NOTES

COMPULSORY RESALE PRICE MAINTENANCE IN LIQUOR:
A NEW YORK EXPERIMENT IN CONTROLLED
COMPETITION*

Periodic price wars among producers of liquor, together with the unique status of that commodity under the Federal Constitution, have resulted in bold experiments in price stabilization. Permissive resale price maintenance, with its reliance upon enforcement by private parties, has not proved a complete answer to the problem presented by allegedly ruinous price competition. As a result, several states have adopted compulsory resale price maintenance in liquor.


2. Resale price maintenance as now practiced in intrastate commerce in 44 states of the United States and in interstate commerce...is a system of pricing a trademarked, branded, or otherwise identified product for resale...[P]ursuant to [fair trade] laws legalizing such arrangements, the manufacturer...prescribes by contract the minimum price at which such product may be sold at wholesale or at "retail in a specified state, or in a specified portion thereof, with the effect of legally binding all other distributors in the specified area to conform to such price. This is done by entering into a contract with at least one such distributor of such product and serving proper notice upon all other distributors who are thereupon obligated to maintain the minimum price named in the contract." FTC, REPORT ON RESALE PRICE MAINTENANCE 4-5 (1945). For background and commentary on permissive resale price maintenance under the fair trade acts, see I Callman, UNFAIR COMPETITION AND TRADEMARKS c. 6 (1945); Grether, Price Control Under Fair Trade Legislation (1939); NATIONAL WHOLESALE DRUGGISTS' ASS'N, THE BASIS AND DEVELOPMENT OF FAIR TRADE (1946); Norwood, Trade Practice and Price Law c. 18 (1938); Seligman and Love, Price Cutting and Price Maintenance (1932); Weigel, THE FAIR TRADE ACTS (1938); Zorn and Feldman, BUSINESS UNDER THE NEW PRICE LAWS 275-316 (1937); McLaughlin, Fair Trade Acts, 86 U. of Pa. L. Rev. 803 (1938); Comment, 45 Yale L. J. 672 (1936); Legis., 36 Col. L. Rev. 293 (1936); Note, 52 Harv. L. Rev. 284 (1938). For comparison of United States with foreign experience, see Wolff and Holthausen, Fair Trade Effects in the Liquor, Tobacco, Gasoline and Drug Trades, Trade Regulation, Fall, 1938, pp. 7-8.

3. Under traditional permissive resale price maintenance legislation, the practice has been to rely upon suit for injunction or damages by the manufacturer or by a competing dealer to prevent retailer violation of the minimum price. Although the manufacturer is not required to proceed at law against every violator, he has been said to be under a duty to make a sincere effort to prevent price-cutting. Calvert Distillers Corp. v. Nussbaum Liquor Store, Inc., 166 Misc. 342, 2 N.Y.S.2d 320 (Sup. Ct. 1938); National Distillers Products Corp. v. Columbus Circle Liquor Stores, 166 Misc. 719, 2 N.Y.S.2d 319 (Sup. Ct. 1938). But the possibility of alienating retail outlets, together with an in-
maintenance, with enforcement by public officials. Typical of these programs is the liquor fair trade amendment recently adopted by New York,

interest in getting prices back to a competitive level with private brands not covered by fair trade acts, have proved effective deterrents to enforcement by manufacturers. See Business Week, Nov. 9, 1940, pp. 39-40. And the expense and delay of litigation have made suits by competing retailers a rarity. Thus, despite the fact that the liquor industry is heavily covered by fair trade, price wars have been frequent. See Edwards, New Alcoholic Beverage Control Laws, 17 N.Y.S.B.A. Bull. 196, 200 (1945); Notes, 8 U. of Chi. L. Rev. 745, 747 n.16 (1941), 6 U. of Newark L. Rev. 257, 264 (1941); N.Y.S. Liquor Authority, Release No. 1524, Aug. 21, 1944.

4. Fourteen states have written mandatory fair trade provisions of some sort into their liquor control laws, some by specific statutory enactment, others by administrative regulations: Arizona, Arkansas, California, Georgia, Idaho, Illinois, Indiana, Kentucky, Minnesota, New Jersey, New York, Oregon, South Carolina.

For a summary of the provisions in these states, see 2 CCH TRADE REG. SERV. §7375 (1947); de Ganahl, supra note 1, at 680-5. There has been a dearth of comment on these provisions in legal periodicals. Where comment has been discovered, however, mandatory resale price maintenance in liquor has been described as "a scheme of doubtful validity which departs from the usual voluntary character of fair trade contracts . . ." Carp, Resale Price Control Under State Fair Trade Acts, 28 CALIF. L. REV. 477, 481 (1940); see also de Ganahl, supra note 1, at 680.

5. In 1945, the legislature amended §17 of the New York Alcoholic Beverage Control Law to give the State Liquor Authority power:

"12. To adopt rules and regulations, in its discretion, (a) prohibiting or regulating the sale of alcoholic beverages in violation of the provisions of a fair trade contract entered into pursuant to article twenty-four-a of the general business law; (b) prohibiting the sale of any or all alcoholic beverages, other than items offered for sale under a brand which is owned exclusively by one retailer and sold within the state by such retailer, except pursuant to a fair trade contract entered into in accordance with the provisions of article twenty-four-a of the general business law. Such rules and regulations shall be calculated to foster and promote temperance, and provide for the orderly distribution of alcoholic beverages. For the violation of any rule or regulation duly promulgated under this subdivision, the authority may suspend, cancel or revoke a license as follows: for a first offense, not exceeding ten days suspension of license; for a second offense; not exceeding thirty days suspension of license; and for a third offense, the authority may suspend, cancel or revoke the license (N.Y.L. 1945, c. 687)."

At that time Chairman O'Connell of the State Liquor Authority stated that only if unsettled conditions within the industry made the promulgation of rules necessary would the statute be given teeth. N.Y.S. Liquor Authority, Release No. 1573, April 26, 1945. In June of 1947, surveys made by the State Liquor Authority revealed the existence of conditions similar to those which had preceded former price-war eras. As a result, Rule 26 was issued. The provisions of the Rule were said to be in accord with the views of the overwhelming majority of the industry's representatives to whom it was submitted for review before promulgation. N.Y.S. Liquor Authority, Release No. 1722, p. 3, June 11, 1947. Alcoholic beverages under Rule 26 include liquors and wines but not beer or cider. Also excluded are private brands (those owned exclusively by one retailer and sold within the state by such retailer) and sales by a court officer. The minimum consumer resale prices provided in the fair trade contract are required to be uniform throughout the state.

§5 specifies the three situations in which written permission to sell at less than the minimum resale price fixed in the fair trade contract will be granted; (a) where the licensee possessed the brand before the fair trade contract governing it was executed; (b) where the licensee is closing out his stock for the purpose of discontinuing the sale
which requires every manufacturer of a trademark-bearing liquor to enter into a so-called fair trade contract establishing the minimum resale price for his product. Filing of the contract with the State Liquor Authority results in that agency's automatic acceptance and enforcement of the price against all distributors, including those not party to the contract, the penalty for non-compliance being suspension or revocation of license. The New York plan, which offers another indication that resale price maintenance may be evolving from manufacturers' privilege with legislative sanction towards compulsory contracting at the behest of an administrative agency, raises serious problems of economic policy and peculiar problems of constitutional validity.

Any charge that the New York law is invalid under the Federal Constitution is countered by reference to the preferred position occupied by liquor under the Constitution as a result of the interpretation given to the Twenty-first Amendment, which provides that

"The transportation or importation into any State, Territory, or possession of the United States for delivery or use therein of intoxicating liquors, in violation of the laws thereof, is hereby prohibited." 8

Though dicta alone have asserted the inapplicability of the due process clause to state liquor regulation, it has been a relatively settled doctrine of such product; (c) where the liquors are damaged and notice thereof is given to the public. In all of these situations, the licensee must first give the brand-owner the opportunity to repurchase the stock at the original invoice price.

6. See pp. 467, 469 and note 33 infra.

7. The penalties prescribed in Rule 26 are exactly the same as those specified in the statute. See note 5 supra.

8. U. S. Const. Amend. XXI §2. For discussion, see Carr, Liquor and the Constitution, 7 Law & Contemp. Probs. 709 (1940); de Ganahl, The Scope of Federal Power Over Alcoholic Beverages Since the Twenty-first Amendment, 3 Geo. Wash. L. Rev. 819, 875 (1940); Hutchinson, The Alcoholic Beverage Control Administration of the State Board of Equalization, 20 Calif. S.B.A.J. 59 (1945); Legis., 38 Col. L. Rev. 644 (1938); Wright, The Growth of American Constitutional Law 2 (1942) (of the amendments "two, the Eighteenth and Twenty-first... cancel out and leave the Constitution where it was before the Eighteenth was adopted.").

9. See Indianapolis Brewing Co. v. Liquor Control Comm., 305 U.S. 391, 394 (1939) (commerce clause and equal protection clause held inapplicable to state liquor regulation and hint that the due process clause of the 14th Amendment also may no longer be a check); Finch & Co. v. McKittrick, 305 U.S. 395 (1939); cf. Ziffrin, Inc. v. Reeves, 308 U.S. 132 (1939), 53 Harv. L. Rev. 671 (1940).

If due process were held to be a limitation on state liquor regulation, it would be possible to fashion an argument that the compulsory contracting requirement of the New York act interferes with whatever remnant of "freedom of contract" still is protected by the due process clause. And this contention could be reinforced by the doctrine of "unconstitutional conditions." See Merrill, Unconstitutional Conditions, 77 U. of Pa. L. Rev. 879 (1929). But it seems highly doubtful that the present Supreme Court would be impressed with this argument, particularly since it relates to a state statute regulating economic affairs.
that state power to regulate the liquor traffic under the Twenty-first Amend-
ment is so broad that it may be exercised without regard for the equal pro-
tection clause\textsuperscript{10} or the interstate commerce clause.\textsuperscript{11} There are recent indica-
tions, however, that the immunity is not so great as the early decisions au-
gured.\textsuperscript{12} Mr. Justice Black, in \textit{United States v. Frankfort Distilleries},\textsuperscript{13} re-

\textsuperscript{10} Mahoney v. Joseph Triner Corp., 304 U.S. 401 (1938) (Twenty-first Amendment
enables state to discriminate as to what liquors it will permit to be imported without
concern for the equal protection clause); \textit{accord}, Indianapolis Brewing Co. v. Liquor
clearly "affected with a public interest," there is little doubt that selection of the liquor
industry for special treatment would be construed as a reasonable classification. An
argument of violation of "equal protection" could conceivably be rooted in the discrimina-
tion between trademarked liquors which are covered by the program and private brands
which are exempted. But apparently, the legislature felt that the evil to be combated was
the use of highly advertised brands as loss leaders and so a distinction between the
trademarked and private brands could be justified.

\textsuperscript{11} State Board of Equalization v. Young's Market Co., 299 U.S. 59 (1936), 37 \textit{Col.
L. Rev.} 307 (1937), 50 \textit{Harv. L. Rev.} 353 (1936) (interstate commerce clause no restric-
tion on state liquor regulation). The reasoning used by the Court was that if a
state may prohibit the importation of liquor entirely under the Twenty-first Amendment,
it may \textit{a fortiori} exact a higher license fee from dealers who import beer from other states
than from those who use domestic beer. \textit{Accord}: Indianapolis Brewing Co. v. Liquor
604 (S.D. Cal. 1937). See also Note, 110 \textit{A.L.R.} 931, 951-5 (1937). In the \textit{Young's
Market} case, the Court said that the question for decision in the case required "no . . .
generalization" that the states, in the field of liquor regulation, had been freed from the
restrictions of other portions of the Constitution. State Board of Equalization v. Young's
Market Co., \textit{supra} at 64.

\textsuperscript{12} These signs of a reversal of trend may be glimpsed in several cases dealing with
the conflict between the Twenty-first Amendment and other Constitutional provisions.
\textit{See}, e.g., \textit{Carter v. Virginia}, 321 U.S. 131 (1944) (state regulation of interstate trans-
portation of liquor through the state is valid independent of the Twenty-first Amend-
ment, in the absence of conflicting federal regulation). Mr. Justice Black, concurring
at 138, said that state liquor regulation should not be invalidated except where a valid
federal statute is contravened, thus paring away at the absolute immunity. \textit{Ziffrin,
Inc. v. Reeves}, 308 U.S. 132, 138 (1939) (dictum that state may protect her people
against evil incident to intoxicants and may exercise "large discretion" as to means
employed. Analysis of the legislation in terms of reasonableness indicates that judicial
review remains to determine the extent of the discretion permitted); \textit{Dowling Bros.
143 F.2d 453 (C.C.A. 6th 1944) (war power not limited by Twenty-first Amendment);
\textit{Jameson & Co. v. Morgenthau}, 307 U.S. 171 (1939) (Twenty-first Amendment does not
affect Congress right to regulate liquor imports from abroad).

\textsuperscript{13} 324 U.S. 293 (1945) (coercion by combinations of businessmen seeking to force
others into making fair trade contracts violated the Sherman Act; horizontal, not vertical,
price-fixing in issue). Justice Frankfurter, concurring, said that the Twenty-first Amend-
ment reversed the traditional legal situation by subordinating the commerce clause to the
power of a state to control the liquor traffic within its borders. " . . . the Sherman Law,
deriving its authority from the commerce clause, can have no greater potency than the
commerce clause itself." Only if the state does not act at all will the operation of the com-
merce clause continue. \textit{Id.} at 300-1. See Note, 55 \textit{Yale L. J.} 815 (1946).
served decision on the broad question of the interstate commerce clause versus the Twenty-first Amendment, but did say that the Amendment did not confer plenary and exclusive power to regulate the interstate liquor traffic. These symptoms of a possible change in the Court’s attitude towards the Amendment, together with its known antipathy to legislation which may stifle competition, may well portend a reexamination of “settled doctrine” if mandatory fair trade is tested.

Any such reexamination would presumably be based upon a consideration of the history of the Amendment, which points only to the intention to protect “dry” states against “wet” encroachment. To accord with this purpose, a redefinition of the “immunity doctrine” would permit untrammeled state regulation of liquor only when it sought to promote temperance by acting upon “transportation or importation” into a state. A pertinent query would then be whether New York’s liquor fair trade amendment, with its regulation of the pricing practices in the industry, is closely enough related to the promotion of temperance to be clothed with the immunity flowing from the Twenty-first Amendment. A critical examination of this

16. Carp, supra note 4, at 481 n.21c, in the course of discussing mandatory fair trade in liquor in California, expresses some doubt as to whether such regulations will ever be challenged in the courts. His doubt arises from the fact that about two hundred representatives of the California liquor industry attended a public hearing and voiced no opposition to the regulation.
17. An historical interpretation of the Amendment as well as its legislative history would indicate that it was an enactment into the Constitution of the Webb-Kenyon Act, 37 STAT. 699 (1913), 27 U.S.C. §122 (1940), and therefore, was not intended to and did not withdraw the other constitutional guaranties just as they were not withdrawn under the Webb-Kenyon Act. See 76 Cong. Rec., especially at 4140-1, 4170-3 (1933) and 4146-47; Carr, supra note 8, at 709-11; de Ganahl, The Scope of Federal Power Over Alcoholic Beverages Since the Twenty-first Amendment, 8 GEO. WASH. L. REV. 819-23 (1940); 37 COL. L. REV. 307 (1937); 50 HARV. L. REV. 333 (1936).
18. See de Ganahl, The Scope of Federal Power Over Alcoholic Beverages Since the Twenty-first Amendment, 8 GEO. WASH. L. REV. 875, 895 (1940). Note, 55 YALE L. J. 815, 816-8 (1946), suggests that state liquor legislation should be permitted to escape the commerce clause and other constitutional limits only when it is a valid exercise of the police power. Thus, “laws” in §2 of the Twenty-first Amendment would be modified by “proper”. See also Legis., 38 COL. L. REV. 644, 658 (1938).
19. It might conceivably be argued that the higher prices which, according to opponents, will result from mandatory fair trade in liquor will promote temperance by eliminating lower-income groups from the market. But proponents of the measure have avoided recourse to such an argument which rests on discrimination against the less-monied and on promotion of liquor-sellers’ profits as well as temperance. Rather has the measure been defended as an aid to removal of disorderly competition which, it is claimed, stimulates an unwholesome atmosphere in the industry and so encourages intemperance.
relationship could easily yield the conclusion that state enforcement of a price fixed by a manufacturer enjoys no absolute immunity from the Constitution and federal statutes.

Thus viewed, compulsory resale price maintenance in liquor must be tested against the language of the Sherman Act. Resale price maintenance, even in its permissive phase, has long been held to be a restraint on trade in interstate commerce and therefore to violate both the letter and the spirit of the anti-trust laws. Only with the passage of enabling legislation, the Miller-Tydings amendment to the Sherman Act, was the taint of illegality removed from the price-fixing combinations permitted by state fair trade. The sole purpose of this enabling act was to permit the movement in interstate commerce of commodities which bore fair trade prices authorized by the permissive type of statute then current. As a result, in considering this amendment to the anti-trust law, Congress was not confronted with the issue of state-imposed and state-enforced resale price maintenance, and any conclusions about its probable attitude are necessarily speculative. In searching for the elusive legislative intent, the broad wording of the Miller-Tydings Act may be construed to include any type of resale price main-

20. Before the Sherman Act, resale price maintenance, in its original meaning as the minimum resale price set by a manufacturer in a contract with a single retailer and binding only upon that retailer, was permissible. See 1 CALLMAN, op. cit. supra note 2, at 359; SELIGMAN AND LOVE, op. cit. supra note 2, c. 2; Doubleday, Doran and Co. v. R. H. Macy and Co., 269 N.Y. 272, 282, 199 N.E. 409, 411 (1936). But with the advent of anti-trust legislation, it was held in Dr. Miles Medical Co. v. John D. Parks and Sons Co., 220 U.S. 373 (1911), that a manufacturer of unpatented articles may not, in the absence of statutory right, fix prices for future sales by independent dealers. Accord; United States v. Bausch & Lomb Co., 321 U.S. 707 (1944); FTC v. Beech-Nut Packing Co., 257 U.S. 707 (1944); United States v. Schrader's Son, Inc., 252 U.S. 85 (1920); United States v. Colgate and Co., 250 U.S. 300 (1919). The decisions reflected the faith of the Sherman Act in a freely competitive price. See also Burns, supra note 15; McLaughlin, supra note 2, at 822 ("... Fair Trade laws are definitely inconsistent with the theory and spirit of the anti-trust laws"); Zlinkoff, supra note 15.

21. 50 STAT. 693 (1937); 15 U.S.C. § 1 (1940) (like almost all state fair trade acts, the Miller-Tydings Act permits only vertical resale price agreements—between manufacturer and distributor); see also 1 CALLMAN, op. cit. supra note 2, at 359 et seq.; de Ganahl, supra note 1, at 578; Recent Statutes, 37 Col. L. Rev. 1429 (1937); Note, 8 U. of Chi. L. Rev. 745 (1941).

22. Rep. McLaughlin of Nebraska, a member of the House subcommittee which considered the Miller-Tydings Act, submitted a report on the bill to the House. He said that the basis for recommendation of the measure was that it enabled the "fair-trade acts passed by so many of the States ... [to] become vital laws." The House bill would "in effect confirm and ratify the judgment of the State legislatures." "H. R. 1611 ... is entirely a permissive act. It merely allows the seller and buyer of trade-marked or identified goods ... to contract for resale of goods according to State law, if they want to do so. It does not compel the buyer and seller to enter into the contract but only authorizes them to do so if they desire." 81 Cong. Rec. 8140, 8141 (1937) (emphasis supplied).

23. The act amends the Sherman act to state that nothing contained therein shall render illegal resale price maintenance contracts lawful in intrastate transactions "under any
tenance. Furthermore, a Congress which appears to have believed that the evils of price cutting were sufficiently serious to justify state-permitted private price-fixing might have been equally receptive to a state-compelled equivalent. But any construction of the scope of the Act must necessarily consider the possibility that opposition to "bureaucratic" intervention in the economic sphere might have induced Congress—had it faced the problem—to withhold its approval from any scheme of compulsory resale price maintenance. Another deterrent to Congressional approval might have been considerable doubt as to the constitutionality of a compulsory scheme, in view of the "permissive privilege" rationale underlying the Supreme Court's validation of state fair trade in the then-recent Dearborn case.24 Thus, the New York statute might be held to lie outside the license of the Miller-Tydings Act, particularly since the present Supreme Court—in order to effectuate the policy of free competition—apparently construes any exception to the Sherman Act strictly.25

But even if the obstacle presented by the Miller-Tydings Act is overcome, an attempt to invalidate the New York liquor fair trade amendment as a restraint on trade in violation of the Sherman Act must meet the argument that it is a form of state action. In Parker v. Brown,26 a state marketing scheme which included price-fixing combinations by producers was held immune from challenge under the Sherman Act on the ground that the act was intended to apply only to combinations of individuals or corporations and not to combinations of which a state was the moving force.27 In the Cali...
fornia regulatory program discussed therein, at every step of the price-fixing proceedings, there was a statutory prescription of public hearings and of careful scrutiny by the California Secretary of Agriculture. The New York statute, on the other hand, lays down policy and standards of the vaguest sort, and, as now administered, prices are determined by private persons unsupervised by the state. This would hardly seem to be state action of the kind validated by the Court in the *Parker* case. In the light of the tendency of the present Supreme Court to pierce the verbalisms obscuring a statute and instead to examine its effects, it would seem that the court will have to answer the question: Even though a state is immune from an action brought under the Sherman Act, may it confer such immunity upon private persons under the protective mantle of a standard-less statute? If this is answered in the affirmative, then a state would be able to authorize restraints of trade almost at will. Such an interpretation is clearly contrary to the strong national policy against clogging the channels of competition, and might induce the Court to hold that the program, at least as presently implemented, is unconstitutional.

The problem of a special immunity for state liquor regulation from the limiting provisions of the Federal Constitution under the Twenty-first Amendment should have no application to the issues of constitutionality raised under state constitutions, for the restrictions on state exercise of legislative power contained in state constitutions still remain. Thus, the compulsory contracting requirement of the New York liquor fair trade amendment may be violative of the state constitution's due process clause—if the New York court decides to revive the much-damaged doctrine of liberty of con-

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28. *Id.* at 346 *et seq.* The statute required that a marketing plan be established only after prescribed economic findings had been made showing, among other things, that there would be no unreasonable profits to producers.

29. See note 33 *infra*.

30. Since the State Liquor Authority could, by exercising the power given it under the statute, prescribe rules and regulations which would deprive the industry of its control of pricing practices, the statute could theoretically be viewed as "state" action. A court seeking to avoid a finding that the statute itself is unconstitutional could thus hold that only the present method of its effectuation contravenes the Sherman Act.

It would be possible to argue that the New York program constitutes an unconstitutional "burden upon interstate commerce." For discussion of a similar constitutional problem involving state statutes prohibiting sales below cost, see *Comment, 57 Yale L. J.* 391, 423 *et seq.* (1947). Thus, even though the court found that the program as presently implemented was a form of "state" action, it would have available a rationale for striking down the statute. The mere failure of Congress to apply the prohibitions of the Sherman Act to the states, it could be contended, does not indicate that Congress approves state-imposed restraints on trade. If, however, the court found that the exemption granted by the Miller-Tydings Act was broad enough to include compulsory resale price maintenance, it would have determined, in effect, that Congress has quite clearly indicated its approval of such programs. Then to find that the program constitutes an "undue burden" would be to substitute the Court's judgment for that of Congress—something that the present Court hesitates to do.
tract. But a more serious charge of invalidity under the New York Constitution is that the statute, by permitting the State Liquor Authority to pass the power to fix prices on to private persons, and by establishing inadequate standards for such price-fixing, delegates legislative power unconstitutionally.

Under the statute as presently administered, a private price is enforced by the State Liquor Authority without examination as to fairness or reasonableness. Nor is this private price-fixing adequately restricted

31. The doctrine permitted abridgment of freedom of contract only under "exceptional circumstances" and by "reasonable regulation" only. Tyson Bros. v. Banton, 273 U.S. 418 (1927); People ex rel. Tipaldo v. Morehead, 270 N.Y. 233, 200 N.E. 799, aff'd, 293 U.S. 587 (1936). See also Billie Knitwear, Inc. v. New York Life Ins. Co., 174 Misc. 978, 22 N.Y.S.2d 324 (Sup. Ct. 1940); New York v. Nebbia, 262 N.Y. 259, 185 N.E. 694 (1933), aff'd, 291 U.S. 502 (1934). Although it has come into disfavor as a result of the decision in West Coast Hotel Co. v. Parrish, 300 U.S. 379 (1937), it would seem to stand ready among the arsenal of legal weapons which could be utilized by a court hostile to forms of economic regulation which suspend freedom of contract in a given industry. See statement of Meyer Kurz in Beverage Retailer Weekly, June 23, 1947. The emphasis of the Supreme Court in the Dearborn case upon the permissive nature of the fair trade act there considered suggests the possibility that validation of the broad grant of power to manufacturers to bind nonsigners to the resale price rested on certain conditions—among them, that fair trade contracts be permissive and not compulsory.

State courts, in measuring the extent of the state's police power over liquor, have continued to adhere to notions of "reasonableness." See, e.g., Marks v. Bruckman, 170 Misc. 709, 9 N.Y.S.2d 947 (Sup. Ct. 1939) (rule of State Liquor Authority said to have a reasonable relation to promotion of temperance); Alcoholic Beverage Control Board v. Hall, 297 Ky. 432, 180 S.W.2d 293 (1944) (discretion vested in liquor regulatory authority may not be so great as to give it "absolute and arbitrary power over citizens' lives, liberty and property"); Franklin Stores Co. v. Burnett, 120 N.J.L. 596, 1 A.2d 25 (1938). A finding that the compulsory contracting requirement bore a reasonable relation to the promotion of temperance would, of course, satisfy the requirements of due process.

32. N.Y. CONST. ART. III, § 1.

33. Chairman O'Connell emphasized that the rules adopted would not constitute price-fixing by the Authority because such prices would continue to be set by the distiller or distributor under the procedure described by the General Fair Trade Law. N.Y.S. Liquor Authority, Release No. 1722, p. 4, June 11, 1947. See also statement by Mr. Kaitz of the Fair Trade Bureau in N.Y. Herald-Tribune, Nov. 5, 1947, p. 36, col. 2. That public scrutiny of the fair trade price is not an unheard of practice is demonstrated by New Mexico's provision in the mandatory fair trade portion of its liquor law that resale price maintenance contracts which yield profits to retailers in excess of 33 1/3% of retail sales price be declared illegal. New Mex. Stat. 1941 Ann. 61-904 (1942). In New Hampshire, the Liquor Commission has the authority to investigate prices charged by wholesalers and retailers and to revoke the permits of those who are found to be enjoying unreasonable profits. Rev. Laws of N.H., c. 170, § 32 (1942). See also Weco Products Co. v. Reed Drug Co., 225 Wis. 474, 274 N.W. 426 (1937) (permissive fair trade act not unconstitutional because power given to Department of Agriculture and Markets to declare contracts void if unfair or unreasonable); R.I. Gen. Laws, c. 164, § 6 (1938), and Reg. 72 (1939), thereunder cited in de Ganahl, Trade Practice and Price Control in the Alcoholic Beverage Industry, 7 LAW & CONTEMP. PROB. 655, 684 n.71 (1940) (power to fix wholesale prices and limit profits given to Division of Intoxicating Beverages). Experience with imposition of maximum rates in public utilities serves as an excellent guidepost to regulation of the liquor
legislative standards—for the statute speaks only in the generalities of "orderly distribution" and the promotion of "temperance." The Supreme Court has stated that delegation of power to a private group to regulate its own industry without carefully defined statutory standards "is unknown to our law and is utterly inconsistent with the constitutional prerogatives and duties of Congress." And in Darweger v. Staats, the New York Court of Appeals invoked the equivalent clause of its constitution in finding a state statute which punished violations of the federal NIRA codes unconstitutional, because the state legislature left too much to be determined by a non-state created agency. Thus, there would be authority to support a finding

industry if it is thought that its economics requires extensive public intervention. Taussig, Price Maintenance, 6 Am. Econ. Rev. Supp. 170, 179 (1916), points out that if price regulation is considered desirable, it should be in the hands of the public, not in the hands of manufacturer and retailer who are "after all interested parties."

34. See note 5 supra.

35. Schechter Poultry Corp. v. United States, 295 U.S. 495 (1935) (NIRA unconstitutional inter alia as delegation of legislative power to the President). "The Government urges that the codes will consist of rules of competition deemed fair for each industry by representative members of that industry—by the persons most vitally concerned and most familiar with its problems . . . Could trade or industrial associations or groups be constituted legislative bodies for that purpose because such associations or groups are familiar with the problems of their enterprises? . . . The answer is obvious. Such a delegation of legislative power is unknown to our law. . . ." Id. at 537. See Carter v. Carter Coal Co., 298 U.S. 238, 311 (1936). Jaffe, An Essay on Delegation of Legislative Power: II, 47 Col. L. Rev. 561, 578 et seq. (1947), discusses later delegation cases pointing out that standards were inserted in subsequent enactments to satisfy the objections to the NIRA. Since the Schechter case, he says at 578, "no delegation has been held invalid, but none of them has had quite the imposing generality of NIRA and the Court has been careful to distinguish it."


The traditional fair trade acts with their non-signer clauses which permit resale price maintenance contracts to be enforced against non-contracting parties would also appear to delegate legislative power, because there is also a governmental agency—the judiciary—which lends assistance in the enforcement of prices fixed by private individuals. New York's Fair Trade Act was invalidated by Justice Rosenman in the lower court on this ground inter alia, in Coty, Inc. v. Hearn Department Stores, Inc., 158 Misc. 516, 284 N.Y. Supp. 909 (Sup. Ct. 1935). But traditionally, judicial participation in the enforcement process has not had the same connotation of affirmative public action as has legislation and administrative decree. Compare the distinction between segregation ordinances which have been declared unconstitutional and private restrictive covenants which are enforced by the courts. See Judge Edgerton dissenting in Hurd v. Hodge, 162 F.2d 233, 239 (App. D.C. 1947); Martin, Segregation of residences of Negroes, 32 Mich. L. Rev. 721, 731 (1934).
that the New York statute permits an unconstitutional delegation of legislative power.\textsuperscript{37}

Even if the grant of power is upheld, however, on the ground that there is no improper delegation of power in the statute itself, it would seem that the State Liquor Authority may have improperly exercised its authority "to adopt rules and regulations, in its discretion . . . prohibiting the sale of liquor except under fair trade contracts."\textsuperscript{38} The method chosen by the agency permits the price set by the manufacturer, in a contract with a presumptively friendly retailer, to go unsupervised. State Liquor Authority pronouncements indicate that there will be no examination of the "fairness" of the fair trade price,\textsuperscript{39} thus ignoring the potential for protection of the public interest inhering in the phrase "in its discretion." Though there is no legislative history which gives content to "discretion" and how it should be exercised, it seems unlikely that the legislature intended that privately fixed prices would not be supervised in some way.

Some evidence of what the New York court may do if it is confronted with the liquor fair trade amendment may be gleaned from decisions in New Jersey and Kentucky, where regulatory schemes similar to New York's have been tested in the courts. In both those states the laws and regulations in question were upheld. But the New Jersey regulation does not require a manufacturer to enter into a fair trade contract.\textsuperscript{40} It merely provides for public enforcement of the price if such a contract is entered into. In discussing the regulation,\textsuperscript{41} the court ignored the problem of delegation of legisla-

\textsuperscript{37} It is arguable that there is no delegation here following the Dearborn case which found no delegation of legislative power involved in permissive resale price maintenance on the theory that any retailer who bought with notice of the fair trade contract price did so voluntarily. But when the price on all trademarked liquor is subject to a fair trade price, as it is under compulsory resale price maintenance, the freedom of a retailer to refrain from buying is illusory. His only alternative to not buying the advertised brands is going out of business. To contend that there is no power to fix prices in such a situation would lead equally to the conclusion that prices are not fixed when a government agency sets retail price ceilings on e.g., meat; for the butcher too buys with notice of the restriction and may exercise his privilege of going out of business if he does not wish to comply. The novelty of such a conclusion would seem to indicate that compulsory resale price maintenance must also constitute an exercise of the price-fixing power—even though delegated to private groups.

\textsuperscript{38} See note 5 supra. The possibility exists, however, that the statute will be given a very restrictive reading so that "rules and regulations" will be held to refer only to "prohibiting" and not to the contents of the fair trade contract itself. Such an interpretation would eliminate speculation concerning proper methods of protecting the public interest.

\textsuperscript{39} See note 33 supra.

\textsuperscript{40} Reg. 30, cited in de Ganahl, Trade Practice & Price Control in the Alcoholic Beverage Industry, 7 LAW & CONTEMP. PROB. 665, 682 n.59 (1940), issued under N. J. STAT. ANN. § 33:1-23.1 (1940). The statute was the same as New York's but the Commissioner exercised his discretion by making entry into fair trade contracts optional with the manufacturer, guiding himself, perhaps, by the theory which is ostensibly the justification for fair trade—that it permits the manufacturer to protect the good-will in his brand.

\textsuperscript{41} Gaine v. Burnett, 122 N.J.L. 39, 4 A.2d 37 (1939); accord, Grant Lunch Corp. v.
tive power to private persons. It spoke as if the Commissioner himself were setting prices rather than enforcing a privately fixed price, and relied heavily upon the fact that administrative officials have always been permitted to exercise wide powers over liquor.

In *Reeves v. Simons*, the Kentucky court upheld a mandatory fair trade law which differs from New York's only in that minimum mark-ups are specified. Kentucky's statute, then, posed the same problems as New York's—liberty of contract and delegation of legislative power. Neither problem was satisfactorily answered nor, following the courts' reasoning, need it have been; the opinion took refuge in the statement that "regulations which would be called discriminatory, arbitrary and unreasonable if applied to any other business have been upheld by the courts as a reasonable exercise of the police power in restricting the liquor traffic." 43

Both laws appear to have depended for their validity upon a judicial conviction that liquor is exempt from the traditional restrictions of the state constitutions. This result, uncalled for by any explicit provision of either constitution, has been reached because these courts have been influenced by a "hands-off" policy where regulation of the "demon rum" is concerned, and perhaps by the wholly inapplicable "liquor immunity" doctrine of federal constitutional law as well. There would, however, seem to be no reason to exempt state regulation of the liquor industry from traditional constitutional limitations. There is no doubt that prohibition of the liquor traffic does not violate constitutional guaranties. 44 But it is quite another thing to say that, once the traffic is legalized, the legislature should be given *carte blanche* to affect private rights without regard to the requirements of due process, or to affect the public interest heedless of the limits on the delegation of legislative power.

Irrespective of the constitutional issues involved, economic considerations in abundance are arrayed against compulsory resale price maintenance. Called to aid originally by manufacturers to prevent injuries to the good will of their branded products when used as loss leaders, resale price maintenance has more recently been the vehicle of retailer self-interest. 45 The lesson to

Driscoll, 129 N.J.L. 408, 29 A.2d 888 (1943), aff'd, 130 N.J.L. 554, 33 A.2d 900 (1943),
cert. denied, 320 U.S. 801 (1943).

42. 289 Ky. 793, 160 S.W.2d 149 (1942).

43. *Id.* at 797.

44. See Carr, *supra* note 8, at 709-10.

45. There seems little doubt today that the rationale used by Justice Sutherland in the *Dearborn Case*—the protection by the manufacturer of his trade-mark—is to a considerable degree divorced from the economic realities. *Cf.* Guerlain, Inc. v. F. W. Woolworth, 170 Misc. 150, 9 N.Y.S.2d 886 (Sup. Ct. 1939). It would appear that Professor Shulman's analysis is more nearly attuned to the present. "... [T]he organized pressure for the Fair Trade Acts... came from distributor groups.... They sought an adequate markup, and adequate profit on the goods which they marketed,—not protection of the manufacturers' trade expectancies. If the producer were also to profit from the scheme, that was an accidental incident." Shulman, *The Fair Trade Acts and the Law of Restrictive Agree-
be drawn from experience with permissive fair trade is one of failure to assure a competitive price. Despite the attempt to keep commodities in free and open competition with one another by provisions against horizontal price-fixing agreements,\textsuperscript{46} inadequate personnel has made scrupulous enforcement of such prohibitions a rarity.\textsuperscript{47} And the books are filled with accounts of retailers banding together to compel manufacturers to provide them with higher margins on resale, thus permitting efficient and inefficient retailers alike to cover costs.\textsuperscript{48}

The resultant non-competitive price has several undesirable consequences: consumers are either priced out of the market or are forced to pay a higher price than is necessary; the waste of resources represented by an excessive number of outlets is encouraged;\textsuperscript{49} competition in advertising with its por-

\begin{footnotes}
\footnote{Affecting Chattels, 49 \textit{Yale L. J.} 607, 616 (1940); support for Professor Shulman's position may be found in FTC, \textit{op. cit. supra} note 2, at 4-11; \textit{Gault, Fair Trade} (1939) (with especial reference to cut-rate drug prices in Michigan); \textit{Grether, \textit{op. cit. supra} note 2; Taussig, \textit{supra} note 33, at 172-7 (1916); McAllister, \textit{Price Control by Law in the U.S.}, 4 \textit{Law \& Contemp. Prob.} 273, 296 (1937). Even accepting the thesis that brand name protection is the \textit{raison d'etre} of fair trade, it is very difficult to see why the state should compel the manufacturer to exercise that privilege. The rationale which led to validation of fair trade has been stretched a long way in this selection of the liquor industry for New York's special solicitude.}

\footnote{New York's Fair Trade Act, N. Y. \textit{Gen. Bus. Law}, Art. 24-A \textsection 369-a contains a provision that the fair trade contract must concern a commodity "which is in fair and open competition with commodities of the same general class produced by others." This proscription of horizontal agreements—among retailers or among manufacturers or wholesale—is aimed at the ever-present danger that members of one of these groups will band together and compel one of the other groups to accede to its demands, thus undermining the competitive price which the provision sought to assure. The New York liquor fair trade amendment transplants the entire Fair Trade Act into the Alcoholic Beverage Control Law, changing it only so that entry into the resale price maintenance contract is made mandatory and is enforced by the State Liquor Authority. The \textit{Miller-Tydings Act}, 50 \textit{Stat.} 693 (1937), 15 U.S.C. \textsection 1 (1940), also contains such a ban against horizontal agreements.}

\footnote{The Department of Justice is reported as feeling that "if its Antitrust Division had sufficient men and money to examine every resale price maintenance contract written under State and Federal legislation, and to proceed in every case in which the arrangement goes beyond the authorizations of the Tydings-Miller amendment [referring to the ban against horizontal agreements which is also in the N. Y. liquor fair trade amendment], there would be practically no resale price maintenance contracts, and that, in the absence of such wholesale law enforcement, the system of resale price legislation fosters restraints of trade such as Congress never intended to sanction." FTC, \textit{op. cit. supra} note 2, lxi. In this view, the Federal Trade Commission concurs, \textit{Ibid.}}

\footnote{Resale price maintenance has served as "a focal point for dealer cooperative effort to bring pressure to bear on manufacturers to place products under price maintenance at prices yielding dealer margins satisfactory to cooperating organized dealer groups." FTC, \textit{op. cit. supra} note 2, at liv. See also Note, 8 \textit{U. of Chi. L. Rev.} 745 (1945); Business Week, Nov. 9, 1940, pp. 39-40.}

\footnote{Abrahamson, \textit{op. cit. supra} note 1, points out that there already exists in the liquor industry a clumsy, inefficient and overdeveloped distributive organization.}
\end{footnotes}
tent of still higher prices is stimulated. The uneconomic nature of permissive resale price maintenance has led to condemnation by the Federal Trade Commission, the Anti-trust Division of the Department of Justice, the Temporary National Economic Committee, and others. Since New York's

50. If Rule 26 succeeds in its avowed purpose of stabilizing prices, then price competition will be replaced by competition in advertising. The existence of competing private brands, however, is a limiting factor on the amount of advertising expenditures which can be made, for such expenses will be reflected in the price. See Borden, The Economic Effects of Advertising 876 (1942).

51. FTC, op. cit. supra note 2, at liv-lxiv. The Report states that continuing studies over many years reinforce the Commission's original opposition to the Miller-Tydings Act which lifted the ban of the antitrust laws from state fair trade. Its conclusion is that "in the absence of the effective Government supervision in the public interest, resale price maintenance, legalized to correct abuses of extreme price competition, is subject to use as a means of effecting enhancement of prices by secret agreements and restraint of competition by coercive action on the part of interested cooperating trade groups of manufacturers, wholesalers, and retailers in such ways and to such an extent as to make it economically unsound and undesirable in a competitive economy." (emphasis supplied) It is interesting to note that the rules issued under the New York liquor fair trade amendment were first submitted to representatives of the industry for recommendations and review. See N.Y.S. Liquor Authority, Release No. 1722, June 11, 1947. For summary and comment on the FTC report, see Grether, The Federal Trade Commission vs. Resale Price Maintenance, 12 J. of MKT. 1 (1947).

52. TNEC, Investigation of Concentration of Economic Power, Final Report and Recommendations 121 (1941). Thurman Arnold, then Assistant Attorney General in charge of the Anti-trust Division, recommended repeal of the Miller-Tydings Act because it had become "a cloak for many conspiracies in restraint of trade which go far beyond the limits established in the amendment." See also Memorandum and Statement by Corwin D. Edwards, id. at 232, 243.

53. Id. at 33. The Committee concluded that the Miller-Tydings Act resulted in legal sanction being given to private price-fixing conspiracies and to economic and social practices flowing therefrom. This "tends to undermine the basic tenets of a competitive economy, and introduces rigidities into the pricing of certain goods which restrain trade."

54. Commissioner Lubin of the Bureau of Labor Statistics, on June 20, 1940, said that the fair trade laws prevented retail prices from being reduced freely. FTC, op. cit. supra note 2, at lxii-lxiii. Opinions of other government officials, ibid. A study of reactions to resale price maintenance demonstrated that consumers opposed fair trade contracts 3 to 1, whereas manufacturers and retailers were overwhelmingly in favor of them. Gault, supra note 45. See Legis., 36 Col. L. Rev. 293, 295 n.10 (1936) for a list of consumer and public groups which opposed the N.Y. Fair Trade Act; McLaughlin, supra note 2, at 822 writes that the fair trade laws are the "product of high pressure political lobbying by groups asserting narrow and unenlightened interests." Compare Business Week, July 20, 1940, pp. 42-4, which summarizes the report of the Druggists' Research Bureau, Fair Trade and the Retail Drug Store (1940). The report concluded that fair trade brought about a net decrease of 1% in retail prices of controlled items. Serious criticisms of the report are indicated in the Business Week article. Strong support was given to resale price maintenance by Brandeis who felt that preservation of the small retailer outweighed the advantages to be derived from the efficient monopolist. He was convinced that resale price maintenance would stamp out the price-cutting which led inevitably to monopoly and higher prices. One of his basic postulates, however, was that competition among manufacturers would result in a competitive fair price. Brandeis,
compulsory liquor fair trade amendment incorporates only those safeguards contained in the original Fair Trade Act, it can be expected that the evils attendant upon permissive fair trade will continue, and may even be accentuated. Especially may this be so in view of the fact that state enforcement will replace relatively ineffective private enforcement in an industry where the anti-competitive forces are already strong. There is reason, indeed, to believe that compulsory resale price maintenance may make "liquor selling a publicly protected sinecure."  

Despite the weight of the considerations pressing for a holding that compulsory resale price maintenance in liquor is unconstitutional, the probability is greater that the courts will once again fall back on a traditional Puritan antagonism towards liquor reinforced by a current of decision which finds for state liquor regulation a special immunity from ordinary standards of constitutionality. Even if upheld by the courts, however, statutes like New York's liquor fair trade amendment are undesirable because artificial restraints on competition are introduced without any compensating protection for the public interest. The State Liquor Authority should not be permitted to pass price-fixing on to the manufacturer but instead should either fix prices directly or should specify permissible mark-ups at each stage of the distribu-

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55. The liquor retailers' associations in the metropolitan center of New York are very well organized and, it is said, powerful enough to compel a manufacturer to respond to their demands. Among such demands have been the entry into resale price maintenance contracts at mark-ups averaging 40% on cost. FTC, op. cit. supra note 2, at xli-xliv; see also Gault, supra note 45; Business Week, Sept. 23, 1940, p. 44, id. Nov. 9, 1940, pp. 39-40.

56. An article in the trade magazine, Spirits, June 28, 1947, points out that there is a belief in some quarters of the industry that the New York liquor fair trade amendment will produce this result.

It is, of course, true that the price of liquor will still be determined to some extent by market conditions. Price must necessarily be related to the inelasticity of demand for trademark bearing liquor, i.e., if a small increase in price is expected to produce a severe drop in demand, there will be a tendency to avoid raising prices. Many factors bear upon the degree of inelasticity of demand. For example, competition from liquor substitutes such as beer and wine affects demand for liquor, and, hence, pricing policy. Perhaps more important is competition from private brands (those owned exclusively by one retailer and sold within the state by such retailer) which are exempted from New York's liquor fair trade amendment. See Business Week, Sept. 28, 1940, p. 44. If too much of a differential is allowed to develop between brands covered by fair trade, and private brands, sales will tend to shift to the lower-priced private brands. See supra note 50, at 593. But although private brands can make a price appeal, the influence of advertising upon the demand for trademarked brands cannot be minimized. See also de Ganahl, Trade Practice and Price Control in the Alcoholic Beverage Industry, 7 Law & Contemp. Prod. 665, 674 (1940).
tive process. Failing such measures, a vigilant enforcement of the prohibi-
tion of horizontal agreements is a minimal necessity. 7

SECTION 102 OF THE INTERNAL REVENUE CODE:
SURTAX ON CORPORATIONS IMPROPERLY
ACCUMULATING SURPLUS

Since the federal income tax system imposes higher rates on individuals
than on corporations, 1 individuals in high surtax brackets profit by inter-
posing the corporate entity between their income and themselves. 2 Through
the withholding of dividends which would on distribution be taxable as per-
sonal income, profits mount in the form of corporate surplus subject only
to the lighter corporate taxes. 3 A provision to discourage this type of tax
avoidance, present since the introduction of the modern income tax system
in 1913, 4 is now contained in Section 102 of the Internal Revenue Code,
which imposes a penalty tax 5 on corporations accumulating earnings for the
purpose of avoiding the surtax on shareholders.

57. A desirable substitute for any type of resale price maintenance may also be
public monopoly of the sale of liquor, now in effect in seventeen states. This permits levy
of high prices (which has been said to be desirable as a means of promoting temperance)
without benefit to a special class of private persons. In addition, the state may use the
profits to defray other expenses of government. See Shipman, State Administrative
Machinery for Liquor Control, 7 LAW & CONTEMP. PROB. 600 (1940).

1. Compare INT. REV. CODE § 11 (normal tax on individuals) and § 12 (surtax on
individuals), with § 13 (tax on corporations in general) and § 15 (surtax on corpora-
tions).

2. Rudick, Section 102 and Personal Holding Company Provisions of the Internal

3. The individual shareholder can realize such profits in the form of long term capi-
tal gain taxed only at 25% by selling shares when the stock goes up in value. INT. REV.
CODE § 117(c). Moreover, if these shares are retained by the shareholder, their basis for
capital gains in the hands of heirs will be their fair market value at the time of the share-
holder's death. Id. § 113(a) (5).

4. The Acts passed from 1913 to 1919 taxed the shareholders on their pro rata
shares of the corporation's earnings. Revenue Act of 1913, § 2A (2), 38 STAT. 166 (1913);
Revenue Act of 1916, §§ 3, 39 STAT. 758 (1916); Revenue Act of 1918, § 220, 40 STAT.
1072 (1918).

5. The basis of the tax is undistributed "section 102 net income," i.e., net income
less the deductions specifically allowed by § 102(d). The amount of the tax has varied
from 25% of undistributed "section 102 net income" in 1921 to 50% from 1924 to 1932.
Revenue Act of 1921, § 220, 42 STAT. 247 (1921); Revenue Act of 1924, § 220, 43 STAT.
277 (1924); Revenue Act of 1926, § 220, 44 STAT. 34 (1926); Revenue Act of 1928, § 104,
45 STAT. 814 (1928); Revenue Act of 1932, § 104, 47 STAT. 195 (1932). The penalty
from 1934 to 1938 was 25% of the first $100,000 and 35% of amount in excess of $100,000.
Previously, the Undistributed Profits Tax,\textsuperscript{5} by forcing dividend distribution, and the Excess Profits Tax,\textsuperscript{7} by limiting the possibility of large accumulations, indirectly accomplished the objectives of Section 102. With their repeal, in 1938 and 1945 respectively, Section 102 was left as the only deterrent to the exploitation of an avoidance device which the current high rate of corporate income\textsuperscript{6} makes particularly tempting. Moreover, the appearance of Question 8 in the 1946–7 Corporation Income Tax Return was thought by some to portend greater reliance on the statute. This requirement compelled the taxpayer to state reasons for the retention of profits if the total of its distribution to stockholders was less than seventy per cent of its earnings and profits for the taxable year.\textsuperscript{9}

Although the incentive to avoid personal surtaxes has increased tremendously with the rise in individual tax rates, the "penalty" method of dealing with the problem has remained essentially the same. Originally, however, the tax was imposed on shareholders of a corporation "formed or fraudulently availed of" for purposes of tax avoidance.\textsuperscript{6} "Fraudulently" was dropped from the Revenue Act of 1934, \$ 102, 48 Stat. 702 (1934); Revenue Act of 1936, \$ 102, 49 Stat. 1676 (1936); Revenue Act of 1938, \$ 102, 52 Stat. 483 (1938). The present penalty is 27\(\frac{3}{4}\)% of the first $100,000 and 38\(\frac{3}{4}\)% of amount in excess of $100,000. Int. Rev. Code \$ 102(a).

It has been suggested that these rates are insufficient since an individual in the maximum surtax brackets may find it cheaper to have the corporation pay the penalty than to withdraw the profits as dividends. Barrett, \textit{The Section 102 Penalty}, 24 Taxes 655, 657 (1946). But see Holzman, \textit{What's New in 102?}, 25 Taxes 101, 103 (1947). It was pointed out that such a situation would generally be true only of closely held corporations where the stockholders are in maximum surtax brackets. Barrett anticipated Holzman's answer by saying that except in the rarest instance the section applies only to close corporations because of the logical difficulty of imputing the motive of avoidance of shareholders' surtaxes to corporations whose shares are widely held. Barrett, \textit{supra} at 655.

6. Revenue Act of 1936, \$ 14, 49 Stat. 1655 (1936). "This tax proved to be such a stimulus to the declaration of dividends that it highlighted the comparative inefficiency of Section 102." Rudick, \textit{supra} note 2, at 174. See \textit{Report of a Subcommittee of the House Committee of Ways and Means}, 75th Cong., 3d Sess. 22 (1938): "So long as the undistributed-profits surtax continued at the rates provided by section 14 of the Revenue Act of 1936, the avoidance of individual surtaxes through the accumulation of corporate surplus by . . . corporations was sufficiently discouraged."


8. See Goodman, \textit{supra} note 7, at 200.

9. Question 8, Form 1120 Treas. Dep't Int. Rev. Serv. 3 (1946). Question 8, a reminder that, after the wartime lapse, Section 102 would be stringently enforced, has been deleted for the 1947–8 return. 5 CCH 1948 Fed. Tax Rep. f 6034 (Press Serv. No. S-554, Dec. 5, 1947).

in 1918,\textsuperscript{11} and, because of the doubts cast by \textit{Eisner v. Macomber} \textsuperscript{12} on the constitutionality of piercing the corporate veil, the imposition of the tax was shifted in 1921 \textsuperscript{13} from the individual shareholder to the corporation itself. The constitutionality of the statute, then challenged under the Fifth and Tenth Amendments,\textsuperscript{14} was first upheld in the lower federal courts in 1933,\textsuperscript{15} and finally by the Supreme Court in 1938 in \textit{Helvering v. National Grocery Co.} \textsuperscript{16}

Although its constitutionality was established, the statute has been difficult to enforce. In cases reaching the courts the Government has lost more often than it has won.\textsuperscript{17} The necessity of proving intent to avoid surtaxes has been singled out by a House subcommittee \textsuperscript{18} as the chief barrier to effective enforcement: Little aid to enforcement was found in statutory provisions that the character of a corporation as a mere holding company \textsuperscript{19} or the accumulation of profits beyond reasonable business needs \textsuperscript{20} be considered "prima facie" evidence of attempted avoidance. As the only response to the

\begin{itemize}
  \item \textsuperscript{12} 252 U.S. 189 (1920). The court held, in a five to four decision, that neither under the Sixteenth Amendment nor otherwise has Congress the power to tax without apportionment a "... true stock dividend made lawfully and in good faith, or the accumulated profits behind it, as income of the stockholder." \textit{Id.} at 219. But see Mr. Justice Brandeis' dissent. \textit{Id.} at 231. See also Mr. Justice Brandeis in \textit{Helvering v. National Grocery Co.}, 304 U.S. 282, 288 (1938): "[T]he sole owner of the business could not by conducting it as a corporation prevent Congress, if it chose to do so, from laying on him individually the tax on the year's profits."
  \item \textsuperscript{13} Revenue Act of 1921, § 220, 42 Stat. 247 (1921).
  \item \textsuperscript{14} It was said that Section 102 violated the Tenth Amendment because it interferes with the power to declare or withhold dividends, a power which the states conferred on corporations, and that Section 102 is without due process in that it prescribes a confiscatory penalty dependent upon a standard which is vague, indefinite, arbitrary and capricious. These contentions were met with the arguments that Section 102 does not limit state power but merely discourages tax avoidance, that the standard of application is no more vague than standards of conduct prescribed by the law of torts, much of which merely commands that a man must act as the occasion demands, and that the standard is not arbitrary because the statutory presumptions are not conclusive and do no more than make the taxpayer show his hand. \textit{Helvering v. National Grocery Co.}, 304 U.S. 282, 286-90 (1938); United Business Corp. v. Commissioner, 62 F.2d 754, 755-6 (C.C.A. 2d 1933), \textit{cert. denied}, 290 U.S. 635 (1933); \textit{Williams Inv. Co. v. United States}, 3 F. Supp. 225, 232-5 (Ct. Cl. 1933).
  \item \textsuperscript{15} United Business Corp. v. Commissioner, \textit{supra} note 14; \textit{Williams Inv. Co. v. United States}, \textit{supra} note 14.
  \item \textsuperscript{16} 304 U.S. 282 (1938).
  \item \textsuperscript{17} See chart of decisions, Simons, Modern Techniques in the Practice of Tax Law, 24 Taxes 330, 332-5 (1946).
  \item \textsuperscript{19} \textit{Int. Rev. Code} § 102(b). \textit{Report of a Subcommittee}, \textit{op. cit. supra} note 6, at 20.
subcommittee’s report, Congress in 1938 made “determinative” of the prescribed intent the existence of earnings accumulated beyond the reasonable needs of business unless the taxpayer by clear preponderance of evidence should prove the contrary. In 1939, the Treasury Department instructed Collectors of Internal Revenue to focus their attention upon corporate situations in which: (1) less than seventy per cent of the earnings has been distributed; (2) earnings are invested in unrelated activities; (3) loans have been advanced to officers and shareholders; (4) the majority of the stock is closely held; or (5) “accumulations beyond the reasonable needs of business” have been retained, whether or not seventy percent of the earnings has been distributed.

Though these standards have been criticized as being arbitrary and discriminatory, they are not inflexible and in fact are merely a restatement of judicial indicia of taxpayers’ intent. The fact that less than seventy per cent of earnings has been distributed was fixed by Question 8 as a point of de-

21. Revenue Act of 1938, § 102(c), 52 STAT. 483 (1938). The Revenue Act of 1913, § 2A (2), 38 STAT. 166 (1913) provided that the fact that any corporation is a mere holding company or that earnings are permitted to accumulate beyond reasonable needs shall be prima facie evidence of fraudulent purpose but shall not be construed as evidence of a purpose to escape the tax unless the Secretary of the Treasury shall certify that in his opinion the accumulation is unreasonable. Minor changes were made in subsequent Acts. The requirement of certification by the Secretary of the Treasury was dropped by the Revenue Act of 1924, § 220, 43 STAT. 277 (1924). See note 50 infra.

Although the language of the 1938 amendment is more imposing than that in corresponding provisions in previous Acts, the provision is said to add little or nothing to the statute, since the burden of proof had been on the taxpayer with an unreasonable accumulation in all previous Acts. Rudick, supra note 2, at 179. But a subtle shift of emphasis in the court opinions from intent of the taxpayer to the objective reasonable accumulation standard is evident. Compare R. C. Tway Coal Sales Co. v. United States, 3 F. Supp. 659, 671 (W.D.Ky. 1933), aff’d, 75 F.2d 336 (C.C.A. 3d 1935) (unreasonable accumulation must be coupled with evasive intent), with Hemphill Schools, Inc. v. Commissioner, 137 F.2d 961, 962 (C.C.A.9th 1943) (the issue centered on reasonableness of accumulation) and Trico Products Corp. v. Commissioner, 46 B.T.A. 346, 375 (1942), aff’d, 137 F.2d 424 (C.C.A.2d 1943), cert. denied, 320 U.S. 799 (1943). See also note 40 infra.


23. See note 14 supra.

24. Other factors commented on include: past dividend record, Florida Iron and Metal Co. of Jacksonville, P-H 1942 B.T.A. MENT. DEC. SERV. ¶ 42,403 (1942); sudden shifts in corporate or individual policy, United Business Corp. v. Commissioner, 62 F.2d 754, 755 (C.C.A.2d 1933), cert. denied, 290 U.S. 635 (1933); proportion of shareholder’s assets transferred to the corporation, Cecil B. DeMille v. Commissioner, 31 B.T.A. 1161, 1176 (1935), aff’d, 90 F.2d 12 (C.C.A. 9th 1937), cert. denied, 302 U.S. 713 (1937); earnings and expansion history of the company, Delaware Terminal Corp. v. Commissioner, 40 B.T.A. 1180, 1191 (1939); amount of surtax saved by the accumulation and financial condition of the company, W. H. Gunlocke Chair Co., P-H 1943 TC MENT. DEC. SERV. ¶ 43,443 (1943), aff’d, 145 F.2d 791 (C.C.A. 2d 1944).
parture, but the courts have indicated that if earnings accumulated are reasonable the tax does not apply regardless of percentage of distribution.\(^5\) It has been held that investments in unrelated activities and long-term unsecured loans to shareholders are inconsistent with an allegation that accumulations are necessary.\(^6\) A closely-held corporation merits particular scrutiny, but again accumulations must be unreasonable to warrant imposition of the penalty.\(^7\) Similarly, under the statute, the fact that any corporation is a mere holding or investment company is "prima facie" evidence of intent to avoid.\(^8\) But despite this presumption, and despite the fact that in theory any corporation with a reasonable accumulation may be liable once intent is present,\(^9\) the compelling criterion to which the majority of opinions refer is the existence of accumulations beyond the reasonable needs of business.\(^10\)

25. This is implied by the practical observations repeated in many of the cases. "Each case involving this issue must bottom on its own facts." Cecil B. DeMille v. Commissioner, 31 B.T.A. 1161, 1176 (1937). See also Universal Steel Co. v. Commissioner, 5 T.C. 627, 638 (1945); W. C. DeMille Productions, Inc. v. Commissioner, 30 B.T.A. 826, 830 (1934). See U.S. Treas. Reg. 111, § 29.102-3 (1943): "It is not intended . . . to prevent accumulations of surplus for the reasonable needs of business if the purpose is not to prevent the imposition of the surtax."

But the mere fact that a corporation distributed a large proportion of its earnings for the year in question does not necessarily prove that earnings were not permitted to accumulate beyond reasonable needs or that the corporation was not formed or availed of to avoid surtax upon shareholders. U.S. Treas. Reg. 111, § 102-2 (1943).

26. Southland Industries, Inc. P-H 1946 TC Mem. Dec. Serv. 46,262 (1946); J. M. Perry & Co. v. Commissioner, 120 F.2d 123 (C.C.A.9th 1941); Wilkerson Daily Corp. v. Commissioner, 42 B.T.A. 1266 (1940), aff'd, 125 F.2d 998 (C.C.A. 9th 1942); United Business Corp. v. Commissioner, 19 B.T.A. 809 (1930), aff'd, 62 F.2d 754 (C.C.A. 2d 1933), cert. denied, 290 U.S. 635 (1933). But "if the loans are secured, are actual debts, involve an established plan for repayment, and are being repaid, and if they do not interfere with surplus accumulation or indicate an abandonment of the purpose for which the surplus is being accumulated, then the courts will hold that they do not indicate that the corporation has permitted itself to be availed of for the purpose of avoiding the surtax payable to the stockholder." Heninger, supra note 22, at 647.

27. See Barrett, supra note 5, at 656. The fact that the corporation is closely held is an apparent basis for imposition, "although usually inarticulated." 7 Mertens, LAW OF FEDERAL INCOME TAXATION § 40.17 (1943). The courts usually discuss the taxpayer's liability in terms of the reasonableness of the accumulation although the great majority of cases involve closely-held corporations. See Simons, supra note 17, at 332-5.

It has been suggested that closely-held corporations should be taxed on a different basis from that of corporations whose shares are widely held, by, for example, the imposition of a high rate undistributed profits tax on closely-held corporations only. REPORT OF A SUBCOMMITTEE, op. cit. supra note 6, at 20.

28. INT. REV. CODE § 102(b).

29. Id. § 102(a). Personal holding companies are excepted. For surtax on personal holding companies, see id. § 500.

30. See notes 17 and 21 supra; notes 31-34 infra.

Question of reasonable accumulation may involve reasonableness of depreciation and obsolescence deductions, Schultz, ECONOMIC EFFECTS OF A CORPORATE INCOME TAX, 21 TAXES 598, 625 (1943); and salaries, Universal Steel Co. v. Commissioner, 5 T.C. 627 (1945).
Recent cases underline this rationalization of intent in terms of the reasonableness of accumulation, and reemphasize that, under conscientious judicial appraisal of all the facts of business operation, what is reasonable in one situation may be unreasonable in another. Earnings accumulated by a publishing company were found unreasonable where war conditions made contemplated expansion remote, affected accustomed operations only slightly, and caused no conversion and reconversion problems; \(^{31}\) but accumulations of a clothing company were held reasonable in light of the unknown risks of war and post-war years complicated by rationing and sky-rocketing costs for new inventory.\(^{32}\) Illustrative of present judicial willingness to examine particular patterns of business conduct was the sanctioning of a nameplate company's surplus, where the company had financed all capital additions from earnings rather than loans ever since its difficulty in refinancing a second mortgage after the mortgagee's refusal to renew in 1931.\(^{33}\) Related business and technical minutiae were carefully probed in finding unreasonable a radio corporation's surplus.\(^{34}\) Among the factors which convinced the court that the corporation had neither immediate purpose nor the ability to carry out expansion plans for which the surplus was supposedly accumulated were the facts that: the taxpayer corporation had made a large loan to an oil company itself entirely owned by the taxpayer's sole shareholder; FCC inspectors reported that equipment which allegedly needed repairs was of the latest type and in good condition; the FCC had already disapproved an alleged need for an increase of power from 50 KW to 500 KW; and the corporation had not requested an FCC license for, or taken other steps to expedite, the allegedly contemplated introduction of frequency modulation, television or facsimile reproduction by 1940.\(^{35}\)

The flexibility designed for cases which must turn on their own facts occasions a much criticized degree of unpredictability.\(^{36}\) Uncertainty stems

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32. Lion Clothing Co. v. Commissioner, 8 T.C. 1181 (1947).
33. Kennedy Nameplate Co., P-H 1947 TC MEM. DEC. SERV. ¶47,150 (1947). The corporation was also worried about reconversion and loss of war customers.
35. Ibid. Television was not a remote possibility, but evidentiary weight of loans and investments in unrelated activities, and the positive evidence proffered by the FCC was sufficient to support a finding that tax avoidance motivated the accumulation. Cf. Whitney Chain and Manufacturing Co. v. Commissioner, 3 T.C. 1109 (1944), aff'd, 149 F.2d 936 (C.C.A.2d 1945).
36. "Corporate officers by a reading of the statute cannot determine in advance whether the corporation is subject to the levy, nor is there any established formula by means of which the proper per cent of earnings to be retained can be determined." Heninger, supra note 22, at 640. See Senator McAdoo in SEN. REP. NO. 617, 65th Cong., 3rd Sess. 3 (1918): "Prosperity cannot be maintained if business is kept in uncertainty as to taxation." See NAT. IND. CONF. Bd., EFFECTS OF TAXES UPON CORPORATE POLICY 42 (1943).

It is suggested that an undistributed profits tax imposed with efficiency and certainty
not only from the fact that the reasonable accumulation standard will vary in different business situations, but also from the fact that courts rather than corporate directors are the ultimate arbiters of the reasonableness of corporate accumulations. The latter has been called an unwarranted judicial usurpation of managerial discretion in the making of business policy decisions regarding the withholding or distribution of dividends. Since enforcement necessarily involves differences of opinion over the amount of profits that should properly be retained, the elimination of judicial discre-

would far outstrip the uncertain Section 102 in business unpopularity. See Hearings before a Special Committee to Investigate Unemployment Relief, U.S. Sen., 75th Cong., 3d Sess. 353–60 (1938).


See note 40 infra.

38. "[T]he determination of what is reasonable under a given set of circumstances is typically a judicial question." Trico Products Corp. v. Commissioner, 46 B.T.A. 346, 375 (1942), aff'd, 137 F.2d 424 (C.C.A. 2d 1943), cert. denied, 320 U.S. 799 (1943).

39. "[T]he Bureau should give much more weight to the judgment of directors as to what earnings should be retained." THE COMMITTEE ON POSTWAR TAX POLICY, A TAX PROGRAM FOR A SOLVENT AMERICA 138 (1945).

Although the Tax Court is the arbiter, the Bureau of Internal Revenue agent is instrumental, "but the Bureau of Internal Revenue is a tax collecting organization, not a business management advisory board, and is therefore not presumed to be qualified to tell corporation executives how the finances of their business should be handled. The effect of Section 102, however, is to give to that Bureau the authority to make vital decisions without corresponding responsibility for the consequences of such decisions." NAT. IND. CONF. Bn. op. cit. supra note 36, at 49.

40. A federal district court, in a case involving the reasonableness of earnings accumulated because the corporation's exclusive patent was about to expire, held that if the management's "conservative policy ... conflicts with the fiscal policy of Congress, the latter must prevail." Trico Products Corporation v. McGowan, 67 F. Supp. 311, 325 (W.D. N.Y. 1946). But see L. Schepp Co. v. Commissioner, 25 B.T.A. 419, 429 (1932). But the court was careful to rationalize its decision on the basis of intentional tax avoidance. Stating that the stockholders had no financial need for dividends, the court asserted that only a "naive and credulous tribunal would find no taint of a purpose" to procure substantial tax savings by its methodical accumulation. Trico Products Corp. v. McGowan, supra at 324. See Trico Products Corp. v. Commissioner, 46 B.T.A. 346 (1942), aff'd, 137 F.2d 424 (C.C.A. 2d 1943), cert. denied, 320 U.S. 799 (1943).

The circuit court of appeals made the seemingly harsh statement that avoidance need not be "shown to have been the dominant factor behind the accumulation." Id. at 426. For comparable dicta, see Semagraph Co. v. Commissioner, 152 F.2d 62, 64 (C.C.A. 4th 1945); R. L. Blaffer Co. v. Commissioner, 37 B.T.A. 851, 856 (1938), aff'd, 103 F.2d 487 (C.C.A. 5th 1939), cert. denied, 308 U.S. 576 (1939); Nipock Corp. v. Commissioner,
tion and its attendant uncertainty would either render the government powerless to prevent tax avoidance under Section 102, or necessitate the adoption of rigid standards of automatic application precluding the flexibility essential to equitable administration.

The unpredictability of liability under Section 102 coupled with the cost and difficulty of litigating the issue of intent, is said to operate as a deterrent to productive enterprise by "obstructing the processes upon which business has traditionally depended for contingency reserves." Some economic consequences not envisioned by the statute are an inevitable by-product of the enforcement of its legitimate purpose. Vigorous application of stringent standards, for example, would promote an economic policy designed to achieve greater "mobility of capital" and to increase purchasing power by forcing the distribution of corporate earnings. On the other hand, restraint would encourage business investment in order to enhance productive employment. The latter seems to be the present governmental policy in view of the repeal of the Excess Profits Tax and Congressional acceptance of Treasury proposals to levy taxes "in such a way that they have the least...

36 B.T.A. 662, 668 (1937). By this the court apparently meant that when an accumulation is shown to be unreasonable, as was the case here, 46 B.T.A. 346, 374-9 (1942), the penalty tax can be imposed so long as the avoidance of personal surtax was a substantial motive even though not the "dominant" or "impelling" motive. Cf. Farmers' Loan & Trust Co. v. Bowers, 98 F.2d 794 (C.C.A. 2d 1940) (substantial motive regarding transfer made in contemplation of death).

41. "Section 102... is the modern 'Sword of Damocles'... the honest corporation is in constant jeopardy by reason of the burden which is placed upon it to prove itself free of guilt." Heninger, supra note 22 at 640-4.

42. Nat. Ind. Conf. Bd., op. cit. supra note 36, at 50. A taxpayer's brief went so far as to say that "the Revenue Department is engaged in a short-sighted attempt to kill the goose that lays the golden egg." Trico Products Corp. v. McGovan, 67 F. Supp. 311, 325 (W.D.N.Y. 1946).

43. "Any tax that produces revenue will in some way alter our social and economic order... Every tax is, in some measure, regulatory, since it imposes an economic impediment to the activity taxed as compared with others that are not taxed." Paul, Taxation for Prosperity 214-5 (1947). See note 40 supra.

44. See Fowler, The Depreciation of Capital 110 (1934).


For the corporate tax as a technique to curb monopoly or the fruits thereof see Hynning and Coll, Taxation of The Corporate Enterprise (TNEC Monograph 9, 1941). But see Scoville and Sargent, Fact and Fancy (TNEC Monographs 120-131, 1942).
harmful effect on the expansion of business investment." Such a policy makes Section 102 indispensable as the only method within our present tax structure of preventing wholesale avoidance at the top of the scale. But under the Section the courts are left with the difficulty of distinguishing improper accumulations motivated by tax considerations from good faith conservative business policy.

Despite the length of time Section 102 has been part of the Internal Revenue Code and the attention it has received, the statute remains unsatisfactory. Uncertainty of imposition is a valid business complaint, and, concomitantly, the illusory touchstone of intent burdens enforcement with litigation. Further tinkering with the statute does not promise to satisfy either the businessman's desire for certainty or the Treasury's need for an effective deterrent to tax evasion. An alternative, however, would lie in reforms of the total corporate tax structure aimed at reducing the inequalities between the total taxes on corporate profits and individual income. Plans designed to coordinate individual and corporate taxes have been proposed by the Division of Tax Research of the Treasury Department, among which the partnership system of taxing corporate earnings was stressed as being appropriate for "thousands of small corporations, probably the great majority of all corporations." If the partnership system would be impractical for large corporations, it has been suggested that a modification might be accomplished along the lines of the British income tax system by the collection of a high flat-rate tax at the source on all corporate income, with credit of this tax to the individual income recipient. These or similar plans would eliminate, to some extent at least, the incentive for the type of tax avoidance which gave birth to Section 102.


48. Id., at 32. The four basic approaches to coordination discussed are: (1) partnership, which would disregard the corporate entity for tax purposes and tax stockholders on their full share of corporate profits, whether distributed or retained, (see note 12 supra); (2) capital-gains, which would eliminate the corporate tax and tax stockholders on realized capital gains at regular individual rates; (3) credit for dividends paid, which would reduce the corporate tax when profits are distributed as dividends; and (4) credit for dividends received, which would adjust stockholders' taxes to take account of the fact that corporations have paid taxes on profits from which dividends are distributed. For comparison and estimates of revenue yield see id. at 64.

49. VICKREY, AGENDA FOR PROGRESSIVE TAXATION 383 (1947).

50. For an excellent treatment of Section 102(c), see Cary, ACCUMULATIONS BEYOND THE REASONABLE NEEDS OF THE BUSINESS: THE DILEMMA OF SECTION 102(c), 60 HARV. L. REV. 1282 (1947), which appeared too late to permit discussion in this Note.
COLLATERAL ATTACK ON COURTS-MARTIAL IN THE FEDERAL COURTS

Military courts have traditionally enjoyed near immunity from the surveillance of the federal judiciary. Early pronouncements by the Supreme Court categorized courts-martial as inferior courts of limited jurisdiction, subject to collateral attack in the civil courts, but exempt from their direct review. Succeeding Supreme Court decisions limited collateral inquiry to whether the court-martial was properly constituted, had jurisdiction of the person and subject matter, or had power to impose the sentence. Recent cases in the lower federal courts indicate a tendency to regard this concept as unduly restrictive, and reflect some deviation from it. Anthony v. Hunter illustrates this trend toward extending beyond jurisdictional considerations the scope of inquiry into decisions of military courts. Anthony, a combat soldier participating in the invasion of Germany, was charged with rape and sodomy, violations of the 92nd and 93rd Articles of War. Following investigation of the charges, accused was removed to the rear and found guilty by a general court-martial, his conviction being approved on review. After serving almost two years of the thirty-five year sentence, prisoner petitioned for a writ of habeas corpus in a federal district court, alleging that the court-martial had lacked jurisdiction because of the failure to comply with Article of War concerning pre-trial investigation, and that errors

1. See generally 1 Winthrop, Military Law and Precedents §§53-64 (2d ed. 1920).
5. Ex parte Reed, 100 U.S. 13, 23 (1879).
7. See notes 17, 21, 22 infra.
10. The death sentence pronounced by the court-martial was reduced on review to life imprisonment by the confirming authority and later to imprisonment for thirty-five years by direction of the President. The reviewing authorities were cognizant of irregularities in the trial procedure, but held some to have been harmless error and the remainder to have been waived by the defendant. 71 F. Supp. 823, 827 (D. Kan. 1947).
11. "... No charge will be referred to a general court-martial for trial until after a thorough and impartial investigation thereof shall have been made. This investigation will include inquiries as to the truth of the matter set forth in said charges, form of charges, and what disposition of the case should be made in the interest of justice and discipline. At such investigation full opportunity shall be given to the accused to cross-examine witnesses against him if they are available and to present anything he may desire in his own behalf, either in defense or mitigation, and the investigating officer
in the court-martial procedure constituted a denial of the due process of law guaranteed by the Fifth Amendment.

Principal witness in the habeas corpus proceeding was a former army officer who had conducted the pre-trial investigation in the military prosecution. He admitted that there were irregularities in the investigation, chief among which was the lack of opportunity for the accused to cross-examine the complaining witnesses—German civilians who had displayed considerable uncertainty in their original identification of accused. In addition, certain witnesses, whose presence at the investigation was requested by the accused, were not examined, even though available. The district court also discovered errors in the court-martial procedure, including insufficient notice of time of trial, failure to secure counsel of defendant’s choice, and incompetence of defense counsel.

The court indicated that relief could properly be granted on proof of inadequate compliance with Article of War 70 or on proof of deprivation of due process. Relying primarily on the former ground in ordering petitioner’s release from custody, the opinion was phrased in jurisdictional terms—that lack of compliance with the 70th Article of War constituted a defect precluding the court-martial from acquiring power over the person and subject matter. But little authority is available to support this position. The court quoted a 1924 ruling of the Judge Advocate General holding the provisions of Article of War 70 mandatory, but noted a recent reversal in which the Judge Advocate General stated that this Article is now to be regarded as only directory in all respects and that failure to comply therewith is not fatal error. The sole appellate decision treating Article of War 70 accords with the Anthony case in indicating that fulfillment of the Article’s provisions is essential to court-martial jurisdiction. The Eighth Circuit

shall examine available witnesses requested by the accused..."


12. The witness had been awarded a battle-field commission only a few weeks prior to the investigation and the defects in the investigation were attributed to his complete lack of experience. 71 F. Supp. 823, 825 (D. Kan. 1947).

13. Id. at 831.

14. The court apparently regarded Opinions of the Judge Advocate General as authority comparable to interpretations of administrative tribunals.

15. "...A court-martial is without jurisdiction to try an accused upon charges referred to it for trial without having been first investigated in substantial compliance with the provisions of A.W. 70..."

DIGEST OF OpINIONS, JUDGE ADVOCATE GENERAL—1912-1940, § 428(1) (U.S. Dep’t War 1941). (There the Judge Advocate General had found no pre-trial investigation whatsoever).


17. Reilly v. Pescor, 156 F.2d 632 (C.C.A. 8th 1946), cert. denied, 329 U.S. 790 (1946) (court-martial conviction on ten charges, one of which had not been investigated; circuit court dismissed petition for habeas corpus because sentence imposed was within that which could have been adjudged on any one of the nine charges investigated).
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there analogized the requirement for preliminary investigation to a similar provision in the criminal procedure of many states in which prosecution by information is authorized, but based its conclusion chiefly on the same superseded Judge Advocate General opinion.

The alternate basis for collateral attack set out in the instant case—violation of the Fifth Amendment—has received more extensive judicial discussion and approbation. Its first significant appearance was in an opinion of the Eighth Circuit, reviewing a district court order dismissing a petition for writ of habeas corpus on the ground that the court-martial had conformed to jurisdictional requirements, leaving no basis for collateral inquiry in the federal courts. Despite such jurisdictional sufficiency, the circuit court remanded the case for rehearing since it appeared from the petitioner's uncontroverted allegations that the military proceedings had been conducted in a highly prejudicial manner. Use of the due process clause to scrutinize military judgments has subsequently been endorsed by other federal courts.

Seeking to reconcile its holding with the long line of Supreme Court cases restricting the civil courts to jurisdictional inquiries only, the court in the

18. According to the circuit court, the statutes authorizing prosecution by information generally provide that an information can be filed only after the defendant has been accorded the right to a preliminary examination or hearing, and states possessing such statutes usually hold the requirement for preliminary examination mandatory unless waived. Reilly v. Pescor, 156 F.2d 632, 634 (C.C.A. 8th 1946), cert. denied, 329 U.S. 790 (1946). For such a statute, see N. Y. Crim. Code §§ 148, 190.

19. See note 15 supra.

20. Due process had been mentioned in early cases unsuccessfully seeking to attack collaterally military judgments, but the Supreme Court held military law to be due process for members of the military service. See French v. Weeks, 259 U.S. 326, 335 (1922); Creary v. Weeks, 259 U.S. 336, 344 (1922); Reaves v. Ainsworth, 219 U.S. 296, 304 (1911).

21. Schita v. King, 133 F.2d 283 (C.C.A. 8th 1943) (petitioner, presumably non compos mentis, applied for writ in forma pauperis, alleging deprivation of due process in World War I court-martial on numerous grounds including incompetence of defense counsel, intimidation of witnesses, denial of right to appeal, and denial of right to call witnesses). On rehearing, the district court dismissed the petition, after a full hearing including testimony by the petitioner and examination of the court-martial record, on its finding that the court-martial had not been irregular, and the circuit court affirmed sub nom. Schita v. Cox, 139 F.2d 971 (C.C.A. 8th 1944), cert. denied sub nom. Schita v. Pescor, 322 U.S. 761 (1944).

22. Shapiro v. United States, 69 F. Supp. 205 (Ct. Cl. 1947) (former army officer held entitled to back pay, because court-martial ordering his dishonorable discharge was conducted in such a manner as to result in deprivation of due process); Hicks v. Hiatt, 64 F. Supp. 238 (M.D. Pa. 1946) (soldier convicted of rape granted habeas corpus because of "totality of errors" in pre-trial and court-martial procedure, amounting to deprivation of due process); See United States ex rel. Innes v. Hiatt, 141 F.2d 654, 666 (C.C.A. 3d 1944) (dismissal of petition for habeas corpus affirmed, but court stated that question of whether a court-martial had violated Fifth Amendment was always open to the civil courts).

23. See notes 2-6 supra.
instant case contrasted the few appellate decisions of the last decade, which reaffirm the historic limits of collateral attack on military judgments,\textsuperscript{24} with the Supreme Court's recent repeated sanction of the use of habeas corpus to impeach state\textsuperscript{25} and federal\textsuperscript{26} convictions upon a showing of deprivation of due process.\textsuperscript{27} The extension of this presently expanded scope of inquiry to include military judgments was said to follow "\textit{a fortiori}."\textsuperscript{28}

That such a conclusion represents the current Supreme Court attitude is questionable. Circuit court decisions as recent as 1941, adhering to the traditional limitations as to collateral attack on courts-martial, were denied certiorari.\textsuperscript{29} The Supreme Court has had no occasion as yet to review any case of the \textit{Anthony} type;\textsuperscript{30} however, military trials of saboteurs\textsuperscript{31} and war criminals\textsuperscript{32} during the war led the Court to examine the comparable subject of

\textsuperscript{24} The only such case cited by the court is Carter v. Woodring, 92 F.2d 544 (App. D. C. 1937), \textit{cert. denied}, 302 U.S. 752 (1937) (former army captain, dishonorably discharged and imprisoned for five years by a court-martial in 1898, sued in equity to have sentence set aside because of prejudice of court-martial members; circuit court held, even though the allegations uncontroverted, that the military court had jurisdiction and its sentence was therefore not subject to collateral attack). Similar holdings during the same period, not cited by the court: Mosher v. Hudspeth, 123 F.2d 401 (C.C.A. 10th 1941), \textit{cert. denied}, 316 U.S. 670 (1942) (causing court-martial sentences for two separate offenses to run consecutively, and not incorporating same, held a matter of military law and not subject to collateral attack); Sanford v. Robbins, 115 F.2d 435 (C.C.A. 5th 1940), \textit{cert. denied}, 312 U.S. 697 (1941) (second court-martial for the same offense held not subject to collateral attack).


\textsuperscript{27} The Supreme Court has cautioned that use of the writ for this purpose is permitted to afford a remedy where circumstances are so exceptional that it is the only means of preserving the petitioner's constitutional rights. Waley v. Johnston, 316 U.S. 101, 105 (1942); Johnson v. Zerbst, 304 U.S. 458, 467 (1938).


\textsuperscript{29} Cases cited note 24 supra.

\textsuperscript{30} Reilly v. Pescor, 156 F.2d 632 (C.C.A. 8th 1946) (petition for writ of habeas corpus denied since conviction supported by other findings); United States \textit{ex rel. Innes} v. Hiatt, 141 F.2d 664 (C.C.A. 3d 1944) (petition for writ of habeas corpus denied); Schita v. King, 133 F.2d 283 (C.C.A. 8th 1943) (remanded for rehearing in which writ of habeas corpus denied); Shapiro v. United States, 69 F. Supp. 205 (Ct. Cl. 1947) (appeal pending); Hicks v. Hiatt, 64 F. Supp. 238 (M.D. Pa. 1946) (petition for writ of habeas corpus granted but case rendered moot by release of petitioner by the War Department without regard to habeas corpus proceedings).

\textsuperscript{31} \textit{Ex parte Quirin}, 317 U.S. 1 (1942) (German saboteurs petitioned for habeas corpus on ground military commission appointed by the President had no authority to try them; Supreme Court affirmed dismissal of petition).

\textsuperscript{32} \textit{In re Yamashita}, 327 U.S. 1 (1946) (Japanese general, convicted of atrocities against civilians and prisoners of war, petitioned for writs of habeas corpus and prohibition on grounds that the military commission was without jurisdiction in that it had been
collateral review of sentences of military commissions. In the *Yamashita* case, Chief Justice Stone dismissed the constitutional argument with language to the effect that questions of due process in the military proceedings were not reviewable by the federal judiciary.

Such a "hands-off" attitude, not surprising in view of the earlier Supreme Court holdings, is one of the various factors which enter into the disposition by the federal judiciary of the problems exemplified by the *Anthony* case. A practical consideration is the increase over the present sizable number of habeas corpus petitions that will result from liberalizing collateral attack. There is little doubt that a considerable percentage of wartime courts-martial contains some defect which could be utilized as the basis for impeachment under the *Anthony* rationale. This opportunity is not likely to be overlooked by military prisoners, greater in number as an aftermath of the war, or by client-seeking counsel. Not all petitioners may be able to meet the burden of proof for successful attack, but mere summary disposition of the petitions may place a heavy burden on the courts.

unlawfully constituted, had failed to charge petitioner with a violation of the law of war and had admitted hearsay and opinion evidence in violation of Fifth Amendment, Articles of War and Geneva Convention; Supreme Court affirmed dismissal of petition).

33. Principal difference between military commissions and courts-martial is that the former are used to try persons and offenses not within the purview of the Articles of War. 1 WINTHROP, *op. cit. supra* note 1, §§ 1296-7.

34. 327 U.S. 1 (1946). The principal distinction between the *Yamashita* and *Anthony* cases, aside from the fact that the former concerns a military commission and the latter a court-martial, is that the Supreme Court found that General Yamashita was not a person subject to the Articles of War and therefore the commission before which he was tried was convened not under authority of the Articles of War but pursuant to "the common law of war." *Id.* at 20.

35. *Id.* at 23.

36. District courts in whose jurisdictions federal custodial institutions are located are already burdened with a large volume of petitions for writs of habeas corpus. For a discussion of the problem including statistical survey, see Dorsey v. Gill, 148 F.2d 857, 861-4 (App. D.C. 1945).

37. The latest figures available, those for Dec. 31, 1945, show 22,744 army and 16,000 navy general prisoners in confinement compared to 486 and 700 respectively on Dec. 31, 1940. *Prisoners in State and Federal Prisons and Reformatories* 101-2 (U.S. Bureau of the Census 1947). This number has been decreased by the War Department rehabilitation program and its policy of re-examining all wartime general courts-martial. See note 39 infra.

38. Of the district court decisions involving habeas corpus petitions of military prisoners announced since *Anthony v. Hunter*, three have granted the petition: Wade v. Hunter, 72 F. Supp. 755 (D. Kan. 1947) (same court as *Anthony* case, based violation of Fifth Amendment on grounds of double jeopardy); Durant v. Hironimus, 73 F. Supp. 79 (S.D. W.Va. 1947) (notorious Hesse jewel thief case; failure to comply with 70th Article of War alleged, but rejected by court and writ issued on novel grounds that officer on terminal leave is not subject to jurisdiction of military courts); United States *ex rel.* Hirshberg v. Malanaphy, 16 U.S.L.W. 2159 (E.D. N.Y. Sept. 26, 1947) (navy court-martial held not to have jurisdiction over enlisted seaman for violations of Navy
On the other hand, it is difficult to ignore the possibility that numerous injustices may have resulted from the wartime courts-martial, particularly in the face of a general dissatisfaction with the system of military justice and the feeling that treatment such as that received by Anthony was not uncommon. Recognition of the problem by the War Department resulted in the appointment of a Clemency Board headed by Justice Roberts and including in its membership prominent civilian penologists with the assigned task of reexamining all wartime general courts-martial in order to insure uniformity of sentences, scale sentences down to civilian standards, and correct miscarriages of justice.8

Wide-spread agitation for reform has culminated in the introduction of legislation40 which embodies considerable revision of the court-martial system, including opportunity for accused to be represented by counsel at the pre-trial investigation, authority for enlisted men to sit as members of courts-martial, prohibition of excessive influence over members of courts-martial by commanders, a lesser punishment than death or life imprisonment for murder or rape, and the establishment of a separate Judge Advocate General Corps to assure independent appellate review.41 Congressional reaction has been most favorable and chances for enactment in the 1948 session are considered excellent.42

The Anthony case furnishes no clue to the judicial response that may be

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40. Highly instrumental in the reform movement was the American Bar Association which, with War Department approval, early in 1946 appointed an Advisory Committee on Military Justice to study the problem. This Committee, composed of civilian lawyers and judges under the chairmanship of Dean A. T. Vanderbilt of New York University Law School, made an extensive study and conducted hearings in all parts of the country. Principal recommendations of the Committee were approved by the War Department and transmitted to Congress with some modification, 33 American Bar Association Journal 40, 319 (1947).


42. The bill was reported favorably on July 22, 1947, by the House Armed Services Committee, and is on the Union calendar for consideration in the 1948 session. Ibid.
expected from such statutory reform. However, should the reformatory measures be realized, and assuming the system as corrected meets the civil courts' standard of procedural due process, a solution to the judicial dilemma may result—the injustices of the wartime courts-martial could be rectified without committing the bench to a future policy of interfering with military justice. Such a rationale may promote the acceptance of the doctrine of the Anthony case by a judiciary predisposed to act as the protector of civil liberties.

USE OF THE DERIVATIVE SUIT BY GROUPS FOREIGN TO THE CORPORATION TO PREVENT CORPORATE VIOLATION OF LAW AND PUBLIC POLICY*

The stockholders' derivative suit has historically performed the function of reimbursing corporate treasuries for loss caused the corporation by officers and directors who fail to serve it carefully and honestly. But the recent de-


1. Courts have generally divided stockholder suits into three categories: individual, representative, and derivative. The individual suit is generally brought to reimburse the complaining shareholder directly for some injury done to him in his shareholding capacity, but not injurious to the general group of stockholders or the functioning of the corporation. A representative action is technically one brought by the stockholder on behalf of himself, and all other stockholders similarly situated. The derivative suit, on the other hand, with which this Note is concerned, is brought on behalf of the corporation to reimburse the corporate treasury for loss resulting from improper activity by directors, officers, or third persons. The corporation is considered the real party in interest, not the plaintiff stockholder. 13 FLETCHER, CYCLOPEDIA CORPORATIONS §§ 5903-12, 5939 (rev. vol. 1943). For excellent discussions of the derivative suit from conflicting points of view compare Hornstein, New Aspects of Stockholders' Derivative Suits, 47 Col. L. Rev. 1 (1947) and Legal Controls for Intracorporate Abuse—Present and Future, 41 Col. L. Rev. 405 (1941), with Carson, Further Phases of Derivative Actions Against Directors, 29 CORN. L. Q. 431 (1944) and Current Phases of Derivative Actions Against Directors, 40 MICH. L. REV. 1125 (1942).

Apparently the earliest judicial recognition of the stockholder's privilege to sue in a derivative suit on behalf of the corporation came in the English case of Hitchens v. Congreve, 4 Russ. & M. 562, 575-6, 38 Eng. Rep. 917, 922 (Ch. 1828). The early cases described the suit as a device to be used only where the corporation was too large and the stock too widely held to conveniently permit individual actions by all stockholders. Id. at 576, 38 Eng. Rep. at 922; see Foss v. Harbottle, 2 Hare 461, 492, 67 Eng. Rep. 189, 203 (Ch. 1843). From the beginning, the English courts imposed strict requirements upon such actions, and laid the groundwork for what later came to be described in this country as the "business judgment" rule. See note 15 infra.

In 1855, the U. S. Supreme Court adopted the English view that such suits could be brought in equity, and thus firmly established the remedy in the United States. Dodge v. Woolsey, 18 How. 331 (U.S. 1855). Later, in Hawes v. Oakland, 104 U.S. 450 (1881), the Supreme Court set out at length the requirements and uses of the suit.
cision of the New York Court of Appeals in Abrams v. Allen\(^2\) gives rise to the possibility that novel use might be made of the derivative suit as an instrument by which a group foreign to the corporation could enforce corporate compliance with law and public policy where such compliance would serve the group's special purposes. Plaintiffs in the Abrams case alleged that the defendant president and directors of Remington Rand, Inc., motivated by their personal hatred for labor unions, had damaged the corporation by the dismantling and removal of plants and the curtailment of production as part of a campaign, unlawful under the National Labor Relations Act,\(^3\) to "discourage, intimidate, and punish" striking employees.\(^4\) In upholding the sufficiency of the complaint the court acknowledged that, "depending on circumstances," proof of these allegations might sustain a recovery, under the rule, \textit{inter alia}, that directors are liable for corporate loss caused by the commission of an "unlawful or immoral act."\(^5\)

The reaffirmation of this rule in the Abrams case suggests a possible method

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  \item \textbf{2.} 297 N.Y. 52, 74 N.E.2d 305 (1947).
  \item \textbf{4.} 297 N.Y. 52, 55, 74 N.E.2d 305, 306 (1947). The activities in question have been widely publicized as "The Mohawk Valley Formula." For a brief description of the formula's principal features see Brooks, \textit{When Labor Organizes} 133-49 (1937); NLRB v. Remington Rand, Inc., 94 F.2d 862 (C.C.A. 2d 1938), \textit{cert. denied}, 304 U.S. 576, 585 (1938). The fight by Remington Rand against unionization continues; the NLRB has recently freed the corporation from further obligation to bargain with the local CIO union as a result of the union's failure to file non-Communist affidavits under the NLRA as amended. Taft-Hartley Act, 29 U.S.C.A. § 159h (Supp. 1947); \textit{N. Y. Times}, Dec. 5, 1947, p. 1, col. 2; \textit{id.}, Dec. 8, 1947, p. 22, col. 5.
  \item \textbf{5.} 297 N.Y. 52, 55, 74 N.E.2d 305, 306 (1947). For other statements of the New York rule see: Roth v. Robertson, 64 Misc. 343, 118 N.Y. Supp. 351 (Sup. Ct. 1909) (director liable for bribe paid to public official to keep amusement company in operation in violation of Sunday laws and public morals); Metropolitan Elevated Ry. v. Kneeland, 120 N.Y. 134, 24 N.E. 381 (1890) (directors who signed promissory notes in corporation's name liable because act exceeded authority and was illegal); Hill v. Murphy, 212 Mass. 1, 98 N.E. 781 (1912) (directors liable for loss resulting from their libel of fellow executive); \textit{accord}, Runcie v. Bankers Trust Co., 6 N.Y.S.2d 623, 624 (Sup. Ct. 1938): "While directors have discretion in the management of the affairs of corporations, and neither courts nor stockholders can interfere with them in the exercise of such discretion, such discretion does not permit the directors in discharging their duties to commit acts prohibited by statute." See Note, 40 L.R.A. (N.S.) 1102 (1912). \textit{Contra:} Dworetzky v. Douglas, 108 N.Y.L.J. 1031 (Sup. Ct. Oct. 15, 1942) (derivative complaint alleging loss to corporation resulting from deliberate director violation of the NLRA held insufficient on ground that such activity was within the realm of "business judgment").

Courts have reasoned that in violating the law directors have "exceeded their authority," committed a "fraud" upon the corporation, or violated their "affirmative trust" to the corporation and stockholders, and are liable for ensuing harm. \textit{See} Leslie v. Lorillard, 110 N.Y. 519, 532, 18 N.E. 363, 365 (1888); Hawkins County v. East Tenn. & Virginia R.R., 1 Shannon Cases 290 (Tenn. Sup. Ct. 1874); 1 Morawetz, \textit{Private Corporations} § 556 (2d ed. 1886); cases collected in Note, 40 L. R. A. (N.S.) 1102 (1912).
by which an outside group—which holds stock or could find a stockholder willing to become a nominal plaintiff—could prevent corporate violation of a statute or public policy. Such a group might, by threatening to bring a derivative action against directors or officers in the event the corporation carries out a projected course of illegal conduct, accomplish a result similar to that which might be reached in a stockholder’s suit for injunction.

Of course, there would be certain barriers to recovery where the primary interest of the plaintiff is that of an outside group—as in the case of a union

6. See 13 Fletcher, op. cit. supra, note 1, § 5972. Several of the commercial states have imposed stringent stock ownership requirements for plaintiffs in derivative suits, which, of course, must be met by complaining stockholders. For example, in 1944 New York amended its laws to allow the defendant corporation, in its discretion, to require that plaintiffs owning less than $50,000 or 5% of the corporation’s stock post “security” for “reasonable expenses,” including attorney fees, which may be incurred by the defendants. At the conclusion of the action, the court can require forfeiture of the amount of the bond. N.Y. Gen. Corp. Law § 61-b. Other commercial states have copied the provisions of this statute. See e.g., N.J. Stat. Ann., tit. 14, § 3-15 (Supp. 1946); Pa. Stat. Ann., tit. 12, § 1322 (Purdon, Supp. 1946). But see Md. Laws 1945, c. 929. Wisconsin has attacked the suit with a statute which prohibits derivative suits by plaintiffs owning less than 5% of the shares outstanding, except where the action is based on conduct resulting in benefit to directors or certain stockholders. Wis. Stat. § 180.13 (1945).

It may be important to note that these restrictions upon the derivative suit have been interpreted to be “procedural,” and thus not binding upon the federal courts in New York. E.g., Boyd v. Bell, 64 F. Supp. 22 (S.D.N.Y. 1945); Craftsman Finance & Mortgage Co. v. Brown, 64 F. Supp. 168 (S.D.N.Y. 1945).

7. The mere knowledge by corporate officials or directors that illegal corporate action might result in a derivative suit by an outside group would tend to deter such action. In the past the prophylactic effect of the derivative suit has undoubtedly been of great importance in regulating the conduct of corporate management. See SEC, Report on the Study and Investigation of the Work, Activities, Personnel and Functions of Protective and Reorganization Committees, pt. I, 691 (1937).

8. The stockholder’s suit for an injunction may serve as an effective and simple means of preventing clearly illegal acts, where the illegality also involves loss to the corporation. However, an extended discussion of the problems peculiar to the use of this device is beyond the scope of this Note. There is, for instance, some conflict as to whether or not a stockholder’s suit to enjoin is derivative or individual, but in its practical effect it appears to fall under the latter heading. Compare 6 Thompson on Corporations 504 (3d ed. 1927), with 13 Fletcher, op. cit. supra, note 1, § 5928. Although the suit for injunction would do away with the necessity for making demand on the corporation to sue and would also escape the legislative restrictions imposed upon the derivative suit, it might encounter other difficulties. For instance, where the alleged “illegal” act had not yet been consummated, some question might arise as to whether it would constitute a violation of the law in question. In the case of such suits brought in state courts alleging threatened violation of federal law, courts would be occasionally forced to dismiss for want of jurisdiction over the federal question involved. Cf., e.g., Wise v. Tube Bending Machine Co., 194 N.Y. 272, 277, 87 N.E. 430, 431 (1909). And, even if properly brought in a federal court a suit for injunction might not lie where an adequate remedy at law had been provided. Cf., e.g., Myers v. Bethlehem Shipbuilding Corp., 303 U.S. 41 (1938).
attempting to enforce collective bargaining provisions of the NLRA. For example, the date of stock acquisition would be important in those states where the plaintiff must have been a shareholder as of the date of the wrong alleged. A second problem would be proof of actual loss to the corporation, stemming from the illegal director activity. In the case of a failure to bargain collectively, such loss could normally be found in a long and costly strike or in damage to corporate good-will. The third obstacle to liability under


For an earlier action along these same lines see Pieplow v. A. J. Lindemann & Hoverson Co., Circ. Ct., Milwaukee County, Wis., Dec. 24, 1936 (complaint held sufficient in derivative suit alleging failure to bargain collectively in compliance with “little Norris-LaGuardia Act” and “public policy”). This case was noted in 46 YALE L. J. 1424 (1937), with particular emphasis upon the use of the derivative suit to force collective bargaining in areas outside the realm of the NLRA, i.e., in intrastate commerce.

Shortly after the complaint was upheld in the Pieplow case, negotiations between the union and corporation officers were renewed, and the existing strike was settled. It had lasted eighteen months and caused loss to the company of $220,000. Communication to the Yale Law Journal from Mr. Max Raskin, attorney for plaintiffs, Sept. 10, 1947.

Pre-trial activity in the case of O'Brien v. Republic Steel Corp., No. 502344, Ct. of C. P., Cuyahoga County, Ohio, has recently been renewed after a lapse of about seven years. The suit was originally filed in 1940, alleging directors' intentional violation of the NLRA and resultant loss to the corporation. Communications to the Yale Law Journal from Mr. William Rosenfeld, attorney for complainant, Sept. 25, 1947, and from Mr. T. F. Patton, General Counsel for Republic Steel Corp., Aug. 21, 1947. The outcome in the Abrams case may have been influential in this renewal of effort.


Although Fed. R. Civ. P., 23(b) contains a similar requirement, it is doubtful that the federal courts—in those states where the date of stock acquisition is immaterial—should be bound by it, since under the doctrine of Erie v. Tompkins, 304 U.S. 64 (1938), such a rule might substantially affect the result of the suit, and thus be “substantive” rather than “procedural.” See discussion and cases cited in 2 Moore's FEDERAL PRACTICE § 23.05 (1938); 2 id. (Supp. 1946).


12. While it is true that the relative importance of loss from unfair labor violations of the NLRA has diminished, many cases involving such practices continued to come
this theory would be proof of a *knowing* violation of the law. Such knowledge, in situations like that in the *Abrams* case, might be evidenced by the refusal of corporate directors to comply with a circuit court of appeals decree implementing an NLRB cease and desist order. Another defense which might be effective against such an action is that of “business judgment.”

before the Board. Thus, from a total of 865 unfair labor cases in 1936 there was an increase to a peak of 4,967 in 1942, with a slight drop in 1946 to 3,815. 11 NLRB Ann. Rep. 75 (1947).

For a survey of some of the types of corporate expenditure for anti-union activities which have occurred in the past, see B ROO KS, op. cit. supra note 4, at 64 et seq.

In 1936, for instance, Remington Rand spent $982,000 on labor disputes, including $656,740.23 attributable to interrupted production and moving machinery, materials and families in accord with the “Formula”; see note 4 supra; Sen. Rep. No. 46, 75th Cong., 2d Sess. 79, 87 (1938).

Senate sub-committee hearings in 1937 brought to light expenditures of $239,462 by the American Bridge Co. in its fight against employing iron workers at union wages upon Pulaski Skyway in Jersey City, N. J. The corporation saved $51,849 in wages by this refusal, but took an over-all loss of $237,613 on the transaction. N. Y. Times, Mar. 4, 1937, p. 1, col. 6.

The following description of the questionable accounting practices tolerated by corporation management in financing illegal espionage and company police activity appears in Sen. Rep. No. 6, 76th Cong., 1st Sess. 195 (1939): “The expenses [of Republic Steel’s police department] incurred in connection with these activities were paid by the corporation upon ‘blind’ vouchers submitted by various members of the police department. These vouchers failed to show upon their face the specific purpose for which the money was spent. Some of these vouchers were blank except for the date, the sum of money, and the signatures of the payee and the officer approving the payment.”

13. E.g., Simon v. Socony-Vacuum Oil Co., 179 Misc. 202, 203, 38 N.Y.S.2d 270, 273 (Sup. Ct. 1942), aff’d without opinion, 267 App. Div. 890, 47 N.Y.S.2d 589 (1st Dep’t 1944): “... if the directors act in good faith and exercise reasonable care in the performance of their duties, they are not liable for mistakes... of law or fact.” See 3 FLETHER, Cyclopedia Corporations §1021 (rev. vol. 1947). But cf. Note, 73 A.L.R. 1120 (1931) for a discussion of the knowledge requirement where directors are charged with fraud against the corporation. If defendants could prove that their purpose in violating the statute was to test its constitutionality, and that no other method of attack was available, it would seem that they should not be held responsible for resultant loss to the corporation.


15. Courts have apparently felt that directors will function most effectively in behalf of the shareholder where they are given freedom to act without fear of frequent derivative suits, and have accordingly surrounded the activity of directors with presumptions of good faith, due care and regularity through development of the “business judgment” rule. See Gamble v. Queen County Water Co., 123 N.Y. 91, 99, 25 N.E. 201, 202 (1890); 3 FLETHER, op. cit. supra note 13, §§1039-40; BAKER, DIRECTORS AND THEIR FUNCTIONS 9 (1945). Justice Shientag presents an excellent discussion of the “business judgment” rule and its proper relationship to the derivative action in Bayer v. Beran, 49 N.Y.S.2d 2, 4-7 (Sup. Ct. 1944). “... [T]he law will not interfere with the internal affairs of a corporation so long as it is managed by its directors pursuant to a free, honest exercise of judgment uninfluenced by personal, or by any considerations other than the welfare of the corporation.
However, this defense has, in some jurisdictions, been held inapplicable where directors have committed a knowing violation of law. 16

A major obstacle to use of the derivative suit by outside groups as a weapon of law enforcement would be possible extension of the rule—now used only rarely—that, where the real purpose of the suit is to inflict damage upon the corporation, the plaintiff may be disqualified for improper motive. 17 Thus, courts might hold that, where the primary purpose of the plaintiff is not to benefit his interest as a shareholder but to promote some outside interest, the plaintiff's motive would be sufficiently "improper" to bar him from proceeding. And even where a court would be willing to admit a suit not motivated by the plaintiff's interest qua shareholder, a plaintiff invoking corporate violation of a statute might well be compelled to show that the legislation did not

"To encourage freedom of action on the part of directors, or to put it another way, to discourage interference with the exercise of their free and independent judgment, there has grown up what is known as the 'business judgment rule.'" Id. at 6.

As to the presumptions established under the "business judgment" rule, a Delaware court has said: "... it is not ... [the courts'] ... function to resolve for corporations questions of policy and business management. The directors are chosen to pass upon such questions and their judgment unless shown to be tainted with fraud is accepted as final. The judgment of the directors of corporations enjoys the benefit of a presumption that it was formed in good faith and was designed to promote the best interests of the corporation they serve." Davis v. Louisville Gas & Electric Co., 16 Del. Ch. 157, 169, 142 Atl. 654, 659 (Ch. 1928); accord, Toebelman v. Missouri-Kansas Pipe Line Co., 41 F. Supp. 334 (D. Del. 1941); Diamond v. Davis, 38 N.Y.S.2d 103 (Sup. Ct. 1942), aff'd, 265 App. Div. 919, 39 N.Y.S.2d 412 (1st Dep't 1942), aff'd without opinion, 292 N.Y. 552, 54 N.E.2d 683 (1944).

16. Under this theory the "business judgment" rule becomes no longer material, and with it disappear the presumptions which normally surround director activity. The only possible relevance of "business judgment" where courts take this view of illegal activity is in determining whether or not the defendants knew or should have known they were violating the law. See 3 Fletcher, op. cit. supra note 13, § 1023; Thompson v. Greeley, 107 Mo. 577, 17 S.W. 962 (1891).

In the Abrams case the court qualifies its statement of the rule of "illegal act" liability by saying, "... they [defendants] may have done ... [the acts alleged] ... for the best of reasons." (Italics supplied.) This may indicate that, in New York, at least, the courts will take into account qualifying circumstances even where a knowing violation of law is proved. 297 N.Y. 52, 56, 74 N.E.2d 305, 307 (1947). Contra: Metropolitan Elevated Ry. v. Kneeland, 120 N.Y. 134, 24 N.E. 381 (1890); Roth v. Robertson, 64 Misc. 343, 118 N.Y.Supp. 351 (Sup. Ct. 1909); cf. Runcie v. Bankers Trust Co., 6 N.Y.S.2d 623 (Sup. Ct. 1938).

intend the enforcement devices provided in the statute to be exclusive.\textsuperscript{18} Problems of motive might be obviated where the nominal plaintiff could show that protection of his personal stock interest was, in fact, the basis of his cause of action; but judicial scrutiny might be intense were there some demonstrable connection between the plaintiff shareholder and an outside group.

If these barriers can be surmounted, it is conceivable that the derivative suit could be used by a variety of groups seeking to prevent corporate misconduct. For example, groups interested in anti-trust enforcement might use the device in a situation similar to that presented in \textit{Clayton v. Farish},\textsuperscript{19} in which the New York Supreme Court, relying on the \textit{Abrams} case, upheld a complaint alleging loss to the Standard Oil Company of New Jersey resulting from the negotiation of cartel agreements.\textsuperscript{20} Threats of a derivative suit might also be made by consumer organizations interested in enforcing rent and price control legislation, should the latter be reinstated.\textsuperscript{21} Groups interested in preventing racial discrimination might, for instance, sue as theater shareholders for loss caused through failure to admit Negro patrons, or as

\textsuperscript{18} Typical of judicial statements to this effect are the following: "Congress declared that certain labor practices should be unfair, but it prescribed a particular method by which such practices should be ascertained and prevented. By the express terms of the Act [NLRA], the Board was made the exclusive agency for that purpose." \textit{Amalgamated Utility Workers v. Consolidated Edison Co.}, 309 U.S. 261, 264 (1940). "The Board as a public agency acting in the public interest, not any private person or group, not any employee or group of employees, is chosen as the instrument to assure protection from the described unfair conduct in order to remove obstructions to interstate commerce." \textit{Id.} at 265. Cf. \textit{Bruce's Juices, Inc. v. American Can Co.}, 330 U.S. 743 (1947) (Robinson-Patman Act violation); \textit{FTC v. Klesner}, 220 U.S. 19 (1929) (attempt to enforce FTC order). \textit{But see id.} at 26 (Interstate Commerce Act creates private rights).

No completely convincing answer can be made to such a contention, since it seems highly doubtful that any legislature has ever considered the possible use of the derivative suit as an enforcement device. However, it could be argued that legislative consideration would not necessarily have meant legislative disapproval. The legislature might well have found that such suits would tend to deter the officials of other corporations from indulging in knowing violation of the law, and thus serve the interest of the public in law enforcement. This benefit might have seemed to the legislature to outweigh the possibly undesirable consequences of making those responsible for corporate violation of law personally liable for resultant corporate loss.

\textsuperscript{19} 73 N.Y.S.2d 727 (Sup. Ct. 1947).

\textsuperscript{20} The court quoted the \textit{Abrams} opinion in its entirety, thus leaving doubt as to the portions of the opinion on which it placed chief emphasis. \textit{Id.} at 733. The holding in \textit{Clayton v. Farish}, appears to have been based largely upon the corporate waste alleged, rather than upon any theory of director liability for illegal acts. \textit{Clayton v. Farish}, 73 N.Y.S.2d 727, 744 (Sup. Ct. 1947).

\textsuperscript{21} It is true that in some instances it might be difficult to prove pecuniary loss to the corporation resulting from violations of this sort of legislation. But where the statute provides for the recovery of double or triple penalty damages, and where corporate good-will is likely to suffer because of the illegal activity, the showing of loss would present an easier problem. \textit{E.g., 56 Stat.} 33 (1942), 50 U.S.C. § 925(e) (Supp. 1942).
stockholders of an auditorium corporation for damage resulting from directors' refusal to permit use of the building by a Negro entertainer.\textsuperscript{22}

It is apparent that such use of the derivative suit could be rationalized on the ground that it would in no way impair the suit's traditional function as a device for recouping corporate loss. But if the courts are to approve this novel application of the suit, they might do better to give frank recognition to the fact that its projected use is justifiable only in terms of society's progressively more insistent demands for high standards of corporate conduct.\textsuperscript{23}

\textsuperscript{22} In some jurisdictions such discriminatory activities would constitute a violation of a statute or local ordinance. In others, a suit might be based upon the theory that such activities contravene "public policy." There is some judicial language which could support such a result.

\textsuperscript{23} Many commentators have emphasized the present need for increased director recognition of corporate obligations to the community. See, e.g., \textit{BAKER}, \textit{op. cit. supra} note 15, at 138: "The essential concern of corporation directors, particularly in our large corporations, is not today, nor should it ever have been, merely protection of stockholders and their interests. These functions are simply more in evidence than others. The problem is vastly more important. It is the reconciliation of private enterprise with the smooth functioning of a democratic society with justice to all groups: stockholders, executives, employees, creditors, customers, and the public. Such a broad concept of the functions of directors is frequently overlooked." For similar statements see \textit{DIMOCK AND HYDE, BUREAUCRACY AND TRUSTEESHIP IN LARGE CORPORATIONS} 123 (TNEC Monograph 11, 1940); \textit{GORDON, BUSINESS LEADERSHIP IN THE LARGE CORPORATION} 341 (Brookings Inst. 1945).