Volume 8 | Number 1 Article 4

12-1-1929

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GUSTAVUS H. ROBINSON*

INTRODUCTION

THE NORTH CAROLINA LAW REVIEW last year published in the April number a discussion by the present writer of what he called the "valuation war" in which post-war financial conditions have brought on, during the last ten years, particularly sharp engagements. It is based upon the determination of the American people to protect themselves from exploitation by those on whom they rely for the supply of essential things. Although newer plans for this protection nowadays involve the control of business merely as business, the valuation problem arises out of the device first resorted to of declaring a business "public" and reading into the "public" status special incapacities for exploitation of customers.[1]

For years the "public" businesses were left to make their service charges under a sort of honor system reviewable by common law litigation at the instance of the customer. The clumsiness of this method and the cost to the customer of invoking it led to positive price fixing by public authority, and the administrative tribunal—the commission —was evolved to do the particular job. Its say-so as to what the individual customer shall pay furnishes a constant squabble all by itself but the "valuation war" concerns the aggregate of these individual charges as the general reward to the utility for its service. This aggregate is the product of a principal sum multiplied by a percentage. The amount, included in this principal sum, which is to be assigned as the value of the property used in the service has furnished the specific battle ground. On the figure in dollars which is to be set down in today's bookkeeping to represent this property as a "rate base" the fight is at its height; and in this "bloody angle" the *O'Fallon Case* is the latest encounter.

Thus far but one phase of the matter has been set forth. In so far as the public is an aggregate of individuals there is a public interest which coincides with the interest of the customer that he be

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[1] See the writer's article *The Public Utility Concept in American Law* (1928) 41 Harv. L. Rev. 277.

not exploited. But there are countervailing interests—individual from the angle of the investor who has already put his money into the public utility enterprises, and social from the consideration of inducing him and others to keep on supplying new capital. Under the whole valuation topic lies the inarticulate premise that utility service is a matter for private enterprise. So long as this is the premise the task of the rate fixing authority is to balance these competing interests, keeping in mind that there is as much social utility in not exploiting the purveyors of the service as in not letting them exploit.

RATE BASE VALUATION

In the previous article the writer said of this "rate base": "When 'one devotes his property to a use in which the public has an interest'[2] he does not abandon it to the public whim. 'The railroad property is private property devoted to a public use.'[3] As private property it is within a constitutional protection which has been phrased that 'There must be a fair return upon the reasonable value of the property at the time it is being used for the public. * * * And * * * the value * * * is to be determined as of the time when the inquiry is made regarding the rates.'[4]

But what is the method of reaching the value? This is the chiefest present day battleground. Various ordinary business methods being excluded[5] the field is narrowed to two: namely, the so-called prudent investment theory, and the present cost of reproduction theory.

Since the world war, and under the variance in purchase-power between the dollar of 1913 and that of the present-day dollar, the question has blazed into hot controversy. The Supreme Court itself sticks to the theory that the value may be more than the cost; and it leans toward ascertaining value by the cost of reproduction, which may put *more* dollars into the present bookkeeping or *fewer;* just now, more.

[2] The phrase is, of course, that of Chief Justice Waite in Munn v. Illinois, 94 U. S. 113 (1876).

[3] Mr. Justice Hughes in No. Pac. Ry. Co. v. No. Dakota, 236 U. S. 585, 595 (1915).

[4] Mr. Justice Peckham in Wilcox v. Consolidated Gas Co., 212 U. S. 194 (1909).

[5] See the discussion by F. G. Dorety in *The Function of Reproduction Cost in Public Utility Valuation and Rate Making* (1923), 37 HARV. L. REV. 173, 174 for the argument which reads out of consideration "the use, as a measure of value of earning capacity under past or existing rates"; and the use of the outstanding securities.

Justice Brandeis has made a classic and a masterly exposition of the general situation in *S. W. Bell Telephone Co. v. Pub. Serv. Comm.*[6] and his view is that the prudent investment theory is the proper one. Notwithstanding, the court in this *Southwestern Bell Telephone Case* bluntly asserted that "If the highly important element of present costs is wholly disregarded" the finding of value was to be reversed. This was not, however, accepted as giving a definite theory, and it was left for recent cases to bring to a head the whole question. One of them involves the dealing of State authority with a local utility of no interstate character; the other concerned the valuation of the railroads by the Interstate Commerce Commission. They were, respectively, *McCardle v. Indianapolis Water Co.*[7] and the *O'Fallon Case* (Excess Income of St. Louis and O'Fallon Ry. Co.).[8]

In the *McCardle Case* Mr. Justice Butler for the majority put the Supreme Court more definitely in opposition to Mr. Justice Brandeis' view. But in the *O'Fallon Case* the Interstate Commerce Commission[9] by Meyer, C., stated that "Briefly, we have had before us the cost of reproduction new of the structural portion of this property estimated on the basis of our 1914 unit prices." "When it comes to bringing these basic valuations so arrived at down to any subsequent date, however, no good reason appears for doing more than making the necessary adjustments to reflect the property changes which have since occurred and which have been fully reported to us, and to reflect any further depreciation of the property. By the adoption of such a method of bringing values down to date we shall achieve the stability of rate base which we have found to be essential to a wise and just plan of public regulation. The method has the further advantages, also, that it is simple and easy of application and involves no great expense or delay and that its results are capable of reasonably accurate forecast. It insures fair treatment to the investor because a fair return will be secured for every dollar that has gone into the project, provided, of course, that traffic is available. Whatever the price level may be, however severe the fluctuations, this method will result in yielding a fair return on every dollar invested and remaining in the property. This is the greatest assurance

[6] 262 U. S. 276 (1923).
[7] 272 U. S. 400 (1926).
[8] 124 I. C. C. 3 (1927).
[9] 124 I. C. C. at 37.

which can be held out to prospective investors. No stronger inducements can be offered in fairness to all the interested parties."[10]

A three judge district court[11] affirmed the order which the commission had made and the case was expedited into the Supreme Court. The spread between the "value" of the nation's railroads as a whole calculated on spot reproduction, as compared with their "value" on the theory taken by the commission, is set at $10,000,000,000-$12,000,000,000. In this "biggest lawsuit in history" the appeal to the Supreme Court was filed on February 8, 1928. Some forty allegations of error were made of which the chief was that the law of the land, i.e., the *McCardle Case,* was ignored. Hearing was set for a day early in January, 1929.

When therefore the Supreme Court on January third last called up the *O'Fallon Case* it was to deal with one of our major economic issues. Because railways were in question; because not the Fourteenth but the Fifth Amendment limiting the Federal government, was in question; because recapture and not rate making was in question, there were those who saw differentiations from the *Water Case.*[12]

By playing upon some of these suggestions the court might possibly have avoided passing upon the general valuation theory, though it had held the amendments to mean the same thing when housing was declared to be a "public" business.[13] The Commerce Commission specifically felt that its task, though pigeonholed under Section 15, the recapture section of the Interstate Commerce Act, was a general job under Section 19, the Valuation Act, and said so. This view the Supreme Court accepted. It sensed that society's inducement to the investor to put his money into railroads must be the same as that

[10] As to price levels, Meyer C. said: "Under the method outlined above we do give weight to such changes in so far as they have been reflected in prices paid for new construction or replacements, and we value lands at their prevailing market values. We know of no other way of giving weight to this factor which is not dependent upon caprice, unless full weight be given under the current reproduction cost doctrine. There is, in our judgment, no intermediate process possible which is capable of being applied by any rule independent of the caprice of those who apply it." p. 39.

[11] 22 F. (2d) 980 (1927).

[12] On this see Goddard, *The Problem of Valuation; The Evolution of Cost of Reproduction as the Rate Base* (1928) 41 HARV. L. REV. 564, and Bonbright, *The Economic Merits of Original Cost and Reproduction Cost, ibid.* 593. At 589 Mr. Goddard argues the differences between local utilities and the railroads; and at 593 Mr. Bonbright adopts the argument.

[13] The cases arose from New York and from the District of Columbia and the decisions made no distinction: see Block v. Hirsch, 256 U. S. 135 (1921), and Marcus Brown Holding Co. v. Feldman, 256 U. S. 170 (1921).

to invest elsewhere, and it did no side stepping. It passed upon the merits. On the very case it held that the Commerce Commission had not taken a proper theory of valuation. Its order was therefore annulled. Announced on May 20th, 1929, the decision was front page news. Under the caption "O'Fallon Railroad Wins Court Fight on Valuation, Stocks Soar, then Break," the New York *Times* next day gave it the place of honor, and beside the story printed in full the opinion which Mr. Justice McReynolds wrote for the court. Justice Butler took no part. Justice Brandeis, naturally in view of his previous position, dissented in an impressive opinion. Mr. Justice Holmes as well as Mr. Justice Stone joined in it, and the latter wrote a dissent of his own in which the other two dissenters joined.

The caption of the *Times* states the early reaction of the press. Editorially the *Times* commented that "Yesterday's decision * * * is a distinct defeat for the Interstate Commerce Commission's contention." In its financial page it remarks on the same day "The decision was hailed as recognition of the fact that while the railroads are paying wages and making disbursements for supplies on the basis of 1929 prices they have been compelled to value themselves at 1914 prices." On the other hand in Boston the *Herald* editorially said on May 23, after more sober thought, "Of several things we may be assured in spite of early snap judgments to the contrary. The roads are not going to obtain a huge boost in rates."[14]

A week after the decision the *Literary Digest,* under the caption "The Railroad Victory in the Supreme Court," collected the newspaper comment. It began "When the O'Fallon pie was opened there was almost as much confusion of opinion as if four-and-twenty blackbirds were singing at once. Offhand, the Supreme Court, in condemning the Interstate Commerce Commission methods, seems to agree with the railroad lawyers that our rail-transportation system is worth the larger figure just mentioned, which would give a basis for higher freight rates, and for smaller sums to be handed back to the Government under the terms of the Transportation Act. This was the song that reached the Stock Exchange when the decision was announced, and the railroad shares went kiting up anywhere from five to twenty-five points.

[14] The editorial continues: "They will not seek boosts in general, if only for the reason that having fought their way back to popularity and fairly earned public approval for vast increases in efficiency, they will think twice before they incur the peril of public reprobation."

"Then, on second thought, the decision seemed less clear-cut; it was remembered that both the Supreme Court and the Interstate Commerce Commission are divided on the issue. Rail stocks sagged again, and editors and correspondents began to wonder whether the decision would have any effect except to throw the whole valuation situation into confusion and make more work for the Interstate Commerce Commission and the railroad lawyers. From the White House came the flat statement of President Hoover: 'I am confident that there will be no increase in railroad rates as the result of the O'Fallon decision'—and not a railroad executive could be found to raise his voice in disagreement."[15]

The comment which the *Literary Digest* recorded shows that to some editors the decision was a "happy outcome," "a victory for reasonableness and equity," "a release of the spring on some of the activities of the railroads." To others it was "what liberal minded people hoped it would not be." But to most it appeared to be an invitation to continued litigation.

These newspaper comments are given in order to show that decisions of the Supreme Court in matters of this sort are no longer of no interest to the man in the street. He senses his own stake in such questions. They also indicate what the business interests conceived to be the effect of the ruling. But it must be remembered that the litigation was actually a recapture proceeding. Only by assumption that it was to be a type case was it a rate base matter. As a recapture decision purely the May announcement of the Supreme Court has a large financial meaning of its own.[16]

[15] Issue of June 1, 1929 at p. 8.

[16] Sums that would have been payable by leading railroad companies to the Government on account of "excess earnings," if the Supreme Court has sustained the Interstate Commerce Commission's methods, as estimated by Dow, Jones and Company, and reprinted from *The Wall Street Journal.* First column shows recapturable half of earnings for 1928; last column the accumulation of liability for the period 1921-28:

	1928	*Total Arrears 1921-1928*		*1928*	*Total Arrears 1921-1928*
Atchison	$2,800,000	$25,500,000	Norf. & W.	$5,800,000	$28,000,000
Atl. C. Line*	.....	14,000,000	Pere Marq.	1,650,000	5,800,000
Balto. & Ohio	2,000,000	7,100,000	P. & W. Va.	.....	300,000
Ches. & Ohio	8,600,000	36,200,000	Reading	.....	8,750,000
Del. & Hud.	400,000	2,200,000	St. L. San F.	2,250,000	21,000,000
Del. L. & W.	100,000	2,750,000	St. L. So'wn	.....	1,600,000
Gt. Northern	500,000	1,700,000	Seaboard	.....	750,000
Kan. C. So.	425,000	2,175,000	Southern Pac.	.....	4,500,000
L. & N.	.....	1,500,000	Southern Ry.	.....	5,100,000
M.-K.-T.	600,000	4,450,000	Union Pac.	1,500,000	4,400,000
Mo. Pac. Sys.	322,000	322,000	Virginian	600,000	6,000,000
N. Y. C. Lines	.....	28,000,000	Wabash	575,000	4,775,000
N. Y. C. & St. L.	500,000	5,500,000	West'n Md.	250,000	1,250,000
New Haven	500,000	500,000			

* (Inclusion of L. & N. if allowed by I. C. C. would reduce recapture liability except for 1926 and 1925.)

This table is from the *Literary Digest,* June 1, 1929.

But it is also properly to be assigned a place in the general valuation war. Mr. Justice Reynolds writes for the court upon the theory that the rate valuation cases were applicable. Though he put the decision accurately under Section 15, he goes on to quote the landmark cases in the thirty years valuation war since *Smyth v. Ames*.[17] Using the dissenting opinion of Mr. Commissioner Hall as "accurately describing the action of the [Interstate Commerce] Commission" he quotes Mr. Hall's statement that "As to this major part of the carrier's property * * * in 1923 no consideration is given to costs and prices then obtaining or to increase therein since 1914."

Mr. Justice McReynolds then concludes:[18] "In the exercise of its proper function, this court has declared the law of the land concerning valuations for rate-making purposes. The commission disregarded the approved rule and has thereby failed to discharge the definite duty imposed by Congress. Unfortunately, proper heed was denied the timely admonition of the minority—'The function of this commission is not to act as an arbiter in economics, but as an agency of Congress, to apply the law of the land to facts developed of record in matters committed by Congress to our jurisdiction.'

"The question on which the Commission divided is this: When seeking to ascertain the value of railroad property for recapture purposes, must it give consideration to current, or reproduction costs? The weight to be accorded thereto is not the matter before us. No doubt there are some, perhaps many, railroads the ultimate value of which should be placed far below the sum necessary for reproduction. But Congress has directed that values shall be fixed upon a consideration of present costs along with all other pertinent facts; and this mandate must be obeyed.

"It was deemed unnecessary by the court below to determine whether the Commission obeyed the statutory direction touching val-

[17] 169 U. S. 466 (1898). He says (279 U. S. 461, 484, 49 S. Ct. 384, 387) "'The elements of value recognized by the law of the land for rate-making purposes' have been pointed out many times by this Court. Smyth v. Ames, 169 U. S. 466, 18 S. Ct. 418, 42 L. Ed. 819; Wilcox v. Consolidated Gas Co., 212 U. S. 19, 29 S. Ct. 192, 53 L. Ed. 382, 48 L. R. A. (N. S.) 1134, 15 Ann. Cas. 1034; Minnesota Rate Case, 230 U. S. 352, 33 S. Ct. 729, 57 L. Ed. 1511, 48 L. R. A. (N. S.) 1151, Ann. Cas. 1916A, 18; Southwestern Bell Telephone Co. v. Public Service Commission, 262 U. S. 276, 43 S. Ct. 544, 67 L. Ed. 981, 31 A. L. R. 807; Bluefield Water Works & Improvement Co. v. Public Service Commission, 262 U. S. 679, 43 S. Ct. 675, 67 L. Ed. 1176; McCardle v. Indianapolis Water Co., 272 U. S. 400, 47 S. Ct. 144, 71 L. Ed. 316. Among them is the present cost of construction or reproduction."

[18] 279 U. S. 461, 487, 49 S. Ct. 384, 387.

uations since the order permitted the O'Fallon to retain an income great enough to negative any suggestion of actual confiscation. With this we cannot agree. Whether the Commission acted as directed by Congress was the fundamental question presented. If it did not, the action taken, being beyond the authority granted, was invalid. The only power to make any recapture order arose from the statute.

"The judgment of the court below must be reversed."

This view that the case is a part of the general valuation chain is clearly manifested in the opinions of the dissenters. Mr. Justice Brandeis renews his insistence upon the nonfluctuating base: "The conviction that there would in time be a fall in the price level was generally held. As a fluctuating rate base would thus directly imperil industry and commerce and investments made at relatively high price levels during and since the World War, would tend to increase the cost of new money required to supply adequate service to the public, and would discourage such investment, the Commission concluded that Congress could not have intended to require it to measure the value or rate base by reproduction cost, since this would produce a result contrary to its declared purpose. And, as confirming its construction of section 15a, the Commission showed that, with the stable rate base which it had accepted as the basis for administering the act, the aim of Congress to establish an adequate national system had been attained. It pointed out that: 'During the period 1920-1926 inclusive, the investment in railroad property increased by 4 billions of dollars. A substantial part of this money was derived from income, but much of it was obtained by the sale of new securities. The market for railroad securities since the passage of the transportation act, 1920, has steadily improved and the general trend of interest rates has been downward. The credit of the railroads in general is now excellent. . . ."[19]

Mr. Justice Stone stated: "I cannot avoid the conclusion that, in substance, the objection, now upheld, to the order of the Commission, is not that it failed to consider or give appropriate weight to evidence of present reproduction cost of appellant's road, but that it attached less weight to present construction costs than to other factors before it affecting adversely the present value of the structural property. . . .

"Without discussion of the evidence and other data which received the consideration of the Commission, the opinion of this court seems to proceed on the broad assumption that the evidence relied on, mere synthetic estimates of costs of reproduction, must

[19] 279 U. S. 461, 503, 49 S. Ct. 384, 394.

so certainly and necessarily outweigh all other considerations affecting values as to require the order of the Commission to be set aside. In effect the Commission is required to give to such index figures an evidential value to which it points out they are not entitled when applied to railroad properties in general or to this one in particular, and this, so far as appears, without investigation of the soundness of the reasons of the Commission for rejecting them. . . .

"As I cannot say *a priori* that increased construction costs may not be more than offset by other elements affecting adversely the present value of appellant's property, and as there was evidence before the Commission to support its findings, I can only conclude that the judgment below should be affirmed."[20] Each concurred in the other's dissent and Mr. Justice Holmes joined with both. On this five to three division the Commerce Commission's order was upset.

Conclusion

Such is the surface exposition of the decision. What are its inward implications? They are two-fold. The first is that there is a lessened threat of recapture of earnings so long as present price levels remain. It has been a bit of an anomaly to say that a private property if profitably operated by its owner results in a trust fund for the public,[21] and in practice the idea has had hard sledding. The *Wall Street Journal* as quoted by the *Literary Digest,* June 1, 1929, shows that the Government has actually collected little and is likely now to collect less.[22]

The valuation for rate-making scheme itself now becomes less attractive for the cultivators of popular political favor. Perhaps we shall not hear so much of it from friends of the "people" as heretofore. Public regulatory authority thus far has constantly sought the theory which gave the lowest figures to the utility. In *Smyth v. Ames* itself, the cost of reproduction, which Wm. J. Bryan

[20] 279 U. S. 461, 550, 49 S. Ct. 384, 410.

[21] Dayton Goose Creek Ry. Co. v. U. S., 263 U. S. 456 (1924) sustained the recapture provisions of the 1920 act. See C. W. Bunn, *The Recapture of Earnings,* etc. (1923) 32 Yale L. J. 213, and notes on the case in (1924) 22 Mich. L. Rev. 579, and (1924) 33 Yale L. J. 669. The holding was: "The statute declares the carrier to be only a trustee for the excess over a fair return received by it. Though in its possession, the excess never becomes its property, and it accepts custody of the product of all the rates with this understanding. It is clear, therefore, that the carrier never has such title to the excess as to render the recapture of it by the government a taking without due process." In the same case Chief Justice Taft's language is "The carrier owning and operating a railroad" etc. That an owner's operation of his own property results in a trust income for another, indicates the labors which attend the judicial rationalizing of legislative fiat.

[22] See note 16 *ante.*

fought for and won for the people, gave the lower figure than that for which the railroads contended. However vague as to what weight must be given to the conflicting theories in reaching the book-keeping total, the decision is positive and imperative that the public cannot arbitrarily select, and impose upon the utility whatever theory will at the moment give the least possible figure. It makes regulation continue to be a task for economic statesmanship rather than mere record keeping arithmetic. It calls for more and more intelligence and quality of personnel in regulation; and it demands coöperative rather than antagonistic public attitudes toward industries which are by hypothesis the necessary foundations of the economics structure of today. Lastly it means that the Supreme Court is unwilling to believe that the time has yet come for it to sanction the formulation of policies by the Commissions. As it reads the signs of the times the public estimation of their place in the present scheme of things is not sufficiently high to let them form the basic theories.[23] Under the decision factual applications of legislative or judicially framed policy remain the field allotted to them.[24]

If the prevailing opinion refuses to set down a valuation theory within a word-package it does no more and no less than Congress itself has done. To the writer it appears the better wisdom not to freeze the matter into a concept and that the cost of meeting changing conditions by a "rate base" as elastic in the public utility business as in other business will be less than that of meeting changing conditions on a rigid base. The capitalizing of earnings as a means of reaching a "value" is a frequent business method. It is acceptable in other than utility investment to current economic thinking. Though much has been written upon the impropriety of reaching rate base valuations by any such process, the courts' denial of the prudent investment theory and its insistence upon the reproduction factor is an indirect assertion that utilities, like other paraphernalia of production may have and should be given a higher earning capacity in periods of inflation. This indirect acceptance of capitalization of earning power makes the utility businesses better competitors for their needed capital, and this is as it should be.

[23] The reference is to the position of Mr. Commissioner Eastman which was substantially that the Commission might handle the situation in the terms of its own ideas as to the general policies involved.

[24] The Federal Senate has lately shown such little appreciation of the self respect of the Commission's personnel as to make tenable the thought that the bold formulation of policy by the Commission would keep the latter in continual hot water. See the writer's *The Hoch-Smith resolution and the future of the Interstate Commerce Commission* (1929) 42 HARV. LAW REV. 610.

Mr. Justice Brandeis makes earning capacity negatively a test of value by arguing that the competitive conditions, which he details, might make impossible sufficient rates to give a proper return on the court's "value." By the majority's theory the question whether the railroads actually have the capacity for earnings commensurate with a "rate base" on other than the investment theory is left a business rather than a legal question. Various commentators assert that the railroads are too mindful of the newer competitive conditions to try rate raising. The decision is a defensive protection to those whose money has gone into the roads rather than a weapon of aggression and to the writer it means that in the utility field post war deflation will continue to be under the evolutionary processes of business adjustment on nation-wide areas rather than under positive and sporadic and perhaps drastic rate reductions brought on by political or demagogic pressure upon the commissions of the country. A decision for the Commerce Commission's figures would have been an invitation to the lynching of utility investments. The consequent investors "strike" would furnish a cry for public ownership which is likely to be the most costly and the most ineffective method by which society gets its wants provided for.[25]

[25] See the writer's *The Public Utility; a problem in social engineering*, (1928) 14 CORNELL L. Q. 1 at 2.

The Commerce Commission after describing its method in the particular case has lately said "Any other plan would immensely complicate and, in fact, might defeat the intent to ascertain values as of current dates in the wholesale manner required by the act. The values now being determined will be revised to later dates when use is made of them for any purpose under the act and in the revision consideration will be given to the costs prevailing at the time. We know of no proceeding in which the instant valuation is important as bearing upon any issue as to which under the act this valuation is admissable as prima facie evidence.

"If, however, the values as of these earlier dates are material in any proceeding under the act, the parties may bring the matter to our attention in order that we may give consideration to the prices applicable as of the respective dates. But with the present basic valuation constituting, virtually, an administrative step in the determination of quantities and other matters of a much greater scope, it is sufficient to indicate our intention to deal with this particular subject at such later dates as we may be called upon to fix values for these properties, when we can give the then costs of reproduction the consideration which may be required by the law of the land." N. Y. Connecting Ry., 157 I. C. C. . . . , decided October 15, 1929, not yet reported. The quotation is from a newspaper statement.

Note: Thus far there has been much writing about the decision. In 5 J. Land and Pub. Util. Economics 329, Mr. E. W. Morehouse discusses it: in 8 HARV. BUS. REV. 1, Mr. W. M. Daniells, a former member of the Commerce Commission, deals with it. See also articles by J. F. Christ in 2 J. Business, Univ. of Chicago, 233; by W. L. Ransom in 44 POL. SC. QT. 321; by W. H. Wherry in (1929) 7 N. Y. U. LAW QT. REV. 39; by N. T. Guernsey (1929) 78 U. of PA. L. REV. 85; by C. B. Elder in (1929) 24 ILL. L. REV. 296.