 ("intentional or negligent"); Tex. Sayle's Civ. Sts. 1914, Tit. 25, ch. 8, art. 1200; Va. Gen. Laws, 1923, Tit. 34, ch. 147, sec. 3840; Wis. Sts. 1921, ch. 85, sec. 1765 ("if directors acted not having reason to believe there were sufficient net profits"). In Victoria, Australia, Companies Act, 1915, sec. 277 a director who "wilfully" pays dividends out of what he knows is not profits is made responsible to the creditors and is liable to a criminal punishment.

²³ Colo. Comp. Laws, 1921, ch. 38, sec. 2270, subsec. 33; Ill. Rev. Sts. 1921, ch. 32, sec. 23; Miss. 2 Hemmingway's Code, 1917, sec. 4097; Vt. Gen. Laws, 1917, ch. 210, sec. 4939.

²⁴ Ky. Carroll's Sts. 1915, ch. 32, sec. 548; Me. Rev. Sts. 1916, ch. 51, sec. 34; Md. Bagby's Code, 1924, Art. 23, sec. 87; Mass. Gen. Laws, 1921, ch. 156, sec. 37, ch. 158, sec. 44; N. H. Pub. Sts. 1901, ch. 150, secs. 3, 5; Ohio, Page's Ann. Code, 1926, secs. 8724, 8728; Pa. Sts. 1920, secs. 5974, 5975; Conn. Gen. Sts. 1918, ch. 188, sec. 3423.

²⁵ N. Mex. Code, 1915, ch. 23, sec. 918; N. Y. Cahill's Cons. Laws.

The statutes of the first group make knowledge that the dividend is not being paid out of profits or surplus a condition precedent to the responsibility of the director,²⁵ and hence the problem of responsibility without fault does not arise in these states. "Assenting to" in the second group presents more difficulties, for it is not clear just what the legislatures meant to require; but a provision of this kind has been interpreted as requiring knowledge on the part of the directors (or gross negligence in failing to discover) that they are declaring dividends out of capital.²⁷ A later Federal case went even further, holding that mere negligence was not sufficient.²⁸

The real difficulty of construction, however, arises when statutes of the last two groups are involved, for their language offers no indication at all as to whether the legislatures meant to codify the common law rule or to lay down a new rule of absolute responsibility. In construing a statute of the last group, a California court in a strong dictum declared that it was not a mere restatement of the common law rule, but that it imposed a responsibility irrespective of the good faith and diligence of the director.²⁹ There, however, the facts indicated a clear case of negligence.³⁰ A similar statute was construed much more liber-

1923, ch. 60, sec. 58; N. C. Cons. Sts. 1919, ch. 22, sec. 1179; N. D. Comp. Laws, 1913, sec. 4543, 4544; Wash. Comp. Sts. 1922, Tit. 25, sec. 3823; Calif. Civ. Code, 1923, sec. 309; Nev. Rev. Laws, 1921, sec. 1169, sub. sec. 68; Mont. Rev. Codes, 1921, Civ. Code Part 3, ch. 4, sec. 5939; Idaho, Comp. Sts. 1919, ch. 186, sec. 4715; Okla. Comp. Sts. 1921, ch. 34, sec. 5336.

²⁵ *Parsons v. Rinard Grain Co.* (1919) 186 Iowa, 1017, 173 N. W. 276. Here the statute held the directors for "knowingly consenting" to excessive indebtedness, and the court said "actual knowledge is required . . . that which might have been obtained by due care is not enough."

²⁷ *Chick v. Fuller* (1902, C. C. A. 7th) 114 Fed. 22. Here the president, who was the active manager of the corporation, had deceitfully swindled it by embezzling the proceeds of the goods sold and by falsifying the books. The directors relying on correctness of the books declared a dividend when in fact there were no profits. The court held that inasmuch as there was nothing to show that the directors had any reason to suspect the president's integrity, and as men of ordinary prudence would not have discovered the fraud, they were not responsible. The Circuit Court of Appeals here did not expressly mention the Illinois statute; but it affirmed the holding of the lower court which based its decision upon it.

²⁸ *White-Wilson-Drew Co. v. Lyon-Ratcliff Co.* (1920, C. C. A. 7th) 268 Fed. 525; see also *Patterson v. Minnesota Mfg. Co.* (1839) 41 Minn. 84, 93, 42 N. W. 926, 929; *Lewis v. Montgomery* (1893) 145 Ill. App. 30, 48, 33 N. E. 880, 884.

²⁹ See *Southern Calif. Home Builders v. Young* (1920) 45 Calif. App. 679, 691, 188 Pac. 586, 592.

³⁰ Although the defendants contended that they relied on statements prepared for them, the court said that it was inconceivable that they could have exercised ordinary prudence in failing to detect an overvaluation of assets of more than a half million dollars. The court intimated that in cases of exceptional circumstances such as presented in *Chick v. Fuller*,

ally by a Federal court which said ". . . directors who had in good faith declared and paid a dividend on the reasonable assumption of there being surplus earnings to be distributed . . . would not be within the provisions of the statute."³¹ The early New York decisions seem to favor the honest director, one case holding that while the plaintiff need not allege that the director knowingly declared the dividend out of capital, if the latter sets up and proves due care he is not responsible.³² Likewise, in a later case,³³ the court said that where there was no fraud in the transaction and no question of negligence was raised by the pleadings, the directors should not be held. But in *Wesp v. Muckle*,³⁴ while the real question at issue was whether the books of the corporation were admissible as evidence, the court suggested *obiter* that the statute imposed a more stringent rule of responsibility not conditioned upon good faith and diligence. In that case, however, as in the California case, the directors had obviously been negligent;³⁵ hence, it is conjectural whether the New York courts would hold a director where the elements of mala fides and negligence were entirely lacking.

The nature of the responsibility imposed by these statutes is a factor which should influence their interpretation. The treatise writers³⁶ and many courts³⁷ regard them as penal; and hence, as

supra note 27, good faith and diligence would be a defense.

³¹ See *United States Smelting Co. v. Hofkin* (1917, E. D. Pa.) 245 Fed. 896, 898; cf. *United States Smelting Co. v. Hofkin* (1919, E. D. Pa.) 261 Fed. 546, *rev'd* in (1920, C. C. A. 3d) 266 Fed. 679. In *Moore v. Murchison* (1915, C. C. A. 4th) 226 Fed. 679, 681, the court said, "It is well settled that when directors declare a dividend in good faith and without negligence, they are not to be held liable merely because the dividend turns out to have impaired capital stock", citing *Briggs v. Spaulding*, *supra* note 12; *Chick v. Fuller*, *supra* note 27.

³² *Gaffney v. Colvill* (1844, N. Y.) 6 Hill, 567. In *Scott v. Depeyster*, *supra* note 8, the court held that directors are not personally responsible to stockholders unless there has been fraud or negligence. Where the directors were negligently ignorant of the facts which it was their duty to know they were not excused. See *Osgood v. Laytin* (1867, N. Y.) 3 Keyes, 521, 523.

³³ *Excelsior Petroleum Co. v. Lacey* (1875) 63 N. Y. 422. This case has been cited for the proposition that good faith plus due care is a defense under such statutes. 2 Morawetz, *op. cit. supra* note 8, at 533; 2 Clark and Marshall, *Private Corporations* (1903) 1639. In fact, however, this case was decided on common law grounds, as the action was brought under a statute which was not applicable to the case.

³⁴ (1910, 4th Dept.) 136 App. Div. 241, 120 N. Y. Supp. 976.

³⁵ The assets were appraised at \$70,000 when the dividend was paid. Six months later the property was sold for \$9,000. Such a glaring inflation could not have been made if ordinary care and prudence had been used.

³⁶ 3 Thompson, *op. cit. supra* note 8, at 3155; Clark, *op. cit. supra*, note 2, at 755; 2 Cook, *op. cit. supra* note 2, at 1933.

³⁷ See *Rorke v. Thomas* (1874) 56 N. Y. 559, 564; *Bruce v. Platt* (1880)

is true in the case of all penal statutes, where there is any doubt as to their construction, such doubt should be resolved in favor of the defendant. Here, there is indeed a great doubt as to whether an insurer's responsibility was intended. Courts which refuse to call these statutes penal do, nevertheless, say that they are to be construed strictly in favor of the defendant.³³ What seems to be the proper rule of construction was applied by a Georgia court³⁹ in a case involving a statute making it a misdemeanor to declare dividends out of capital. The court said, "The code section in question does not contain an express provision relieving a president or director from criminal liability when he declares a dividend in good faith believing that the bank has earned it, yet it seems to be the correct view that such an exception exists by implication. . . ." This rule, it is believed, although enunciated in relation to a criminal statute, should be applied to civil statutes covering the same acts.

In order that the modern commercial and industrial machine which has so emphatically adopted the corporate form may function to its maximum efficiency, it is indeed necessary that the best business men be retained as directors. To construe these statutes as placing on directors a responsibility for non-negligent, non-fraudulent acts would render the risk of accepting such offices almost prohibitive. The problem was aptly described by an English judge,⁴⁰ "One must be very careful . . . not to press so hardly on honest directors as to make them liable for these constructive defaults, the only effect of which would be to deter all men of any property, and perhaps all men who have any character to lose from becoming directors of companies at all. On the one hand, I think the Court should do its utmost to bring fraudulent directors to account, and on the other hand, should also do its best to allow honest men to act reasonably as directors."

80 N. Y. 379, 381 (statutory responsibility for failing to file report); *Patterson v. Thompson* (1898, C. C. D. Or.) 86 Fed. 85; *Patterson v. Wade* (1902, C. C. A. 9th) 115 Fed. 770; *Continental Oil Co. v. Montana Concrete Co.* (1922) 63 Mont. 223, 207 Pac. 116; *Patterson v. Minnesota Mfg. Co.*, *supra* note 28; *White-Wilson-Drew Co. v. Lyon-Ratcliff Co.*, *supra* note 28

³⁸ *Parsons v. Rinard Grain Co.*, *supra* note 26; *Lewis v. Montgomery*, *supra* note 28.

³⁹ *Cabaniss v. State* (1910) 8 Ga. App. 129, 68 S. E. 849. In a later case under this statute the court held that where the director was present when the dividend was declared the burden was on him to show that he did not know the financial condition of the bank. *Mangham v. State* (1912) 11 Ga. App. 440, 75 S. E. 508.

⁴⁰ Sir George Jessel in *Re Forest of Dean Coal Mining Co.* (1878) 10 Ch. Div. 450, 451.