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Comments

LEGAL AND ECONOMIC ASPECTS OF TAXES AS COSTS OF OPERATION IN UTILITY RATE-MAKING

In the past sixty years a rather comprehensive system of public utilities regulation has been evolved, governing utility rates, services, accounting, combination, labor relations and finance.¹ Because of the economic nature of public utilities,

1. Unless otherwise indicated, public utilities as herein used include not only those corporations properly denominated utilities, but also railroads.

competition is not particularly suited to natural regulation of prices and services by the operation of normal economic laws. Rather, because of the nature of the public utility, it is considered that competition should not exist. The presence of one railroad in an area, for instance, may be sufficient to insure an adequate means of transportation for the businesses and population of that area, and the presence of another railroad in the area would only slightly increase the amount of traffic moving by rail as competition forced rates downward while capital investments of a substantial nature would be wasting away. The regulation that has developed in the past sixty years has a dual aspect. Originally, the aim was probably solely to protect the user of service from monopoly exploitation. In more recent years, however, regulation has had a protective aspect for the utility, with the particular unit of government concerned standing in a position of *parens patriae*, protecting the utilities *inter sese* from undesirable competition and attempting to guarantee their economic well being in the interest of continued public service. That which serves the public cheaply is of public value only when it does not serve so cheaply as to prejudice its ability to continue such service.

The primary feature of utility regulation, at least in the eyes of the public, is rate regulation. Here is the immediate contact between the public and the utility. Three cardinal factors prescribe the framework within which rate regulation functions: (1) Rates must not be so high as to constitute an undue burden upon the public. There must be no taint of excessive profits or public exploitation by the utility. (2) Rates must not be so low as to be unreasonable. The lower limit of rates as established by the regulatory body is imposed as a matter of Constitutional Law. A utility is entitled to "a fair return upon the value of that which it employs for the public convenience."² Rates so low as not to afford such a return constitute deprivation of property without due process of law. (3) Aside from the matter of due process, rates should not be so low as to drive private capital out of the industry with a resultant loss of services to the public.³

Bearing these three factors more or less consistently in mind, the regulatory body examines the condition of the utility from time to time, usually at the request of the utility or a third party or group economically concerned, and scrutinizes the rate structure. So far as the second and third factors are concerned (and indirectly, of course, the first factor is always present for consideration), the focal point of attention is the net operating return of the particular utility (or perhaps, the particular group of utilities), that is, an adequate return must be a net return. This determination of the net return, then, of necessity requires an examination of the accounts of the utility to determine what charges and disbursements are properly deductible from gross income. A reasonable uniformity in charges against gross income has been attained among the various railroads subject to the jurisdiction of the Interstate Commerce Commission, but no such uniformity has appeared with respect to railroads and utilities subject exclusively to state

2. *Smyth v. Ames*, 169 U.S. 466 (1898).

3. Unless, perhaps, the industry is no longer an economic necessity, a situation that has not yet presented itself in any of the public service industries.

regulation. About the most that can be said so far as taxes are concerned is that *most* regulatory bodies allow *most* taxes as charges against gross operating income in determining what is an adequate return.⁴ And perhaps it can be said that there is a strong tendency towards allowing *all* taxes as charges against gross operating income.

An examination of the accounting systems of railroads and public utilities discloses that taxes are uniformly deducted from gross operating income, along with other appropriate costs and charges, in arriving at net operating income. This is equivalent to charging taxes to current operating costs, and, to the extent that rates are authorized by regulatory bodies to derive a given net income over and above such costs, represents a passing on of the burden of the taxes to the users of the utility services. In so far as the taxes are those levied against property, this practice is consistent with the generally accepted view that property taxes imposed on the possessions of business enterprises are largely shifted to the consumer.⁵ The same is true of the excise taxes to which the utilities are subject. As to such taxes, there has been little controversy, and courts and commissions generally acquiesce in such accounting treatment of the taxes as operating costs which may be passed on to the user of the utility's service.⁶

4. An illustration of the process of rate determination in its crudest form will show how taxes may be considered operating costs and passed on to the consumer:

Cost of carriage on the Hocking Valley Railroad from Nelsonville, Ohio, to Toledo, Ohio (coal).	
Line haul and assembling	51.29 cents
Excise taxes	3.20
Other taxes	1.50
Rentals	1.11
Switching charges	7.28
TOTAL RAILROAD COSTS	64.38 cents
Reasonable profit	15.62 cents

TOTAL COST PER TON OF COAL80.00 cents

Dist. 6, U.M.W.A. v. Akron, Canton and Youngston Railway, Case No. 571, Ohio Public Utilities Commission (1916). *Quaere*: Where did the reasonable profit item come from?

5. It does not always follow that taxes are successfully shifted to the consumer. Thus, if a utility fails to earn a fair return, as sometimes happens (your attention is called to the history of railroad earnings in particular over the past twenty years), the taxes are borne at least in part by the stockholders of the utility. In such cases, a remission of taxes by the taxing units would not necessarily mean that a rate reduction must follow but merely that the utility might now earn a fair return upon its invested capital which it had failed to earn before. Furthermore, it may very well be that a substantial tax bill is absorbed by utility stockholders when increases in taxes occur. Rate increases take time to acquire and are relatively infrequent. In the interim, it is probably true that increased taxes are absorbed rather than shifted.

6. "It is the *duty* of these patrons to contribute to the defendant company a sufficient amount of revenue to pay *operating expenses and taxes*." Meade Coal Co. v. Appalachian Power Co., P.U.R. 1923E, 221 (W. Va.). No doubt the consumer of power in West Virginia would be startled if told that he was under a duty to support a local utility.

The practice of treating railroad taxes and utility taxes as operating expenses, however, is not confined to property and excise taxes, for there is a strong tendency to treat federal and state corporation income taxes in the same manner. Certainly one would be entitled to raise an academic eyebrow at this, since (i) the theory of the income tax assumes an inability of the taxpayer to shift the incidence of the tax from himself to the consumer of his product or services by an increase in the price of his product or services, and (ii) it may be questioned whether utility corporate income should be treated preferentially as compared with the income of other corporations which are unable to shift the incidence of the income tax without incurring constantly greater tax liability in successive years. If the process of rate-determination were scientifically accurate, the inclusion of income taxes as costs of operation chargeable against gross operating income would result in an increase in rates (and of taxes) every successive year until the service was priced out of the market.⁷ Rate-determination, however, is not such a scientific process, and any attempt to make it such with reference to income taxes by the establishment of an algebraic formula of rate/tax determination would soon be lost in the limbo of rule of thumb qualifications.

When the income tax question was first raised, the weight of authority of the various regulatory commissions apparently was against the allowance of such taxes as charges against gross operating income, probably on the basis of the two ideas mentioned above,⁸ but there was a substantial volume of contrary rulings.⁹ In the *Galveston* case, in 1922, the United States Supreme Court (the ultimate arbiter of economic theory) held that income taxes were properly considered as costs of operation.¹⁰ After the Supreme Court decision, most state commissions that had previously taken the opposite position came into line, allowing income taxes as

7. An increase in rates to meet the income taxes would result in an increase in income; the increase in income would result in an increase in income taxes, *et cetera ad infinitum*. This process could not long continue, however, for those utilities subject to competition (as railroads) would rapidly lose their business to competitors; and those not subject to competition would inevitably price themselves out of the reach of the public. It may be seen that public policy and interest in maintaining the services of such industries would be contrary to such a process, as would the financial self-interest of the utilities.

8. *State Corporation Commissioner v. Newport News Light & Water Co.*, P.U.R. 1923D, 91 (Va.); *Re Leadville Water Co.*, P.U.R. 1921D, 172 (Colo.); *Re Public Service Co.*, P.U.R. 1919D, 809 (Ill.); *Springfield City Water Co. v. Springfield*, P.U.R. 1919D, 853 (Mo.); *Re Iroquois Natural Gas Co.*, P.U.R. 1919D, 76 (N.Y.); *Re Midwest Power Co.*, P.U.R. 1923A, 816 (N.D.); *Kane v. Spring Water Co.*, P.U.R. 1920E, 803 (Pa.).

9. *Re San Diego Consolidated Gas & Electric Co.*, P.U.R. 1919D, 924 (Cal.); *Danbury v. Danbury & B. Gas & Elec. Co.*, P.U.R. 1921D, 193 (Conn.); *Re United Fuel Gas Co.*, P.U.R. 1920C, 583 (W. Va.).

10. "In calculating whether the five cent fare will yield a proper return, it is necessary to deduct from gross revenue the expenses and charges; all taxes which would be payable if a fair return were earned are appropriate deductions. There is no difference in this respect between state and federal taxes, or between income taxes and others." Brandeis, J., in *Galveston Electric Co. v. Galveston*, 258 U.S. 388 (1922). *Accord: Georgia Railway & Power Co. v. Railroad Commission of Georgia*, 262 U.S. 625 (1923).

costs of operation,¹¹ as did the federal regulatory bodies.¹² Some state commissions have apparently adhered to their original position forbidding such treatment of income taxes, and have not been disturbed in their ruling so long as there is a reasonable return within the rule of *Smyth v. Ames*. While the question still engenders debate,¹³ it must be stated that at the present time it is largely academic.

Whether excess profits taxes should be considered as costs of operation is still a contested issue, and rulings and cases handed down in recent years have done little to establish a uniform rule of treatment. On the one hand, it may be argued that an excess profits tax is just another income tax; that excess profits within the meaning of a taxing statute are not necessarily profits which are excessive to a public service industry;¹⁴ and that the fact that a public utility is within an excess profits tax bracket does not necessarily mean that rate determinations of the regulatory body charged with establishing rates for the particular corporation or industry concerned have been laxly beneficial to that corporation or industry at the expense of the public using its services. Fair return is a percentage earned "upon that value of that which it (the utility) employs for the public convenience." Excess profits tax income is income in excess of an average income of past years.

11. *Re Mommouth Telephone Co.*, P.U.R. 1923B, 858 (Ill.); *People ex rel Pennsylvania Gas Co. v. Public Service Commission*, P.U.R. 1934, 608 (N.Y.); *Michigan Public Utilities Commission v. Michigan State Telephone Co.*, 228 Mich. 658 (1924); *Re Red Phil, Rapid Transit Co.*, P.U.R. 1923E, 190 (Pa.).

12. Thus the Interstate Commerce Commission follows the supreme court rule, treating income taxes as an expense of operation. But, it recognizes the tax-free nature of the resulting net income of railroads in determining what constitutes a fair rate of return. Thus in 1922, the I.C.C. held that a fair rate of return would be 5.75% which would be substantially equal to a rate of return of 6% if income taxes were not treated as an expense. "In our view, railway corporations should, like other corporations, pay their federal income taxes out of the income, rather than collect it, in effect, from the public in the form of transportation charges adjusted to enable it (them) to retain the designated fair return over and above the tax." *Reduced Rates 1922*, 68 I.C.C. 676 (1922).

13. In addition to pro and con arguments as to the shifting of such taxes [E.g., Thompson, *Some Fundamentals of Utility Taxation*, 11 J. LAND & P. U. ECON. 148 (1938)], there is a considerable sentiment for elimination of some or all taxes imposed on railroads and public utilities, particularly income and excess profits taxes. "A considerable number of railroads are now paying in large amounts, not only income taxes, but also excess profits taxes. Public utility corporations are surely inappropriate mediums for collecting taxes of this character from the public which they serve." Commissioner Eastman in I.C.C. *Ex Parte* No. 148, 255 I.C.C. 357 (1943). This position is strongly advanced by the railroads. The demand for railroad services is highly elastic, and tax burdens imposed on railroads, at least to the extent that they are higher than the burdens imposed on competing carriers, if shifted, result in the loss of traffic to those competing carriers.

14. "The uninitiate may feel that, since the purpose of both utility regulation and excess profits taxation is to prevent the retention of excessive profits, there can be no harm in applying the tax to public utilities so long as the stockholders rather than the consumers bear the burden. The similarity of purpose is more apparent than real. Excess profits for tax purposes are not the same as earnings in excess of a fair rate of return. In fact, the utility which is soundly capitalized may be penalized thereby in excess profits taxation." Freeman, *Public Utility Taxation*, 23 J. LAND & P. U. ECON. 42 (1947).

During the second World War, excess profits were defined as income in excess of that income realized on the average in the period from 1936 to 1940, a period when utilities earnings (particularly railroad earnings) were notoriously low; or, it is based on a percentage of a capital item which does not correspond to the book capital of the utility, *e.g.*, capital stock is taken at one hundred per cent but borrowed capital is included in the base at only fifty per cent. Thus a utility with a stock investment will, all other things being equal, be entitled to a greater excess profits tax credit than a utility with the same *capital investment* and earnings but which has a *capital structure* only partly composed of stock (the remainder representing debt). This lack of equality is demonstrated by a study of the California Railroad Commission. In determining the point at which corporations within its jurisdiction became liable to excess profits taxation, it was found that one railroad became subject to excess profits taxation when it had earned 4.41% on its rate base; another could earn 9.11% on its rate base without being subject to the excess profits tax.¹⁵

On the other hand, granting that "excess profits" may be a misnomer when considering public service industries, it may be argued that an excess profits tax is an abnormal tax in every respect, so abnormal as to warrant a different treatment than that accorded income taxes. The corporate contribution to a war effort deemed necessary and proper by Congress should be effectuated, and the tax should not be passed on to the public, traditionally the fiscal beast of burden in war financing. Along with this argument, the proposition that shifting of the excess profits tax to the users of such services is inflationary may be advanced, the theory being that to permit such shifting in war time would not only be economically dangerous but contrary to the spirit of price control acts and the whole general philosophy of war economy planning.

During the administration of the excess profits tax of World War I, it was commonly accepted that the tax could not be considered a cost of operation and could not, thus, be shifted. The only exception appears to have been Texas rules.¹⁶ During World War II, however, the question was again raised, and, while some state commissions permitted the allowance of such taxes as operating costs, the general trend was to affirm the position taken during the first World War. The federal regulatory bodies were careful to lay this rule down in the first rate increase application hearings brought before them after World War II began so as to discourage state commissions from allowing the tax as an operating cost. Thus the Interstate Commerce Commission and the Federal Power Commission so acted.¹⁷

15. *Id.*, at p. 48.

16. *San Antonio Public Service Co. v. City of San Antonio*, P.U.R. 1924A, 259.

17. "It is not fair or just that these excess-profits taxes should be shifted through rates to the shipper." *Minnelusa Oil Corp. v. Continental Pipe Line Co.*, 258 I.C.C. 41 (1944).

"The doctrine of unjust enrichment as well as equity and good conscience compel the conclusion that a utility should not be permitted to thwart the purpose and spirit of the war price control legislation and the revenue acts by passing . . . abnormal tax requirements along to its consumers as an operating expense to be collected

Some states, *e.g.*, Michigan, took advantage of the times and reduced utility rates on the theory that the residents of these states using utility services might as well have the advantage of a rate reduction as to pay increased rates for the benefit of the Federal Government or to tax the utility (*i.e.*, its stockholders) for the benefit of the Federal Government.¹⁸

This writer feels that excess profits taxes should be considered as costs of operation and that they should be thus passed on to the consumer of the services of the utility. Such a result is consistent logically with the treatment accorded ordinary income taxes paid by the utility, and the excess profits tax is an income tax. The arguments stated herein in favor of such a position appeal more strongly to logic, it is urged, than those contra. This position does not ignore the strength of the public policy arguments made, but rather assumes as its basic premise that such questions of war-time public policy are not within the scope of rate-determination by regulatory bodies as now constituted. If treatment of the problem is desired consistently with other phases of a program of wartime fiscal policy, then the moving source should not be the regulatory bodies.

In closing the discussion of excess profits taxes, one suggestion that has been made, and which is equally applicable to income taxes generally, may be referred to briefly. That is that a distinction should be made between taxes arising from transactions of an operating nature and taxes attributable to non-operating transactions, the thesis being that those taxes not actually attributable to public service operations should not be passed on through rate increases or adjustments to users of utility services.¹⁹ The suggestion would appear to be logically sound but fails

in increased rates. Indeed . . . increased rates on such a basis would be unjustifiable. To allow them would in effect impose upon the consumers a sales tax." In the Matter of Panhandle Eastern Pipe Line Co., 45 P.U.R. (n.s.), 203 at 219 (F.P.C. 1942). *Cf.* sec. 942, Emergency Price Control Act, 50 U.S.C. 942 (Supp. 1942); ". . . nothing in this act shall be construed to authorize the regulation of . . . rates charged by any common carrier or other public utility."

Accord: *Re* Chicago District Electric Generating Corp., 39 P.U.R. (n.s.) 263 (F.P.C. 1949); *Re* Interstate Natural Gas Co., 48 P.U.R. (n.s.) 267 (F.P.C. 1943); *Re* Investigations of Rates and Charges for Communications, 50 P.U.R. (n.s.) 468 (F.C.C. 1943).

18. That step was taken in Michigan only after it became apparent that the Michigan Public Service Commission could deny excess profits taxes as costs of operation. The Public Service Commission had ruled that the excess profits tax was to be considered as a cost of operation, holding that it had no authority to do otherwise. This ruling was attacked by the City of Detroit which urged that the tax should not be considered as a cost of operation, and that a fair rate of return should be computed independently of the excess profits tax. The O.P.A. intervened on the ground that the P.S.C. had statutory authority and duty to disallow war income and excess profits taxes. *Held:* That the P.S.C. could in its discretion include excess profits tax liability in whole or in part as demonstrating excessive earnings; that such a decision was not contra to Michigan Public Utilities Commission v. Michigan State Telephone Co., *supra*, note 11, or the Galveston case, *supra*, note 10, since those decisions were confined to normal taxes. The City of Detroit v. Michigan Public Service Commission, 308 Mich. 706, 14 N. W. 2d 784 (1944) (four to three decision).

19. Snapp, *War Taxes and Public Utility Rates*, 31 GEO. L. J. 164 (1943).

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to take into account the administrative difficulties (in a field already too beset by complexities) of tracing the source of particular tax liabilities.

It has sometimes been suggested that taxation may be used as another means of regulation, supplementing normal rate regulation processes.²⁰ According to this theory, taxes would not be shifted by allowance as costs of operation, but, rather, tax policy would be aimed at recapturing earnings in excess of what might be considered reasonable. Unfortunately there is no more reason to suppose that taxation would be a more exact or more discriminating instrument of regulation than present methods of rate-determination. What has already been said with respect to excess profits taxation is equally applicable here. Needless to say, there has been strong opposition to this proposition, and by able critics.²¹ One of the most telling criticisms points out that tax law permits deduction of bond interest but not dividends; that there is a combination of bonds, preferred and common stock which will assure a low capital cost and the soundest possible financial structure. It is towards this "optimum" financial structure that regulation has worked to encourage the lowest rates to the consumer and the most stable public service corporations possible. Tax regulation would tend to work at cross purposes with this end by encouraging heavy bond financing unless present concepts of taxable income are altered beyond reason. Furthermore, such a policy of tax regulation fails to recognize that present methods of rate-determination are not sufficiently flexible to guarantee that the public service corporation will earn a fair return in every year. The history of railroad revenues during the past twenty years will show the validity of this statement. Tax regulation would tend to take away returns in excess of a fair return in good years which would otherwise go towards making up of deficits incurred (or deficiencies in the "fair return") in prior or subsequent years.

WILLIAM R. PETERSON*

PAID-IN SURPLUS—ITS AVAILABILITY AS A DIVIDEND BASE AND FOR
OTHER PURPOSES UNDER THE MISSOURI STATUTES

At common law and under some statutes no differentiation was made between earned surplus and paid-in or capital surplus.¹ Surplus other than earned surplus

20. The tax "should be so arranged, also, as to bring back into the public coffers in the case of all companies, as large a share as possible of the profits arising from the necessary inexactness of the rate-fixing process." Report of the Committee of the New York Legislature, Legis. Doc. 72, p. 11 (1922).

21. Thompson, *Some Fundamentals of Utility Taxation*, 11 J. LAND & P. U. ECON. 148, 152-153 (1938); Bush, *The Impact of State and Local Taxation on Railroads*, PROCEEDINGS, Nat'l Tax Ass'n., 1947, p. 255.

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1. *Equitable Life Assur. Soc. of U. S. v. Union Pac. R.R.*, 212 N. Y. 360, 106 N.E. 92 (1914), 56 L.R.A. (N. S.) 1052 (1915). (The defendant retired a bond issue at the rate of \$175 in bonds for one share of common stock of the par value of \$100. Thus on the issue of each share a premium of \$75 was received. Plaintiff, a preferred stockholder, sued to restrain a dividend to common stock on

was freely available as a dividend base. From a legal viewpoint any net worth in excess of legal capital was surplus, and in the absence of statutory provisions to the contrary, such net worth in excess of stated capital could be used by the board of directors for any desired purpose. But from the viewpoint of the accountant there is a distinction between contributed capital and earned capital or earned surplus.² Accountants take the view that paid-in surplus should be used only for those purposes for which stated capital may be used; that the purchaser of a share in a corporation contributes the entire purchase price with the expectation that it will be permanently devoted to the corporate business and will not be available for dividends at the election of the board of directors. The shareholder does not ordinarily expect to receive any of his capital back except upon reorganization or liquidation of the corporation. He expects nothing until profits are earned, and a dividend out of paid-in surplus is not a "return on capital;" it is a "return of capital." The dangers of deception are great if no distinction is made between earned surplus and paid-in surplus. A corporation which is operating at a loss may continue to pay dividends out of paid-in surplus and, if the corporation is not required to notify its shareholders of the source of the dividend, lead the shareholders to believe that the corporation is operating prosperously. The intelligent investor demands to know whether his dividends are a "return of capital" or a "return on capital." He must have this knowledge in order to make sound investment decisions. The Missouri statutes have gone a long way in recognizing this view, long entertained by the accountants.

An examination of the net worth section of a typical balance sheet of a corporation will reveal two major parts: (1) the capital stock and (2) surplus. Surplus is divided into earned surplus and capital surplus. The excess of past profits over losses and dividends constitutes earned surplus.³ Capital surplus is of two general classes: paid-in surplus, and appreciation surplus.⁴ Some accountants would divide surplus into three types: earned surplus, paid-in or capital surplus, and appreciation surplus or surplus from revaluation.⁵ In *Edwards v. Douglas*⁶ Justice Brandeis set forth a definition of surplus which takes into account three kinds:

"The word 'surplus' is a term commonly employed in corporate finance and accounting to designate an account on corporate books. . . . The surplus account represents the net assets of a corporation in excess of all liabilities including its capital stock. This surplus may be 'paid-in surplus' as where the stock is issued at a price above par; it may be earned surplus' as where it was derived solely from undistributed profits. Or it may,

the ground that the premium was an accretion to capital. The court allowed payment of the dividend on the ground that the premium became part of the surplus); *Smith v. Cotting*, 231 Mass. 42, 120 N.E. 177, 181 (1918); Comment, 8 OHIO SR. L. J. 96 (1944).

2. Marple, *The Sources of Capital Surplus*, 9 ACCOUNTING REV. 75 (1934).
3. KARRENBROCK & SIMONS, INTERMEDIATE ACCOUNTING 10-11 (1949).
4. FINNEY, PRINCIPLES OF ACCOUNTING, INTERMEDIATE 153 (3d ed. 1946).
5. PATON, ACCOUNTANT'S HANDBOOK 1023 (3d ed. 1948).
6. 269 U. S. 204, 214 (1925).

among other things, represent the increase in valuation of land or other assets made upon a revaluation of the company's fixed property."

The statutory provisions of states vary considerably in regard to the use of paid-in surplus as a dividend base. Some states do not permit the payment of dividends from paid-in surplus. Other states such as Illinois, California, and Pennsylvania restrict the payment of dividends out of paid-in surplus to preferred stockholders with the requirement that the shareholders be notified of the source of the dividends. A third group of states permits, under certain restrictions, the payment of dividends from paid-in surplus to both common and preferred shareholders.

Paid-in surplus is primarily a concomitant of no-par stock, although it is not uncommon that the sale of par stock will result in paid-in surplus.⁷ Section 351.015(11) of the 1949 *Missouri Revised Statutes* in defining paid-in surplus provides:

"Paid-in surplus means all that part of the consideration received by the corporation for, or on account of, all shares issued which does not constitute stated capital minus such formal reductions from said sum as may have been effected in a manner permitted by law."

Section 351.190 prescribes a manner in which paid-in surplus may be created.⁸

Section 351.210 provides:

"Paid-in surplus, whether created by reduction of stated capital or otherwise, may be distributed in cash or in kind to the shareholders entitled thereto, subject to the following restrictions and in the following manner:

- (1) No such distribution shall be made to any class of shareholders unless all cumulative dividends accrued or preferred or on special classes of shares entitled to preferred dividends shall have been fully paid.
- (2) No such distribution shall be made to any class of shareholders when the net assets are less than its stated capital or when such distribution would reduce the net assets below the stated capital.⁹
- (3) Each such distribution, when made, shall be identified as a liquidating dividend and the amount per share shall be disclosed to the shareholders receiving the same, concurrently with the payment thereof."

The definition of paid-in surplus laid down by Section 351.015(11) would appear not to be exclusive for Section 351.210 speaks of paid in surplus "whether

7. KEHL, CORPORATE DIVIDENDS 68 (1941).

8. Section 351.190 provides that in the case of par shares the corporation may determine that the amount received for the shares in excess of the aggregate par value shall be paid-in surplus and in the case of no-par shares without a preferential liquidation value, the corporation may determine what part of the total consideration received shall be paid-in surplus.

9. Net assets within the meaning of the corporation act is the excess of assets over liabilities, the term liabilities not including stated capital. Net assets would thus equal stated capital plus the surplus of the corporation. Net assets in excess of the stated capital would equal the surplus of the corporation. If the net assets are less than the stated capital, the corporation would have a deficit.

created by reduction of stated capital¹⁰ or otherwise." Paid-in surplus may arise in any of the following ways:

1. Through the issuance of par value shares for more than par.
2. Through the issuance of no-par value shares where a part of the consideration received is allocated to paid-in surplus.
3. Through the forfeiture of partly-paid stock subscriptions.
4. Through the reduction of stated capital.
5. Through assessments levied on shareholders.
6. Through dealings in treasury stock.
7. Through the receipt of stock or properties as a donation.¹¹

Not all gains realized in treasury stock dealings will constitute paid-in surplus. The American Accounting Association in its tentative statement principles has provided that gains from the sale of reacquired share constitute paid-in surplus.¹² In 1938 the committee on accounting procedure of the American Institute of Accountants ruled that the gain should be treated as paid-in or capital surplus on the ground that there was no difference between (a) the purchase and retirement of a corporation's own common stock and the subsequent issue of common shares and (b) the purchase and resale of its own common stock.¹³ This ruling was made in the face of the withdrawal of the Treasury Department from the position that taxable income cannot arise from a purchase and resale of a corporation's own shares.¹⁴ In the same year an opinion of the chief accountant of the SEC was published recommending that the gain "should be treated as capital stock or capital surplus as the circumstances require."¹⁵ But this is not the law. Whether the gain constitutes paid-in surplus or profit for tax purposes depends upon the nature of the treasury stock dealings.¹⁶ The Attorney General of Illinois has ruled that profit on the resale of treasury shares constitutes earned surplus under the Illinois Corporation Act.¹⁷

10. The term paid-in surplus embraces surplus created from the reduction of stated capital which is referred to as reduction surplus. FINNEY, *PRINCIPLES OF ACCOUNTING, INTERMEDIATE* 127-133 (3d ed. 1946).

11. Marple, *The Sources of Capital Surplus*, 9 *ACCOUNTING REV.* 75 (1934); KARRENBROCK & SIMONS, *INTERMEDIATE ACCOUNTING* 347 (1949).

12. *A Tentative Statement of Accounting Principles Affecting Corporate Reports*, Principle #15, 11 *ACCOUNTING REV.* 187 (1936).

13. 65 *J. ACCOUNTANCY* 417 (1938).

14. U. S. Treas. Reg. 103, Sec. 19.22 (a)-16; *Helvering v. R. J. Reynolds Tobacco Co.*, 306 U. S. 110 (1939) See Katz, *Accounting Problems in Corporate Distributions*, 89 U. of Pa. L. Rev. 764 (1941).

15. S.E.C. ACCOUNTING SERIES RELEASE No. 6, May 10, 1938.

16. "Whether the acquisition or disposition by a corporation of shares of its own capital stock gives rise to taxable gain or deductible loss depends upon the real nature of the transaction, which is to be ascertained from all its facts and circumstances. . . . But if a corporation deals in its own shares as it might in the shares of another corporation, the resulting gain or loss is to be computed in the same manner as though the corporation were dealing in the shares of another. U. S. Treasury Reg. 111, Sec. 29.22 (a)-15. See 160 A.L.R. 1080 (1945) for a collection of cases.

17. Op. No. 526, Nov. 10, 1933, reprinted in *ILL. BUS. CORP. ACT ANN.* 998 (1947 ed.).

Under the Missouri statutes, a corporation is not restricted to preferred shareholders in the payment of dividends out of paid-in surplus. Paid-in surplus may be distributed to common shareholders within the limitations laid down by Section 351.210. Nor, apparently, does the existence of an earned surplus prevent the distribution of paid-in surplus in dividends to common or preferred shareholders. Even if the corporation has an earned surplus available for dividends, it may use its paid-in surplus as a dividend base, thus keeping its earned surplus intact, so long as the shareholders are apprised of the fact that the distribution is a liquidating dividend. On the other hand a corporation may pay liquidating dividends out of paid-in surplus if the corporation has an earned surplus deficit so long as it still has net assets in excess of stated capital and the distribution of paid-in surplus will not reduce the net assets below the stated capital.

The Missouri General and Business Corporation Law recognizes the fact that it is often of practical importance that there be an initial surplus available for the declaration of dividends. For example, let us assume that a corporation requires \$2,000,000 to carry out a development program. It can raise \$1,500,000 through the sale of no-par common stock. It can raise the remaining \$500,000 through the sale of preferred stock to investors who demand a fixed dividend return. By the allocation of a part of the consideration received from the sale of the no-par stock to paid-in surplus under Section 351.190, it can create a surplus from which dividends may be paid until earnings from operations are available. On the other hand Section 351.210 requires that the dividends be designated as liquidating dividends so that investors will not be misled.

Section 351.210 also provides:

"The corporation may by resolution of its board of directors apply any part or all of its paid-in surplus to the reduction or elimination of any deficit arising from operating or other losses, or from diminution in value of its assets."

Under this section a corporation with an earned surplus deficit,¹⁸ but having paid-in surplus, can use its paid-in surplus, to absorb the deficit and thus make available for dividends the earnings of future periods. For example, assume that the net worth section of the A B C corporation is as follows on December 31, 1951:

A B C CORPORATION
NET WORTH SECTION OF BALANCE SHEET
DEC. 31, 1951

Capital Stock:

Preferred stock	\$ 100,000
No-par common stock (stated value)	1,000,000
Total Capital Stock	\$1,100,000

18. The profits of a corporation are transferred to earned surplus at the end of an accounting period by a bookkeeping entry. It is the usual practice to charge dividends against earned surplus. Losses are also charged against earned surplus. Thus, "an excess of dividends and losses over profits results in a negative (debit) surplus balance called a deficit." KARRENBROCK & SIMONS, *INTERMEDIATE ACCOUNTING* 11 (1949).

Surplus:

Paid-in surplus on common stock	2,000,000	
Less: Earned surplus deficit	100,000	
Total Net Worth		1,900,000
		<u>\$3,000,000</u>

On Dec. 31, 1951 the A B C Corporation would be able to declare liquidating dividends up to \$1,900,000 since the net assets exceed stated capital by that amount. If the corporation earns a profit of \$100,000 in 1952 that profit would normally be transferred to earned surplus and thus absorb the deficit leaving the corporation with neither a debit or credit balance in the earned surplus account. But under Section 351.210 the corporation can offset the deficit against the paid-in surplus, thus reducing paid-in surplus to \$1,900,000. The earned surplus account would then be clear, and at the end of 1952, after the profit has been closed to earned surplus, there would be in the earned surplus account a credit balance of \$100,000 which is available for dividends without the requirement that the dividends be designated as liquidating dividends. The corporation is not required to recoup the deficit out of profits. Such practice without notice to the shareholders has been objected to on the ground that if the losses of one accounting period can be absorbed by paid-in surplus, the payment of dividends out of net earnings of a subsequent accounting period without restoring paid-in surplus is, in effect, a dividend from paid-in surplus.¹⁹ But it has also been pointed out that a rigid adherence to the view that earned surplus deficits cannot be eliminated by charges to paid-in surplus will cause a serious freezing of the corporate financial structure.²⁰ Section 351.210 permits the corporation to get back on a dividend paying basis without the necessity of a formal reorganization. This is frequently referred to as "quasi-reorganization."²¹ The SEC and the accounting societies are of the opinion that sound accounting practice requires that a clear report be made to the shareholders if the corporation does offset an earned surplus deficit against paid-in surplus and that their formal consent thereto be obtained.²² But Section 351.210 does not require that this be done.

Is it permissible for a corporation under Section 351.210 to use its paid-in

19. Hills, *Model Corporation Act*, 48 HARV. L. REV. 1334 (1935).

20. KEHL, CORPORATE DIVIDENDS 97 (1941); PATON & LITTLETON, AN INTRODUCTION TO CORPORATE ACCOUNTING STANDARDS 112 (1940).

21. Katz, *Accounting Problems in Corporate Distributions*, 89 U. OF PA. L. REV. 764 (1941).

22. S.E.C. ACCOUNTING SERIES RELEASE No. 16 (1940). "Where a deficit is charged against paid-in surplus subsequent accumulated surplus should be dated as beginning with the new starting point for the enterprise. This dating requirement with respect to earned surplus is included among the accounting standards advanced by the Executive Committee of the American Accounting Association." PATON, ACCOUNTANTS' HANDBOOK 1032 (3d ed. 1948). The corporation should be required to disclose the date from which its earned surplus has been accumulated for the "quasi-reorganization" places the corporation in a position akin to that of a new corporation.

surplus to absorb a loss even though there is existing an earned surplus?²³ Certainly to do so would not be conforming to sound accounting practice.²⁴ "Where the deficit arises from current operations, and the corporation has a prior earned surplus, the deficit ought to be charged against the latter rather than against paid-in surplus."²⁵

In a hypothetical case submitted to the Attorney General of Illinois as to whether a corporation with earned surplus of \$500,000 and a paid-in surplus of \$500,000 would write down its assets to the extent of \$500,000, charging such write-down against paid-in surplus, the Attorney General ruled that it was legal to do so under Section 60A of the Illinois Corporation Act.²⁶ Section 60A of the Illinois Corporation Act and Section 351.210(2) of the Missouri Statutes are identical in wording.²⁷ No definition of the word, "deficit," is included in either statute. It is difficult to ascertain what construction the Attorney General put upon the word "deficit." The Attorney General says: "Section 60A provides that the board of directors may apply any part or all of its paid-in surplus to the reduction or elimination of any deficit arising from operating or other losses or from diminution

23. After the last depression many corporations reduced their capital stock, thus creating paid-in or capital surplus, and against such paid-in surplus extraordinary losses arising out of the depression were charged off. By this means earned surplus was retained intact and made available for dividends. Marple, *The Sources of Capital Surplus*, 9 ACCOUNTING REV. 75, 81 (1934).

24. PATON, ACCOUNTANTS' HANDBOOK 1032 (3d ed. 1948); PATON & LITTLETON, AN INTRODUCTION TO CORPORATE ACCOUNTING STANDARDS 112-114 (1940); BALLANTINE ON CORPORATIONS 539 (rev. ed. 1946). In 1938 the S.E.C. published the following statement of its chief accountant: "It is my conviction that capital surplus should under no circumstances be used to write off losses which, if currently recognized, would have been chargeable to income. In case a deficit is thereby created, I see no objection to writing off a deficit against capital surplus, provided stockholder approval has been obtained. In this event, subsequent statements of earned surplus should designate the point from which the new surplus dates." S.E.C. ACCOUNTING SERIES RELEASE No. 1, April 1, 1937. See *First Industrial Loan Co. v. Daugherty*, 26 Cal. 2d 545, 159 P. 2d 921, 930 (dissenting opinion). See also in the *Matter of Allegheny Corp.*, 6 S.E.C. 960 (1940). It has been suggested that "writedowns recording catastrophic physical or economic destruction of capital may be proper charges against capital or capital surplus. SANDER, HATFIELD & MOORE, A STATEMENT OF ACCOUNTING PRINCIPLES 40 (1938).

25. *Matter of Associated Gas & Electric Corp.*, 6 S.E.C. 605 (1940). In this case the commission refused to recognize writeoffs to paid-in surplus of realized losses on the sale of stocks and bonds over a 15 year period. The commission held that the charges should have been made to earned surplus. Mr. Kehl takes the opposite view, at least where the corporation wishes to write off losses arising from market declines. KEHL, CORPORATE DIVIDENDS 97-98 (1941).

26. Op. No. 682, August 9, 1934, reprinted in ILL. BUS. CORP. ACT ANN. 1021 (1947 ed.).

27. Section 60A Provides: "A corporation may, by resolution of its board of directors, apply any part or all of its paid-in surplus to the reduction or elimination of any deficit arising from operating or other losses, or from diminution in value of its assets. . . ." The Attorney General admits that such a charge of losses to paid-in surplus is not good accounting practice. Certainly it is not for the law to enforce good business policy upon a corporation, but it should prevent any legal wrong resulting to anyone from the corporation's not following sound accounting practice. The interpretation of the Attorney General avoids these restrictions.

in value of its assets. Accordingly it will be noted that there is nothing in the act which would prohibit a charge down from being applied to either earned surplus or paid-in surplus." Of this opinion Mr. Katz has said: "The opinion of the Attorney General to the effect that such a charge may be made is of very doubtful soundness."²⁸

It is submitted that Section 351.210 gives a corporation no authority to charge a write-down or loss against paid-in surplus while it has an earned surplus. Earned surplus should first be exhausted, and then any deficit can be offset against paid-in surplus.²⁹ Is it possible for a corporation to have a deficit when an earned surplus exists? Section 351.210 does not say that any *loss* or *write-down* may be charged against paid-in surplus. It says that "*any deficit arising from operating or other losses, or from diminution in value of its assets*" may be written off against paid-in surplus. A dividend declared out of earned surplus after a loss has been charged against paid-in surplus is in effect a dividend out of paid-in surplus to the extent of the loss charged against paid-in surplus which should have been taken to earned surplus. The corporation should not be permitted to evade the requirement of notice in this manner. Paid-in surplus should not be allowed to be exhausted by this method under a statute providing that paid-in surplus may be distributed "subject to the following restrictions," one of which is that a dividend out of paid-in surplus must be designated as a liquidating dividend. Section 351.210 contemplates the application of sound accounting principles in adopting the accountant's concept of paid-in surplus. Those principles should be applied.³⁰

RICHARD H. ICHORD

TREATIES PAST AND PRESENT

This article is limited to the ascertainment of the extent of our treaty power. A categorical approach to this problem limits itself to (1) historical development,

28. Katz, *The Illinois Business Corporation Act*, 12 Wis. L. Rev. 473, 476 (1937).

29. Section 8623-38 of the *Ohio General Code* provides: "A corporation may, by action of its board of directors, apply any part or all of any paid-in surplus or any excess of assets however created or arising from revaluation or assets, to the reduction or writing off of any deficit in the account of earned surplus or to the writing off of any *particular loss* or *expense* or to the creation of any reserve for any proper purpose. . . ." The specific language of the Ohio Act would seem to leave no doubt that paid-in surplus can be used to absorb losses even where there is an earned surplus. In *Haggard v. Lexington Utilities Co.*, 260 Ky. 261, 84 S.W. 2d. 85 (1935), it was indicated that reduction surplus may be used to write off losses, thereby making available for dividends earnings which were subsequent to the loss but apparently antedated the reduction of state capital. The Kentucky statutes contain no provision on the subject. Other statutes similar to Mo. REV. STAT. § 351.210 (1949) are: CAL. CORP. CODE ANN. § 1910 (Deering, 1947); Md. LAWS 1951 c. 135 § 21; MICH. COMP. LAWS § 450.20 (1948); NEV. GEN. CORP. LAW § 1624c as last amended by NEV. LAWS 1949, 121, effective 7-1-49. The writer has been able to find no cases construing these statutes. The lack of authority is probably due to the favorable economic conditions existing since the enactment of the statutes so that few corporations have felt it necessary to treat paid-in surplus as other than a permanent investment.

30. See note 24 *supra*.

(2) the present status of the treaty power, (3) the possible future status in light of recent decisions.

HISTORY

To understand the legal situation we start with Article VI of the Constitution of the United States which with regard to treaties reads as follows: ". . . Treaties made, or which shall be made, under the Authority of the United States, shall be the Supreme Law of the Land; and the Judges in every State shall be bound thereby, any Thing in the Constitution or Laws of any State to the Contrary notwithstanding." This provision is unique in our Constitution.

It is believed, as expressed in the *United States v. Curtis-Wright Export Corporation*,¹ that the treaty-making power is an admitted attribute of sovereignty, i.e., it is neither a grant from the states nor dependent upon any affirmative grant in the Constitution, and that it embraces all the power of government adequate to an effective control of its international relations. This statement of the extent of the treaty power is the broadest ever asserted by the United States Supreme Court. We shall discover from an examination of the leading cases whether this belief is justified. This problem is our basic inquiry.

In *Ware v. Hylton*,² involving an examination of the definitive treaty of peace between the United States and Great Britain whereby British creditors were allowed to recover debts previously contracted by the United States citizens notwithstanding a payment thereof into the State Treasury, by virtue of a state law of sequestration, the court concluded that this treaty was of equal force with the Constitution itself; and certainly with any law whatsoever. This would seem to substantiate the belief expressed in *United States v. Curtis-Wright Export Corporation*, but fifty-seven years after *Ware v. Hylton* the Supreme Court viewed a treaty, made by the proper authorities, as that which the courts of justice have no right to annul or disregard as to any of its provisions, *unless the treaty conflicts with the Constitution*.³ This is the first limitation that was imposed on the treaty-making power and conflicts with the view of *United States v. Curtis-Wright Export Corporation*. For some time thereafter the United States Supreme Court considered that limitations of the treaty power existed but refused to consider the subject.⁴

In this same period the *Head Money Cases*⁵ laid the basis for later confusion by declaring, "That so far as a treaty made by the United States with any foreign nation can be the subject of judicial cognizance in the courts of this country it is subject to such acts as Congress may pass for its enforcement, modification or repeal." This classification of treaties on a par with acts reappeared in recent years

1. 299 U.S. 304 (1936).

2. 3 Dall. 199, 284 (U. S. 1796).

3. Doe v. Braden, 16 How. 635 (1853).

4. Hauenstein v. Lynham, 100 U. S. 483 (1880). "There are doubtless limitations of the power as there are of all others arising under such instrument, but this is not the proper occasion to consider the subject."

5. 112 U. S. 580, 599 (1884).

to confuse a federal circuit court in ascertaining the extent of the treaty power.⁶ Ascertaining the extent of the treaty power and determining the application and repeal of a treaty are not the same thing. The *Head Money Cases* refer to the latter. As to this latter point, there are at least two types of treaties: (1) the self executing type, (2) those requiring implementation by statute. *Whitney v. Robertson*⁷ explains this distinction and the language of the *Head Money Cases* by stating, "If the treaty contains stipulations which are self executing *i.e.*, requiring no legislation to make them operative, then to that extent they have the force and effect of a legislative enactment. A different Congress may modify such provisions, so far as they bind the United States, or supercede them altogether. By the Constitution a treaty is placed on the same footing, and made of like obligation, with an act of legislation. Both are declared by that instrument to be the supreme law of the land, and no superior efficacy is given to either over the other. When the two relate to the same subject, the courts will endeavor to construe them so as to give effect to both, if that can be done without violating the language of either; but if the two are inconsistent, the one last in date will control the other, provided always the stipulation of the treaty on the subject is self executing." The classification of treaties requiring implementation by legislation, as to application and repeal, was not developed at this time, though in *Botiller v. Dominguez*⁸ it is stated, "It may be said that so far as an act of Congress is in conflict with a treaty . . . that is a matter in which the Court is bound to follow the statutory enactments of its own government." The ascertainment of the extent of treaty power was also undeveloped at this time, and this is our main inquiry.

The difficulty with attempting to list, as all inclusive, the limitations of the treaty power is clearly shown by Justice Field in *Geofroy v. Riggs*.⁹ In this case Field declares that, "The treaty power, as expressed in the Constitution, was in terms unlimited except by those restraints which are found in that instrument against the action of the government or of its departments, and those arising from the nature of the government itself and of that of the States. It would not be contended that it extends so far as to authorize what the Constitution forbids, or a change in the character of the government or in that of one of the States, without its consent." From this definition the belief expressed in *United States v. Curtiss-Wright Export Corporation*, *i.e.*, inherent right of sovereignty to make treaties, could not be completely upheld. Field's statement was dictum. Therefore, our initial inquiry remains unanswered. This was the situation prior to *United States v. Shawver*¹⁰ and *Missouri v. Holland*.¹¹

6. *Amaya v. Standard Oil and Gas Company*, 158 F. 2d 554 (1946). "A treaty lawfully entered into stands on the same footing of supremacy as does the Constitution and Laws of the United States. . . . The treaty-making power might even be superior to those powers which are reserved to the states."

7. 124 U. S. 190 (1888).

8. 130 U. S. 238, 247 (1889); *The Cherokee Tobacco*, 11 Wall. 616 (U. S. 1870); *Whitney v. Robertson*, 124 U. S. 190, 195 (1888).

9. 133 U. S. 258, 267 (1890); *Fort Leavenworth R. R. v. Lowe*, 114 U. S. 525, 541 (1885).

10. 214 Fed. 154 (1914).

11. 252 U. S. 416, 433 (1920).

To understand Justice Holmes' opinion in *Missouri v. Holland*, which has been stated to stand for the proposition that exercise of power not allowed by statute due to constitutional limitations can exist by a treaty implemented by a statute, one must first examine *United States v. Shawver*. In this latter case an act of congress declared that "All wild geese . . . and all other migratory game and insectivorous birds which in their . . . migrations pass through or do not remain . . . within . . . any state, shall hereafter be deemed to be within the custody and protection of the government of the United States. . . ." In pursuance of this authority the Department of Agriculture adopted suitable regulations, which were approved by the President. The contention was that the act was unconstitutional. The United States district court held that the United States does possess what is analogous to the police power, which every sovereign nation possesses, as to its own property. The constitutional authority to sustain validity is Article IV, Section 3, Sub-section 2, "The Congress shall have power to dispose of and make all needful rules and regulations respecting the territory or other property belonging to the United States; and nothing in this Constitution shall be construed as to prejudice any claims of the United States or of any particular state." Note the commerce clause of the Constitution was not claimed as the power under which Congress acted. The court did cite *Kansas v. Colorado*¹² at which time the court still believed the Tenth Amendment was more than a truism. Without further reason, the court concluded that it was unable to find any provisions in the constitution authorizing congress to protect or regulate the shooting of migratory wild game when in a state, and therefore was forced to the conclusion that the act was unconstitutional. On rehearing, an attempt to justify the legislation under the commerce clause was dismissed by citing *Gibbons v. Ogden*¹³ and *Geer v. Connecticut*.¹⁴ In light of *United States v. F. W. Darby Lumber Company*,¹⁵ had this situation arisen in 1941 the legislation would likely have been upheld, because this case extensively modified the *Kansas v. Colorado* opinion as to the effect of the Tenth Amendment. Unfortunately, this matter never reached the United States Supreme Court. Six years later the case of *Missouri v. Holland* was before the United States Supreme Court. The United States had entered into a treaty with Great Britain for the purpose of protecting migratory birds which were of great value as a source of food and destroyed insects injurious to vegetation. To implement this treaty, congress enacted the Migratory Bird Treaty Act. A bill in equity was brought by the State of Missouri to prevent a game warden of the United States from attempting to enforce this statute on the ground that it was an unconstitutional interference with rights reserved to the states by virtue of the Tenth Amendment. *Kansas v. Colorado* was the basis for this contention. The question raised was whether the treaty and statute were void as an interference with the rights reserved to the states. The United States Supreme Court in *Missouri v. Holland*,

12. 206 U. S. 46 (1907).

13. 9 Wheat. 1 (U. S. 1824).

14. 161 U. S. 519 (1896).

15. 312 U. S. 100 (1941).

noting that if the treaty were valid then the act was valid as a necessary and proper means of executing the treaty, said: "Acts of congress are the supreme law of the land only when made in pursuance of the Constitution, while treaties are declared to be so when made under the authority of the United States. . . . We do not mean to imply that there are no qualifications to the treaty-making power; but they must be ascertained in a different way. It is obvious that there may be matters of the sharpest exigency for the national well being that an act of congress could not deal with but that a treaty followed by such an action could, and it is not lightly to be assumed that, in matters requiring national action, 'a power which must belong to and somewhere reside in every civilized government' is not to be found."¹⁶ After declaring the foregoing, the court states it is not yet discussing the validity of the test proposed, *i.e.*, the contravention of any prohibitory words in the constitution. It appears the foregoing discussion of the court is dictum for the remaining portion of the opinion is limited to a search for prohibitory words in the constitution, and the court concluded that since there were no prohibitory words applicable, the act and treaty must be upheld. Even the "invisible radiation" from the Tenth Amendment was decided to contain no prohibition in this matter. The belief expressed in *United States v. Curtiss-Wright Export Corporation*, *i.e.*, inherent right of sovereignty to make treaties, finds its only justification in the apparent dictum of *Missouri v. Holland*, therefore our basic inquiry was at least not definitely decided. Whether this portion of *Missouri v. Holland* is dictum is ascertained from the later cases.

Justice Butler in *Asakura v. City of Seattle*,¹⁷ while holding that pawn-broking, a recognized business by the law of the State of Washington, is trade within the meaning of a treaty and that a city ordinance in that state which undertook to confine the business to citizens of the United States was void, evidently considered Justice Holmes' decision in *Missouri v. Holland* as not to be dictum, because he believed that, "The treaty-making power of the United States is not limited by any express provisions of the constitution, and though it does not extend so far as to authorize what the constitution forbids it does extend to all proper subjects of negotiation between our government and other nations." Justice Butler cites *Missouri v. Holland*, and removing the doubt as to dictum in that case, limits its application to a more usable formula. In *Missouri v. Holland* we are not shown any limitation of the treaty-making power, or how to ascertain a limitation. In *Asakura v. City of Seattle*, we are shown that the treaty-making power does not extend to what the constitution forbids. In *Santovincenzo v. Egan*,¹⁸ the court states, "The treaty-making power is broad enough to cover all subjects that properly pertain to our foreign relations, and agreements with respect to the rights and privileges of citizens of the United States in foreign countries, and of the nationals of such countries within the United States, and the disposition of the property of aliens dying within the territory of the respective parties, is within the scope of

16. 252 U. S. 416, 433 (1920).

17. 265 U. S. 332 (1924).

18. 284 U. S. 30, 40 (1931).

that power, and any conflicting law of the state must yield."¹⁹ While this decision appears to be a reiteration of Butler's theory it certainly approaches the proposition that there is an inherent right of sovereignty to make treaties. The foregoing development points to the divided picture of (1) a broad interpretation of the treaty power or (2) an inherent sovereign right of treaty-making with obscure limitations.

Five years after *Santovincenzo v. Egan*, the United States Supreme Court in *Valentine v. United States*²⁰ reiterates Chief Justice Marshall's opinion in *Foster v. Neilson*,²¹ where he states that a treaty is to be regarded as equivalent to an act of the legislature, whenever it operates of itself without the aid of any legislative provision. This language is as difficult to apply as to ascertaining the extent of the treaty-making power at this time as it was when developed, and still seems to be limited to treaties that are self executing. The following year the court continues the general viewpoint in *Santovincenzo v. Egan* by declaring that a treaty can alter a policy that a state might otherwise adopt.²² Thus we complete our historical study of the treaty power.

PRESENT STATUS OF THE TREATY POWER

It will be remembered that in *Terrace v. Thompson*²³ there was involved a treaty between the United States and Japan which granted liberty to, "The citizens and subjects of each . . . Party . . . to own or lease . . . land for commercial purposes." The State of Washington withheld from aliens, who had not in good faith declared their intention to become citizens of the United States, the right of owning land. The Alien's contention was that he was within the protection of the treaty. Though no cases were cited it appears he was relying on the viewpoint expressed in *Santovincenzo v. Egan*, that a treaty can alter a policy that a state might otherwise adopt. This contention was dismissed by the court on the ground the treaty provisions were not broad enough to cover this case, and since there was no conflict the state action was upheld.

The problem of a treaty and state statute being in conflict was recently discussed by the California courts in *Fujii v. State*.²⁴ The validity of the California alien land law was in question.²⁵ The plaintiff was born in Japan and ineligible to become a citizen of the United States by reason of naturalization laws, and by virtue of the state alien land law was not qualified or permitted to acquire real property in the State of California. Property was deeded to the plaintiff and Cali-

19. *Hauenstein v. Lynham*, 100 U. S. 483 (1879); *Geofroy v. Riggs*, 133 U. S. 258 (1890); *Missouri v. Holland*, 252 U. S. 416 (1920); *Sullivan v. Kidd*, 254 U. S. 433 (1921); *Asakura v. Seattle*, 265 U. S. 332 (1924); *Todak v. Union State Bank*, 281 U. S. 449 (1930).

20. 299 U. S. 5 (1936).

21. 2 Pet. 253, 314 (U. S. 1829).

22. *United States v. Belmont*, 301 U. S. 324 (1937); *United States v. Pink*, 315 U. S. 203 (1942).

23. 263 U. S. 197 (1923).

24. 217 P. 2d 481 (1950).

25. Alien Property Initiative Act of 1920, Stats. 1921 p. LXXXII, 1 Deering's Gen. Laws, 1944 Ed. p. 129, Act 261.

California claimed an escheat by virtue of its alien land law. The plaintiff contended this statute was inconsistent with the declared principles and spirit of the United Nations Charter. The applicable provisions of the Charter of the United Nations declared, "The purpose of this group is to reaffirm faith in fundamental human rights, in the dignity and worth of the human person . . . to achieve international cooperation . . . in promoting and encouraging respect for human rights and for fundamental freedoms for *all* (emphasis added). . . . The United Nations shall promote universal respect for, and observance of, human rights and fundamental freedoms for all without distinctions as to race, sex, language or religion. . . . All members pledge themselves to take joint and separate action in cooperation with the Organization. . . ." The President of the United States said, "This Charter seeks to achieve universal respect for, and observance of, various human rights and fundamental freedoms for all men and women without distinction. . . ." In the face of Article 2, Section 7, of this Charter, "Nothing contained in the present Charter shall authorize the United Nations to intervene in matters which are essentially within the domestic jurisdiction of any state or require the Members to submit such matters to settlement under the present Charter; . . .," The California District Court of Appeal said the alien land law was in conflict with the Charter and must yield to the treaty as the superior authority. The court cites *Terrace v. Thompson* and shows that it has not been overruled, but states, "In the period of thirty years since the Alien Land Law was adopted we have revised our opinions concerning the rights of other people." The questions raised by this decision are (1) whether the California court applied the viewpoints of Justice Holmes and Justice Butler, *i.e.*, if the treaty does not extend so far as to authorize what the constitution forbids and does extend to a proper subject of negotiation then it is valid, and (2) whether Article 2, Section 7, of the Charter provides for such a decision. The clarification and security of human rights are undoubtedly proper subjects for negotiation and not prevented by the constitution, while the purchase of land in California by an alien in anticipation of promoting his country's interest in war against the United States is a different matter. A limitation to the existing facts of the *Fujii* case shows conformity to the viewpoints of Holmes and Butler. As to the interpretation of Article 2, Section 7, of the Charter it has been argued that the relations between governments and their citizens is a matter which is excluded from the intervention of the United Nations. To see if this viewpoint is correct we must first look to the rest of the Charter. The Charter does not define what matters are "essentially within the domestic jurisdiction of any state." It is a matter of interpretation. Some believe the correct position would be that once a matter has become, in one way or another, the subject of regulation by the United Nations, be it by resolution of the General Assembly or by convention between member states at the instance of the United Nations, that subject ceases to be a matter being "essentially within the domestic jurisdiction of the member states." This position represents the view of the member states that have voted in favor of the Universal Declaration of Human Rights. Therefore, it appears the California Court was correct: Article 2, Section 7, did not stand in the way of declaring the state act invalid.

Therefore, the present status of the treaty power, while not fully developed, seems to be as extensive as viewed in the *United States v. Curtiss-Wright Export Corporation* case, *i.e.*, inherent right of sovereignty to make treaties, though it is believed by many a sounder analysis than inherent sovereignty is broad interpretation of constitutional provisions. The same result can be reached by either approach.

THE POSSIBLE FUTURE STATUS OF THE TREATY POWER IN LIGHT
OF RECENT DECISIONS

On the way to completion and submission to our Senate is a Covenant on Human Rights. The program is to have this document ratified as a treaty. The provisions thereof will affect the basic right of Americans to legislate for themselves on matters heretofore of domestic concern.²⁶ It can affect the present relationship of individuals to the several states and the Federal Government. It would seem in the light of the foregoing analysis that should this be a departure from constitutional principles it would not be accepted. Assuming this treaty is consummated, the United States Supreme Court would be faced, for the first time, with a treaty that some believe conflicts with the Constitution. Dicta of the existing cases indicate such a treaty would have to give way, though the theory of the court instead of being constitutional violation might well be an unwarranted extension of inherent sovereignty.

ROBERT L. RILEY*

UNLICENSED FOREIGN INSURANCE COMPANIES:
THE JURISDICTION AND ENFORCEMENT PROBLEMS¹

When an insurance company insures persons or property in a state other than that of its incorporation difficult problems arise as to the ability of the state in which such insurance is procured to secure proper jurisdiction over and enforce its laws against the company. This is especially true when the company has placed the insurance solely by use of the United States mails² (the contracts being consummated in the state of incorporation) and the company has not complied with the licensing regulations of such state, having neither agents, offices, nor property in the state where the insured interest lies. The same problems arise where an insured or his beneficiary seeks to enforce a potential right against such a company, though the factors involved may be somewhat different.

26. Holman, *An International Bill of Rights*, 34 A. B. A. J. 984 (1948).

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1. This discussion is not intended to include the following: fraternal benefit associations (which seem to be in a legal category all their own); the situation where the foreign insurance company is plaintiff; cases where the cause of action arose outside the state in question.

2. The same problem may arise by use of other impersonal facilities, such as telephone, telegraph, or radio. *Ace Grain Co. v. American Eagle Fire Insurance Co.*, 95 F. Supp. 784 (S.D. N. Y. 1951) (telephone).

Though the earlier law was clear that insurance was not (interstate) commerce³ the converse seems equally settled today.⁴ Many thought that the *Southeastern Underwriters* case would, in large part, nullify existing state regulation of insurance. This idea was greatly dispelled by *Robertson v. California*⁵ and completely so by passage of the McCarren Act⁶ shortly thereafter. Congress has not "occupied the field" and the continued validity of state regulation of insurance seems certain.

All the states have enacted stringent legislation regulating insurance companies. Though varying as to minor provisions, the various state laws regulating foreign companies tend toward uniformity. At the risk of over-simplification it may be stated that these statutes are aimed at the following:

1. Provision for appointment of an agent (usually the secretary of state or commissioner of insurance) for service of process, so that the company will be amenable to suit in the local jurisdiction.
2. Solvency of the company.
3. Protection of competing local business interests (often interwoven with the solvency requirements).
4. Taxation.

Most of such laws are, of course, ultimately intended for the protection and benefit of the local state's citizens, and one of the essential elements is the mode and place of enforcement of the company's liability, which may be available to the claimant, his beneficiary, or the state itself.

I. JURISDICTION

A very brief review of the historical development of the bases of a state's jurisdiction over foreign corporations⁷ will highlight the problems encountered with the foreign mail-order insurance company. It will be remembered that the original theory was that a corporation, having existence only within the state of its incorporation, was not amenable to an *in personam* suit beyond the territory of its origin.⁸ After the vast expansion of corporate activities into foreign fields, a need arose for some means by which a state could, for the protection of its citizens, secure jurisdiction over foreign corporations whose activities in some way involved

3. *Paul v. Virginia*, 8 Wall. 168, 183 (U.S. 1868).

4. *United States v. Southeastern Underwriters Association*, 322 U.S. 533 (1944).

5. 328 U.S. 440 (1946).

6. 59 STAT. 33, 15 U.S.C. §§ 1011-1015 (1945). "§ 1011. Declaration of Policy. Congress declares that the continued regulation and taxation by the several States of the business of insurance is in the public interest, and that silence on the part of Congress shall not be construed to impose any barrier to the regulation or taxation of such business by the several States."

7. See HENDERSON, *THE POSITION OF FOREIGN CORPORATIONS IN AMERICAN CONSTITUTIONAL LAW* (1918); BEALE, *FOREIGN CORPORATIONS*, Ch. XI (1904); FLETCHER, *CYC CORP.* Vols. 17, 18 (Perm. Ed 1933); GOODRICH, *CONFLICT OF LAWS* § 76 (3rd Ed. 1949).

8. *Bank of Augusta v. Earle*, 13 Pet. 519, 588 (U.S. 1839).

the state or its citizens. To satisfy this need the theory of "consent"⁹ came into our law, whereby a corporation, by doing or transacting intrastate business¹⁰ within a state other than that of its incorporation, "consented" to service of process so as to make it amenable to suit in such jurisdiction. That this theory was fictional was evident from the fact that in the majority of cases the corporation obviously did not so consent, but adamantly refused to do so, the doctrine nevertheless being applied. To deal with some of the inadequacies¹¹ of the consent theory the courts developed the doctrine of "corporate presence."¹² The rationalization of this doctrine was that the corporation by its activities within a state, so manifested its presence there as to be amenable to that state's jurisdiction. This theory wore thin when a corporation had ceased doing business in the state in question and yet was held liable to suit there.¹³ Neither theory proved entirely satisfactory and the latter doctrine did not render the former fiction entirely obsolete. Indeed at times the courts have seemed to apply the two formulae simultaneously.¹⁴ The expression that a foreign corporation has submitted or "submitted"¹⁵ itself to the jurisdiction of the court of another state by doing business in such state has been used occasionally, but this seems merely another way of stating a conclusion rather than a reason. These cases all involve the difficult and confusing problem of proving that the corporation was doing business¹⁶ within the state—such activity being necessary to subject it to the court's jurisdiction within the meaning of due process.¹⁷ This question has been left to the decision of each case as it arises upon its own particular facts.¹⁸

Two classic examples of the older law on the subject involving non-complying insurance companies are the *Allgeyer*¹⁹ and *Benn*²⁰ cases. The *Allgeyer* case²¹ involved a Louisiana statute²² which prohibited "any person, firm, or corporation"

9. *Lafayette v. French*, 18 How. 404 (U.S. 1856).

10. *St. Clair v. Cox*, 106 U. S. 350, 359 (1882).

11. CARNAHAN, *CONFLICT OF LAWS AND LIFE INSURANCE CONTRACTS*, p. 16 (1942). "Since the basic assumption of a state's power to exclude was not applicable in cases involving foreign corporations engaged in interstate commerce, the fiction that the act of doing business manifested its consent to be sued thereon was untenable in cases of that type. Consequently and to deal with this problem, in *International Harvester Co. v. Kentucky*, the Supreme Court advanced another theory, that of presence within the state."

12. *International Harvester Co. v. Kentucky*, 234 U.S. 579 (1914).

13. *State ex rel. Bond & Goodwin & Tucker v. Superior Court*, 289 U.S. 361 (1933).

14. *People's Tobacco Co. v. American Tobacco Co.*, 246 U.S. 79 (1918).

15. *St. Louis Southwestern Ry. v. Alexander*, 227 U.S. 218, 227 (1913); *Ohio River Contract Co. v. Gordon*, 244 U.S. 68, 72 (1917).

16. *St. Clair v. Cox*, *supra* note 10. As to what constitutes "doing business," see Isaacs, *An Analysis of Doing Business*, 25 COL. L. REV. 1018 (1925).

17. *Riverside & Dan River Cotton Mills v. Menefee*, 237 U.S. 189, 194 (1915).

18. *St. Louis Southwestern Ry. v. Alexander*, *supra* note 15; *People's Tobacco Co. v. American Tobacco Co.*, *supra* note 14, at 87.

19. *Allgeyer v. Louisiana*, 165 U.S. 578 (1897).

20. *Minnesota Commercial Men's Association v. Benn*, 261 U.S. 140 (1923).

21. See note 19 *supra*.

22. Acts, 1894, No. 66.

from making contracts of marine insurance on property within the state with companies which had not complied with the local regulatory laws. Violation was punishable by fine. The state sued to enforce the penalty against Allgeyer and Company, which had procured such insurance. The contract had been consummated at the insurance company's home office in New York. The United States Supreme Court held the statute violative of due process in that it purported to regulate contracts made outside the state's territorial limits and hence beyond its jurisdiction.

In the *Benn* case²³ a Minnesota insurance company had insured the life of plaintiff's decedent, a Montana resident. A claim was made and rejected, whereupon suit was brought in Montana. Service was made on the Secretary of State and Insurance Commissioner, pursuant to that state's statutes. A default judgment was entered for the plaintiff. Plaintiff then brought her action in Minnesota on the judgment. The Association's principal contention was that it had never done business in Montana, therefore the Montana court had no jurisdiction and the judgment was void as violative of due process. Plaintiff contended that the Association was doing business in Montana because the application was filled and signed, notices received, and dues and assessments sent, all in Montana, and the Association reserved the right to investigate claims. The association relied, in large part, upon recommendations and solicitations of its old members to procure new ones, as is true with many, if not all, such mail-order businesses. The United States Supreme Court upheld the Association's contention that it was not doing business in Montana and therefore the case seems ample authority for the statement that mere solicitation is not "doing business."²⁴

Mail-order insurance companies, relying on the above decisions, apparently assumed that they would not be subject to process or regulation by states other than the one in which they were incorporated. Their reliance was misplaced. Four cases²⁵ within the past decade loom large in the law applicable to foreign corporations in general and foreign insurance companies in particular.

In *Osborn v. Ozlin*,²⁶ the Supreme Court affirmed the state court's refusal to enjoin enforcement of a Virginia statute which required a resident agent to countersign insurance contracts, and limited non-resident brokers to 50% of the brokerage fee or commission. Violation was punishable by fine, revocation of license, or both. The statute was aimed at the evil of channeling insurance into out-of-state concerns, through the placing of insurance by non-resident individuals (agents or brokers), which resulted, according to Mr. Justice Frankfurter, in diffi-

23. See note 20 *supra*.

24. *Id.* at 145. See *Green v. Chicago, B. & G. Ry.*, 205 U.S. 530 (1907); *Philadelphia & Reading Ry. v. McKibbin*, 243 U.S. 264 (1917); *People's Tobacco Co. v. American Tobacco Co.*, *supra* note 14. Scott, *Jurisdiction Over Non-Residents Doing Business Within A State*, 32 HARV. L. REV. 871 (1919); 18 FLETCHER, CYC. CORP. § 8718 (Perm. Ed. 1933).

25. *Osborn v. Ozlin*, 310 U.S. 53 (1940); *Hoopston Canning Co. v. Cullen*, 318 U.S. 313 (1943); *International Shoe Co. v. Washington*, 326 U.S. 310 (1945); *Travelers Health Association v. Virginia*, 339 U.S. 643 (1950).

26. See note 25 *supra*.

culty in enforcing statutes regulating rebates, rates, and solvency of the insurance companies. At this time twelve other states²⁷ had similar requirements. One practical reason for such legislation was that it prevented at least 50% of the commissions from inuring to the benefit of non-residents. However, this probably was not the controlling inducement for the statute's passage. There would seem to be a reasonable relation between the statute and the ease with which Virginia's laws regarding rebates, rates, and solvency are enforced, since a resident agent, assuming him to be a proper agent for service of process, would obviate the jurisdictional problem inherent in the situation where there are no agents within the state. The Supreme Court had no difficulty in sustaining Virginia's power to pass such a statute.²⁸ Mr. Justice Roberts dissented, primarily, it seems, on the ground that Virginia was regulating transactions which took place outside Virginia, and hence beyond her jurisdiction. He emphasized that the Virginia resident whose countersignature was required may not render any actual service to the company. The case is of value in showing the extent to which foreign insurance companies may be regulated consistently with the Constitution. Further, it highlights what may be an adequate answer to the enforcement problem, discussed *infra*, where transient agents actually operate within the state.

In *Hoopeston Canning Co. v. Cullen*,²⁹ reciprocal insurance associations engaged primarily in insuring against fire, with attorneys-in-fact in Illinois, sought a declaratory judgment as to whether they could constitutionally be made subject to the New York Insurance Law as a condition to being licensed and insuring property there. The associations had formerly been licensed for some years in New York and wished to obtain a license under the Insurance Law of 1939. The regulations in question were aimed primarily at guaranteeing the association's solvency. The associations' chief contention was that since the contracts were made in Illinois and checks mailed from that state, they were not doing business in New York, hence not subject to regulation by the latter state. The Court, in determining that the Associations were doing business in New York, took a realistic approach and repudiated "conceptualistic discussion of theories of the place of contracting or of performance,"³⁰ saying that this viewpoint, as expressed by the *Allegeyer* case,³¹ was out-dated.³² Recognizing the state's interest in the protection of its citizens and its own general economic well-being, the Court had little difficulty in sustaining the validity of the regulations.

About two years later, the well-known case of *International Shoe Co. v. Wash-*

27. *Id.* at 65.

28. Shortly after this case the validity of a Montana statute requiring *all* of the commission to be paid to a resident agent was upheld by the Supreme Court: *Holmes v. Springfield Fire & Marine Insurance Co.*, 311 U.S. 606, 726 (1940).

29. 318 U.S. 313 (1943).

30. *Id.* at 316.

31. *Allegeyer v. Louisiana*, *supra* note 18, at 587.

32. *Hoopeston Canning Co. v. Cullen*, 318 U.S. 313, 319 (1943): ". . . the *Allegeyer* line of decisions can not be permitted to control cases such as this, where the public policy of the state is clear, the insured interest is located in the state, and there are many points of contact between the insurer and the property in the state."

ington³³ was decided. This suit, a non-insurance case, was brought to enforce payment of a tax under the Washington state unemployment compensation statute against a foreign corporation whose chief contention was that it was not doing business within the state. Personal service was had on a local sales solicitor of the company's products, and a copy was sent by registered mail to the company's home office in Missouri. The company had no office in Washington, made no contracts there, maintained no stock of merchandise there, and made no deliveries of goods there in intrastate commerce. However, approximately 11 to 13 salesmen, who resided in Washington and whose activities were confined to that state, were employed there, were compensated on the basis of sales there, were given samples for display, and sometimes rented sample rooms for such display. Their authority was limited to exhibition and solicitation. The Supreme Court affirmed the lower court's finding that the company was doing business within the state and therefore subject to the tax. A changed attitude toward jurisdictional requirements seemed evident, the court saying that

"... due process requires only that in order to subject a defendant to a judgment *in personam*, if he be not present within the territory of the forum, he have certain minimum contacts with it such that the maintenance of the suit does not offend 'traditional notions of fair play and substantial justice.'"³⁴

The Court recognized the fictional aspect of the "presence" doctrine and stated that its application merely begs the question to be decided.³⁵ Mr. Justice Black, in a separate opinion, deemed the due process issue without merit here and thought the court should

"... decline the invitation to formulate broad rules as to the meaning of due process, which here would amount to deciding a constitutional question 'in advance of the necessity for its decision.'"³⁶

Mr. Justice Black's views on the case would seem to strengthen the result of the case, though not the rule expressed therein. His opinion raises the problem of the vagueness of the rule announced in the majority opinion:

"... For application of this natural law concept, whether under the terms 'reasonableness,' 'justice,' or 'fair play,' makes judgment the supreme arbiters of the country's laws and practices. . . . This result, I believe, alters the form of government our Constitution provides."³⁷

33. 326 U.S. 310 (1945).

34. *Id.* at 316.

35. *Ibid.*: "... For the terms 'present' or 'presence' are used merely to symbolize those activities of the corporation's agent within the state which courts will deem to be sufficient to satisfy the demands of due process. . . . Those demands may be met by such contacts of the corporation with the state of the forum as make it reasonable, in the context of our federal system of government, to require the corporation to defend the particular suit which is brought there. . . . 'Presence' in the state in this sense has never been doubted when the activities of the corporation there have not only been continuous and systematic, but also give rise to the liabilities sued on, even though no consent to be sued or authorization to an agent to accept service of process has been given. . . ."

36. *Id.* at 322.

37. *Id.* at 326.

The *International Shoe* case shows a relaxing of the requisites of "doing business" and perhaps a departure from a strict rule of personal service within the state's territory.

Still greater departure from the earlier restrictions is apparent in *Travelers Health Association v. Virginia*.³⁸ The Association, a Nebraska corporation engaged in the health insurance business, had issued insurance certificates to some 800 Virginia members without having obtained a permit to do business in Virginia or having complied with other conditions required by Virginia law. The Association had no office, no agents as such, and no property in Virginia. For several years it had sold or issued these certificates in Virginia by means of the United States mails, the old members "recommending" prospective members by sending their names to the Omaha office of the Association, whereupon applications were sent to the prospects which often resulted in new memberships, such contracts being consummated in Nebraska. Virginia's "Blue Sky Law"³⁹ required a permit from the State Corporation Commission to sell these certificates, the issuance of which depended on compliance with certain conditions, primarily providing information relative to the solvency of the seller, and appointment of the Secretary of the Commonwealth as agent for the service of process. The Virginia Corporation Commission instituted cease and desist proceedings against the Association and its treasurer as provided by Virginia law. Service was by registered mail only, and the Association and its treasurer appeared specially to contest jurisdiction. Their motion was denied and the defendants were ordered to cease and desist from further sale or offer of the Association's certificates in Virginia until it obtained the requisite permit. The state court affirmed⁴⁰ this decision and an appeal was taken to the United States Supreme Court, where the original decision was again upheld. The principal contention of the Association was that it was not doing business in Virginia and hence not subject to Virginia's jurisdiction. The Association relied heavily upon the *Benn* case, *supra*,⁴¹ but the Court, after a brief resume of that decision, said:

"But where business activities reach out beyond one state and create continuing relationships and obligations with citizens of another state, courts need not resort to a fictional 'consent' in order to sustain the jurisdiction of regulatory agencies in the latter state. And in considering what constitutes 'doing business' sufficiently to justify regulation in the state where the effects of the 'business' are felt, the narrow grounds relied on by the Court in the *Benn* case cannot be deemed controlling."⁴²

". . . Metaphysical concepts of 'implied consent' and 'presence' in a state

38. 339 U.S. 643 (1950).

39. VA. CODE § 3848 (47) *et seq* (Michie, 1942), Now. VA. CODE § 13-106 *et seq.* (Michie, 1950). Similar statutes in other states have been upheld by the Supreme Court: *Hall v. Geiger-Jones Co.*, 242 U.S. 539 (1917); *Caldwell v. Sioux Falls Stockyards Co.*, 242 U.S. 559 (1917); *Merrick v. Halsey & Co.*, 242 U.S. 568 (1917).

40. 188 Va. 877, 51 S.W. 2d 263 (1949). The Virginia court regarded the proceeding as more in the nature of a criminal action than did the United States Supreme Court.

41. See note 20 *supra*.

42. *Travelers Health Association v. Virginia*, 339 U.S. 643, 647 (1950).

should not be solidified into a constitutional barrier against Virginia's simple, direct and fair plan for service of process on the Secretary of the Commonwealth. . . ."⁴³

It may be significant that Mr. Justice Black wrote the majority opinion here, in view of the fact that he hesitated to formulate a general rule in the *International Shoe* case,⁴⁴ yet relied most heavily on that same rule here. His opinion may be further significant by reason of the fact that in the *International Shoe* case he thought due process not in issue,⁴⁵ yet accepted the existence of the issue without a qualm in the *Travelers* case. His former position was occupied by Justices Minton and Jackson. These justices dissented in a two-point opinion,⁴⁶ first stating that they would dismiss the appeal since due process was not in issue, there being no criminal sanctions applied nor any enforcement of the order, other than adverse publicity, and second, taking the position that the corporation was not "present" in Virginia and regarding service on an agent within the jurisdiction as indispensable to a judgment against the corporation. Justices Reed and Frankfurter seemed to agree with the latter part of the dissent.⁴⁷ Mr. Justice Douglas, in a separate concurring opinion, took a somewhat intermediate stand, regarding the Association's old members as defacto agents,⁴⁸ though not agents in form. While the old members might be regarded as "agents" for the purpose of determining whether the Association was "doing business" there, it would seem highly doubtful that they could be regarded as proper agents for service, since they were not employees and their services were gratuitous. Moreover, there was no service on these "agents" in the instant case.

From an analysis of the preceding cases it would appear that the fictions of "presence" and "consent" have been largely relegated to the realm of historical jurisprudence. Henceforth the standard used⁴⁹ in determining whether a foreign corporation is subject to the jurisdiction of the forum would seem to be nearer that of "reasonableness": If there is reasonable notice and opportunity to defend, if there are minimum contacts between the forum and the defendant, if it is unreasonable to require plaintiffs to bring suits elsewhere, and not inconvenient or a hardship to require the defendant to submit to suit in the forum indicated, then the jurisdictional requirements have been fulfilled and the judgment obtained will be valid. Some may object that this standard is too vague, but at least it is clear that present "rule" is a far cry from the ancient principle that jurisdiction is obtained by physical power over the person of the defendant.

One may question the decision in the *Travelers* case. As a moral solution it seems unassailable. A contrary result would enable an insurance company to col-

43. *Id.* at 649.

44. See note 36 *supra*.

45. See note 35 *supra*.

46. *Travelers Health Association v. Virginia*, 339 U.S. 643, 655 (1950).

47. *Id.* at 659: "Mr. Justice Reed and Mr. Justice Frankfurter, agreeing with the Court in reaching the merits, on the merits join this dissent."

48. *Id.* at 654.

49. At least by the federal courts.

lect premiums from its policy holders and yet avoid, for all practical purposes, liability on those same policies, if it so desires, by remaining beyond physical reach of the local courts. If we follow the older cases, however, we must inevitably reach the conclusion, as did Justices Minton and Jackson, that personal service on a proper agent within the boundaries of the forum's territorial jurisdiction is requisite to the satisfaction of due process. Such a conclusion means that our law must be regarded as static and inflexible, the converse of which has been one of the most cherished principles of the common law for many generations. Nowhere has the adaptability of the law to the times been more evident than in the field of constitutional law. It has been said that the law is a living thing. To decide that the requisites of jurisdiction are not present in such a situation as that presented by the *Travelers* case is to deny this fundamental maxim, to ignore legal history, and to disregard present trends in other branches of the law.⁵⁰

II. ENFORCEMENT

Assuming the requisite jurisdiction and the entry of a judgment (or order, as in the *Travelers* case), what may be an even greater problem is presented: How can such judgment or order be enforced?

A. *Action within the forum*

Statutes prohibiting transaction of business by unauthorized insurers may provide for enforcement by way of cease and desist order, or by fine, or both. It would seem that there is no direct way for the forum, at the instigation of the state, to enforce either a cease and desist order in the nature of an injunction, or a fine, since there are no agents within the forum's territory which could be cited for contempt for non-compliance with the order or judgment, and there is no property of the defendant within the territory which could be reached by garnishment, unless the obligations of local insureds be considered such. The state could not infringe federal control over the United States mail⁵¹ by attempting to prevent the defendant's mail from entering the state. Another possibility might be open to the state, however. It might, through use of the Uniform Criminal Extradition Act⁵² now in force in some states, obtain personal jurisdiction over the individual agents of the company who were involved, and thus subject them to fine as per a judgment, or for contempt by reason of non-compliance with an order. This procedure could be used only where the incorporating state has Section 6⁵³ of the Uniform Act on

50. *Kane v. State of New Jersey*, 242 U.S. 160 (1916); *Hess v. Pawloski*, 274 U.S. 352 (1927).

51. U.S. CONST. Art I, § 8, Cl. 7.

52. 9. U.L.A. 169.

53. "Extradition of Persons not Present in Demanding State at Time of Commission of Crime.—The Governor of this state may also surrender, on demand of the Executive Authority of any other state, any person in this state charged in such other state in the manner provided in Section 3 with committing an act in this state, or in a third state, intentionally resulting in a crime in the state whose Executive Authority is making the demand, and the provisions of this act not otherwise inconsistent, shall apply to such cases, even though the accused was not in that state at the time of the commission of the crime, and has not fled therefrom."

its books, and even in this case compliance is not mandatory.⁵⁴ Further, such action seems out of proportion to the violation involved and is no actual solution to the problem of continued violation.

Because there are no agents and no property of the defendant within the forum the same problems arise when the suit is brought by a beneficiary rather than the state, to enforce the insurers liability on a policy. Garnishment even is usable, seems an extremely impractical remedy here, since the costs of obtaining satisfaction of the judgment might often exceed the amount of the judgment itself.

Publicity could be given to the order or the fact of non-compliance, but the notoriety sufficient to cause the company to discontinue its solicitations within the forum would be difficult and expensive to achieve. Statutes declaring contracts void when made with non-complying companies might be utilized, but complete avoidance of such contracts, until the company does cease its solicitations, penalizes the innocent and unknowing local citizens rather than the company.⁵⁵

*B. Action within the forum initially, combined with
subsequent action in the incorporating state*

A number of states have adopted the Uniform Unauthorized Insurers Act⁵⁶ or a variant thereof, providing for service in such cases upon the commissioner of insurance or similar official, with a copy being forwarded to the defendant company.⁵⁷ Under these or similar statutes, if the state courts recognize the test of jurisdiction laid down by the Court in the *Travelers* case, there seems to be no reason why a beneficiary could not obtain a judgment in the form, then sue on such judgment in the state of incorporation, by virtue of the "full faith and credit" clause.⁵⁸ However, Mr. Justice Douglas, in the *Travelers* case, would lead us to

54. 9 U.L.A. 169, 171: "Commissioners' Prefatory Note . . . The effectiveness of Section 6, therefore, depends upon comity between the states, rather than upon the mandatory effect of the Constitution. . . ."

55. As to the variety of problems raised by these statutes see 75 A.L.R. 446 (1931), 81 A.L.R. 1134 (1932), 7 A.L.R. 2d 256 (1949).

56. 9 U.L.A. 728. See ARK STAT. ANN. § 66-240 *et seq.* (1947); Calif. Stats. 1949, c. 495, § 2, CALIF. CODE ANN. Ins. § 1610 *et seq.* (Deering, 1950); CONN. GEN. STAT. § 563a (Supp. 1949); Fla. Laws 1949, c. 25368; Ga. Laws 1950, pp. 58, 347; ILL. REV. STAT. c. 73 § 733 (1949); Iowa Acts 1949, c. 212 § 1, IOWA CODE ANN. § 507A; Kan. Laws 1949, p. 485; La. Acts 1948 Vol. 2, § 27.02 *et seq.*; Me. Laws 1949, c. 96; Mich. Acts 1949, § 548, MICH. STAT. ANN. 24,567 (101); Nebr. Laws 1949, c. 137; N. H. Laws 1949, c. 200; N. Y. Laws 1949; § 59a; N. C. Laws 1945, c. 386; Pa. Laws 1949, Vol. 2, p. 1491; S. C. Acts 1947, No. 232, § 79 (1947); S. D. Laws 1939, c. 129.

57. 9 U.L.A. 728. Section 5 provides, in part, as follows: "SERVICE OF PROCESS UPON UNAUTHORIZED INSURER.—(a) The transacting of business in this state by a foreign alien insurer without a certificate of authority . . . is equivalent to an appointment by such insurer of the (Commissioner of Insurance) . . . to be its . . . attorney, upon whom may be served all lawful process . . . and . . . is of the same legal force and validity as personal service of process in this state upon it. . . ."

58. U.S. CONST. Art IV, § 1, 62, STAT. 947, 28 U.S.C. 1738 (1948).

believe that when an individual is plaintiff jurisdictional requirements might differ⁵⁹ from those imposed in an action where the state is seeking to assert its regulatory power. Why there should be such difference is not apparent, nevertheless it is a possibility that must be considered. Even if this jurisdictional difficulty be no objection to recognition of the initial judgment by the incorporating state there remains the practical objection of expense and inconvenience in requiring a beneficiary to resort to foreign courts to satisfy the judgment.

Where the state is the instigator of the action, however, a different problem arises.⁶⁰ If it attempts to enforce a judgment calling for the payment of a fine by means of the full faith and credit clause, the well-established principle that one state does not enforce another's penal laws⁶¹ is encountered. The rule does not seem to rest upon a strong logical foundation, at least where the state itself is asking for enforcement, since the reason for the rule has been stated to be non-interference with the other state's sovereignty. There are some indications that the rule may be dwindling in importance,⁶² but it is still a probable barrier here.⁶³

If the original action resulted in a cease and desist order, as in the *Travelers* case, rather than a money judgment, the forum might ask the state of incorporation to enforce this injunction by reason of the full faith and credit clause. Though the "penal" stigma may not be attached here, the problem of enforcement of a foreign decree is encountered. Most courts are hesitant to act in such cases, the reason supposedly being that there was, at common law, no action to enforce decrees, other than debt or assumpsit, which lie only for sums of money.⁶⁴

C. Action within the state of incorporation directly

Obviously, many of the difficulties encountered by reason of joint state action or the full faith and credit clause will be obviated if enforcement is possible in or by the incorporating state itself.

At least four states have passed "reciprocal" statutes⁶⁵ which forbid *domestic* companies, under penalty of revocation of license, from insuring in states where they are not authorized to do business, provided the states in which such business is done have the same law. These statutes seem analogous to interstate compacts, which suggest another possible solution to the problem, but the statutes avoid the pro-

59. *Travelers Health Association v. Virginia*, 339 U.S. 643, 652 (1950): ". . . I put to one side the case where a policy-holder seeks to sue the out-of-state company in Virginia. His ability to sue is not necessarily the measure of Virginia's power to regulate, . . ."

60. See Note, *Reaching the Out-of-State Mail-Order Insurer*, 64 HARV. L. REV. 582 (1951).

61. *Huntington v. Attrill*, 146 U.S. 657 (1892).

62. *Milwaukee County v. M. E. White Co.*, 296 U.S. 268 (1935) (enforcement of a foreign judgment for taxes).

63. *Id.* at 271: ". . . the obligation to pay taxes is not penal. . . ." The extent of the "penal" law exception to the requirements of "full faith and credit" seems to remain an open question.

64. 2 BEALE, CONFLICT OF LAWS § 449.1 (1st Ed. 1935).

65. La. Acts 1948, Vol. 2, § 27.01; Md. Laws 1943, c. 312; N. H. Laws 1943, c. 105; WASH. REV. STAT. § 45.07.14 (Supp. 1947).

cedural difficulties of the compacts, especially the necessities of concerted action and Congressional approval.

A more effective statute⁶⁶ eliminates the reciprocal feature and prohibits domestic insurance companies from insuring in foreign jurisdictions *regardless* of what law the foreign jurisdiction has in relation to the matter. This latter statute, if passed by all or most of the states, would seem to be an answer to the difficult problems previously encountered. One practical problem that might conceivably arise here, however, would be lack of initiative by the attorney-general, or other enforcement official, in instigating appropriate proceedings against the offending company or companies. If the attorney-general is diligent in obtaining accurate information and in prosecuting the matter through to a rapid conclusion, the problem would seem to be largely obviated.

At least one other possibility of direct action in the incorporating state suggests itself. It may be that the offended state could institute direct proceedings in the incorporating state to enforce any taxes (or perhaps even penalties) placed upon unauthorized insurers by the offended state's statutes. In the past revenue laws have been placed on the same footing as penal laws, so far as regards enforcement in and by another state.⁶⁷ Yet in spite of this at least two recent cases⁶⁸ have allowed the taxing state to sue directly in a second state for taxes due by individuals formerly resident in the taxing state but at the time of suit located in a second state. Such action was taken without any prior judgment being obtained in the taxing state. If the analogy of these cases is followed then it would seem that any taxes levied by an offended state against unauthorized insurers could be collected in the incorporating state in this same manner. Logically, there seems no reason to prevent the issuance of a cease and desist order by the incorporating state through such direct action, provided the incorporating state is willing to cooperate. The possibility of enforcing fines in this manner, in view of precedent, remains rather dubious.

D. *Action by the federal government*

Federal legislation could fill the present gaps. So far, only two federal agencies appear to be in a position to regulate mail-order insurance: the Federal Trade Commission and the Post Office Department.

Insurance comes under the provisions of the Federal Trade Commission Act by virtue of the McCarran Act,⁶⁹ and certain unfair trade practice rules have been promulgated by that body, but to date the regulations appear to have been aimed at actual fraud⁷⁰ and not ordinary cases of non-compliance or non-licensing.

66. Md. Laws 1943, c. 495; Mich. Laws 1948, 511.2a; Mont. Laws 1943, c. 214; Ore. Laws 1943, c. 260 § 1; S. D. Laws 1943, c. 118; W. VA. CODE ANN. § 3321.(40) (1943).

67. *The Antelope*, 10 Wheat. 66, 123 (U.S. 1825).

68. *State ex rel. Oklahoma Tax Commission v. Rodgers*, 238 Mo. App. 1115, 193 S.W. 2d 919 (1946); *State of Ohio ex. rel. Duffy, Atty-Gen. v. Arnett*, 234 S.W. 2d 722 (Ky. 1950).

69. 59 STAT. 34, 15 U.S.C. § 1012 (1945).

70. 16 C.F.R. 3.10-3.285, 3.395 (1949 ed.). See KUTAK, *LEGAL AND ECONOMIC ASPECTS OF MAIL ORDER INSURANCE* (1948), reviewed in *INS. L. JOUR.* 593 (Aug. 1949).

The Post Office Department could stamp mail "fraudulent" and return it to the sender,⁷¹ but again, this "fraud" approach is no solution to the usual situation of mere unauthorized solicitation.

Existing federal legislation and regulation, then, is inadequate to cope with the non-fraud cases which arise in the mail-order insurance field.

CONCLUSION

Some satisfactory solution to the enforcement problem is necessary to protect the rights of insureds who are unable to do so by their individual efforts. If this cannot be accomplished by the states themselves the federal government may feel the necessity for over-all federal regulation of the mail-order insurance business. There seems no reason for this country to follow the pattern of nationalization evident in other nations by extending federal control over insurance. Indeed, Congress has expressed its unwillingness to do so in the McCarran Act. Assuming the desirability of continued state regulation, the most effective solution, as well as the one most easily obtained, from a procedural point of view, is appropriate legislation in the incorporating state: legislation which is aimed at regulation of *domestic* insurers requiring them to possess a license or otherwise comply with the regulations of other jurisdictions where they transact business, on penalty of losing the license granted by the incorporating state. In the writer's opinion this statute or a variant should be recommended to the attention of all far-sighted legislatures which have not at the present time enacted such a statute.

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71. 39 C.F.R. 36.9 (1949 Ed.).

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