NEW YORK LAW SCHOOL

NYLS Law Review
Vols. 22-63 (1976-2019)

Volume 1
Issue 1 *NEW YORK LAW FORUM, vol 1, 1955*

Article 34

January 1955

THE IRRELEVANT CONDITION AS AN ILLUSTRATION OF THE ADMINISTRATIVE PROCESS IN ACTION

WILLIAM M. WHERRY

THE IRRELEVANT CONDITION AS AN ILLUSTRATION OF THE ADMINISTRATIVE PROCESS IN ACTION

WILLIAM M. WHERRY

I. INTRODUCTION

ONE of the most fascinating chapters in the field of administrative law is that in which the use of the device of an irrelevant condition nullified and destroyed a constitutional right established by the highest court of the State of New York buttressed by well reasoned opinions in decisions of the United States Supreme Court in numerous cases.

The difference between the administrative process and the judicial process in action has been frequently commented upon, most forcibly by Dean Roscoe Pound and the late Justice Robert H. Jackson, who point out that the administrative process seeks "to promote particular ends" in "disregard of legal principles" and seeks to achieve political rather than just decisions. In short, expediency rather than principle too often dictates the decisions and orders of administrative bodies.

In the illustration which will be discussed in this paper, not only were decisions of the highest courts nullified but the legislature of New York was defied. Repeatedly the Public Service Commission of New York attempted to get the law amended to conform to its views. Just as often were they denied. Nevertheless, they imposed their views upon the public utility companies who came before them for authority to finance or exercise some other power incidental to carrying out their franchise obligations.

II. THE JUDICIAL PROCESS

THE technique of the device is to attach an objectionable condition to a privilege, the advantages of which outweigh the objections and so to conceal the extortionary character of the bargain as to make it acceptable. Of course, this has been a favorite technique in politics, the most familiar example being a rider proposed as an addition to a bill dealing with a subject entirely different from the matter itself, usually an appropriation bill. A recent example of this was found in the riders proposed by Representative Powell of New York

WILLIAM M. WHERRY is a member of the New York Bar.

for a highly laudable purpose. Representative Powell attached by amendment to the bill creating a national military reserve, a rider to accelerate anti-segregation. It is worth quoting what the President said in regard to this:

"I believe that it is erroneous to try to get legislation of this character through by tacking it on to something that is so vital to the security of the United States. I do not believe that the bill creating a reserve is the place for any kind of extraneous legislation. I don't care what it is."[1]

That is a very clear statement of the principle which has been recognized by the courts from the earliest times. This device of politicians is effectively used by administrative bodies, but its use is by no means confined to them. Labor leaders and even parents use it.

Many illustrations could be supplied, but a few examples will suffice to bring out the point as to why such conditions are objectionable. The most familiar example of an irrelevant condition is found in the nursery rhyme where it was not only irrelevant but repugnant.

"Mother may I go out to swim?"
"Oh, yes, my darling daughter
But hang your clothes on a hickory limb
—and don't go near the water."

Obviously if the child is to take advantage of the permission she can not comply with the prohibition. She will either have to forego her swim or ignore the condition. This may seem a frivolous illustration but over and over again we find in the cases a similar dilemma presented.

Sometimes the device is used in contracts, and the courts themselves do some legislating by refusing to enforce them. A good example of this is found in a recent decision of the Supreme Court of the United States in connection with salvage operations. A usual provision in contracts covering such operations is a clause which releases the company furnishing tug boats from all liability for damages due to accidents. These clauses have given rise to much litigation especially where accidents are caused by gross negligence or deliberate design. In *Bisso* v. *Inland Waterways Corporation*,[2] and in *Boston Metals Co.* v. *The Winding Gulf*,[3] such conditions were held to

1 Editorial Page, N. Y. Times, June 10, 1955.
2 349 U. S. 85, 75 S. Ct. 629, 99 L. Ed. 523 (1955).
3 349 U. S. 122, 75 S. Ct. 649, 99 L. Ed. 543 (1955).

be void because they were against public policy. Of course, the conditions were relevant to the object of the contract, but it was shocking to the judges that anyone could escape liability for a tortious act by contract. Therefore, the court held the condition void. The courts have dealt with objectionable conditions and nullified them, not only when they were irrelevant but when they were unjust, extortionate, against public policy or unconstitutional.

An ancient conception of equity and justice was also involved in the salvage cases. From early days, extortionate charges were resisted and legislated against because of the inequality in the bargaining position of the parties. The traveler arriving late, on a stormy night, at the only inn, was in no position to bargain with the landlord. He was even worse off than the "Chieftain to the Highlands Bound", for his pence was more precious to him than the latter's pound. In later years laborers, consumers, shippers in non-competitive markets invoked the same principle, sometimes without justification but always with emotional eloquence.

In dealing with these conditions, the courts have been guided by their conception of what justice required. The principles thus developed and the method of developing them is illustrated in two important cases in the Supreme Court of the United States, which are examples of many other similar cases. That principle has also been beautifully expounded in several cases in the Court of Appeals of New York.

In *United States* v. *Chicago, Milwaukee & St. Paul Railroad,*[4] the Interstate Commerce Commission issued a certificate of convenience and necessity authorizing issuance of securities by a railroad company with the proviso that the applicant should impound in a separate fund money which was not to be paid out unless authorized by order of the court or the Interstate Commerce Commission. Suit was brought to have this proviso declared void and to enjoin its enforcement. The decision of the Supreme Court held the condition beyond the statutory and constitutional power of the Commission to impose. Judge Sutherland wrote the opinion. He said in part:

. . . "A condition contained in the order by which the grant is limited is as much a part of the order as any of its substantive provisions, and, if beyond the jurisdiction of the commission, is not ratified by an acceptance of the valid part of the order. It long has been settled

[4] 282 U. S. 311, 51 S. Ct. 159, 75 L. Ed. 359 (1930).

in this court that the rejection of an unconstitutional condition imposed by a state upon the grant of a privilege, even though the state possesses the unqualified power to withhold the grant altogether, does not annul the grant. The grantee may ignore or enjoin the enforcement of the condition without thereby losing the grant. . . . The order in itself, being complete and self-sustaining and resting upon grounds found to be sufficient to support it, cannot be made to depend upon submission to a collateral condition, which, as we have shown, is beyond the statutory constitutional power of the commission to impose. Whatever may be the general rule, we have no difficulty in concluding that, under the circumstances above recited, the principle in respect of the separability of unconstitutional conditions imposed upon a privilege granted by a state is applicable to the present order of the commission—and for a stronger reason, since that body, unlike a state in the class of cases referred to, does not possess the power arbitrarily to deny the authority here sought by the carrier."[5]

The other case to which I wish to call attention is an earlier decision where the opinion was written by Justice Brandeis. In *Buck* v. *Kuyckendall,*[6] a proviso was attached to a certificate of public convenience and necessity issued by an administrative bureau. The condition was condemned as being inconsistent with the granting of the certificate and of "such a character as to defeat the purpose of Congress", as expressed in the legislation providing for Federal aid to states for the construction of interstate highways. Justice Brandeis stated: "The vice of the legislation is dramatically exposed by the fact that the State of Oregon issued this certificate which is equivalent to a legislative declaration that despite existing facilities public convenience and necessity require the establishment by Buck of the auto stage line between Seattle and Portland." From this it followed that the provision had the effect "not merely to burden" interstate commerce "but to obstruct it."[7]

From the above illustrations, the technique is clear and also the attitude of courts towards conditions which are objectionable and unenforceable.

There are other elements essential to the technique.

The first deals with the relevancy of the condition and the high motives of those imposing it. It is often difficult to determine the *relevancy* of the condition or the fact whether it will or will not hinder the carrying out of the main purpose of the legislation or the

[5] *Id.* at 328, 331, 51 S. Ct. at 176, 179, 75 L. Ed. at 376, 379.
[6] 267 U. S. 307, 45 S. Ct. 324, 69 L. Ed. 623 (1925).
[7] *Id.* at 316, 45 S. Ct. at 333, 69 L. Ed. at 632.

order to which it is attached. Sometimes what seems irrelevant at one time may appear quite relevant at another time. Besides, very often, the high purpose of those who propose the condition conceals its irrelevancy. A good illustration is found in the speeches which preceded our Civil War. Although the abolition of slavery was dear to the heart of Lincoln and recognized as an essential step in the progress towards freedom which was initiated by the American revolution; nevertheless, in debates and addresses to Congress, Lincoln recognized that the achievement of this freedom must be subordinated to the main purpose of preserving the Union. If the Union was dissolved the progress toward freedom would certainly have been obstructed and delayed, and perhaps, fatally so. It was only late in the War that he felt that he could demonstrate that the abolition of slavery was essential to the preservation of the Union.

A parallel case is presented by the War of 1812, and here we find the most essential ingredient for resistance to the device—viz. a resolute fighting spirit and refusal to appease. That War was urged by the War Hawks, whose main purpose was to secure peace on the border to stop Indian raids and the action of the British in inciting those raids. For this purpose they were willing to go to war. It was not until Henry Clay came East that he found that even more essential to the growth of the republic was freedom of trade and that the action of the British in impressing our seamen and in obstructing sea trade, constituted a greater threat to the new republic and its freedom than even the Indian raids. In his great speech on June 7, 1812, Clay, who never before had advocated resistance to these acts, made a stirring speech which practically laid the foundation for the declaration of war, because it enlisted the East in the cause which the West was already engaged in. In that speech, Henry Clay eloquently urged the defense of our rights at sea and asserted "that the career of encroachment is never arrested by submission", and therefore the only alternative, to the increasing curtailing of our liberties by the British, was war.

Primarily, he wanted to check the flow of arms and liquor to the Indians but he was willing to assert our rights at sea so long as in the end that would mean safety on the frontier. What seemed irrelevant when he left for the East was found to be essential to his main objective when he made the speech of June 7, 1812.[8]

[8] TUCKER, POLTROONS AND PATRIOTS 55 (1954).

There are, of course, many conditions attached to grants of privilege or other legislation which are relevant and which meet the test of forwarding the main objective. Nevertheless, there are too many conditions which are obviously "vicious" to use Justice Brandeis' word. The vice inherent in them is the illusory nature of the alternative they present. The freedom of contract or choice is quite illusory in most cases. For that reason, these riders to appropriations and other bills have been defined as little short of extortion or blackmail. Certainly, in many instances the device is first cousin to the method of the highway man. Yet, as is shown by the action of Representative Powell and of Henry Clay, the motives of those using this method may be of the highest character and their sincerity unimpeachable.

Unless we keep this in mind, it will be difficult to understand why the Public Service Commission of New York was so successful in defeating the decisions of the highest court of the State in the cases which we are now about to review.

In the speech of Henry Clay above quoted from, we find a warning against the essential ingredient in the technique of forcing acceptance of a repugnant or irrelevant condition. Clay denounced *appeasement,* which always results in the increase of regulation, regimentation and the loss of liberty. It is this failure to resist which has resulted in the acceptance of the illegal conditions and in the nullification of constitutional rights established by the high courts, both state and Federal.

In those days, "appeasement" was not popular and duels were fought by Kentuckians and others at the drop of a hat.

Those are the elements in the technique of using the device of the irrelevant condition that present the most difficult aspects of our study.

Undoubtedly, members of administrative boards sincerely felt that they were fighting the Good Fight, and, therefore, did so with dogged persistence, great ingenuity and fanatical zeal—not only to "promote the particular end", they were established to achieve, but also to compel adoption of a mechanical formula which was only one of the means to that end.

More difficult to understand is why the managers of the utility companies, their boards of directors and their stockholders were willing to appease rather than to fight. They felt compelled to accept the alternative forced upon them when they applied to the Commis-

sion for authority to take steps which they considered essential to the rendering of the service for which their companies were chartered.

III. THE ADMINISTRATIVE PROCESS

IN New York the courts had many occasions in which they had to deal with objectionable conditions similar to those involved in the Federal cases above referred to. However, it was not until administrative boards were established to regulate railroads and public utilities that the contrast between the judicial approach and the administrative approach commented upon by Dean Pound and Justice Jackson became most apparent with consequences which both of those observers, among others, have deplored.

These new modern tribunals, equipped with staffs of legal, accounting and secretarial assistants, empowered to make rules of procedure, evidence and social conduct in specialized fields, were designed to perform legislative, judicial and administrative functions in "adjusting relations and conduct of individuals to meet social needs," and were naturally apt to consider themselves superior to other law makers. They were certainly better equipped to do so within definite limitations than most legislatures and courts.

They were not trained to seek justice but to reconcile and correct social maladjustments.

These cases were part of the struggle of the managers of utilities against the efforts of the public utility commissioners to force lower rates for the benefit of domestic customers at the expense of investors, especially the holders of equity securities.

The New York legislature in statutes defining the powers and duties of the State railroad commission attempted by statutory provision to limit and define the kind of conditions which that administrative board could attach to approvals it might be called upon to give in regard to issuance of securities, transfer of franchises and the exercise of similar powers. The Public Service law regulating public utilities was enacted in 1907 and contained provisions taken from these earlier laws. Section 69 dealt with the issuance of securities; Section 70 with the transfer of franchises. In both of these sections, the legislature defined the findings which the Commission would have to make in order to give its approval and provided that if it made these findings then it must *ipso facto* give its approval. In other words, the attempt was made by the legislature to limit the power

of the Commission to attach conditions. Section 69 related to electric and gas companies; Section 55, to the issuance of railroad securities. They were similar in their character.

At the time of the passage of the Public Utility law in 1907, Frank W. Stevens, the first chairman of the Public Service Commission of New York, appointed by the Governor, opposed this limitation on the power of the Commission and stated that the "Commission believes that such a limitation will effectually destroy its usefulness in regulating capitalization". In spite of his opposition, the legislation was enacted.

In 1911, the first case directly concerning the invalidity of an irrelevant condition under this section came before the Court of Appeals. In *Delaware & Hudson Company* v. *Stevens*,[9] Judge Haight, writing for the Court of Appeals, disapproved of an effort on the part of Mr. Stevens to evade the statute. In that case, Mr. Stevens actually submitted a statement in addition to the brief of counsel, in which he repeated the argument he made when the legislation was pending. This case was commented on in the opinion in the later case of *Binghamton Light, Heat & Power Company* v. *Stevens*,[10] which arose in 1911. The opinion was written by Judge Chase. The Binghamton Light, Heat & Power Company applied to the Commission for leave to issue bonds for certain purposes and a hearing was held under Section 69. The Commission made its approval of the issuance of the securities conditioned on the company's reducing its capital stock and adjusting its book accounts by writing off part of the book value of the plant, real estate, franchise and other rights. This condition was held by the court to be utterly void and of no effect. The court quoted with approval, the opinion below in the Appellate Division written by Justice Kellogg,[11] where the Justice said: "It is beyond the power of the Commission to permit the issue of improper securities on the condition that the company cancel stock of about half the amount. Read together, the two orders permit the company to issue unauthorized securities to attempt to lessen the harm to the public which may result therefrom". Both the Appellate Division and the Court of Appeals held the Commission had no power to thus barter away the public interest or, on its own terms, to permit the issue of securities which the law prohibits.

[9] 197 N. Y. 1, 90 N. E. 60 (1909).
[10] 203 N. Y. 7, 90 N. E. 114 (1911).
[11] 143 App. Div. 789, 801, 128 N. Y. Supp. 440, 452 (3d Dept. 1911).

In the *Iroquois Gas Company* case,[12] decided in 1934, Judge Lehman wrote the opinion dealing with the power of the Commission to attach conditions to an order concerning transfer of franchises and plant under Section 70 of the Public Service law. He held there was no power to annex conditions to its approval and that the power granted by Subdivision 4 of Section 66, to prescribe uniform methods of keeping accounts and records did not include the power to attach such a condition under Section 70, to compel a corporation to write off from its book values, a loss which it had not sustained. The court disapproved of the contention that the power to grant consent included the power to withhold it and therefore that the Commission might impose conditions in granting such consent.

Judge Lehman said: "The Public Service Commission by its consent to a transfer confers no franchise or authority to operate a public utility. That is derived from the state and the contract of purchase. The functions of the Commission, in this respect, are purely regulatory. Its orders are subject to review by the court. It may withhold its consent to a transfer of a franchise granted by the state, unless such transfer is shown to be in the public interest. It may insist upon the insertion in the contract of terms and conditions which will reasonably protect the public interest, before it grants consent. It may exercise powers of regulation or direction elsewhere given in order to assure proper operation of the franchise after the transfer is approved. The most that can be urged is that it may impose conditions which will insure efficient operation in the public interest in those matters which fall within the general field of its power. It cannot make its consent dependent upon conditions which are unreasonable or which do not change the terms of the transfer of the franchise, works or systems, or which encroach upon the right of the relator to administer its corporate affairs according to its own judgment in matters in which the legislature has not given the Public Service Commission any regulatory or supervisory powers."

In *People ex rel. Dry Dock, East Broadway & Battery RR.* v. *Public Service Commission,*[13] the Court emphatically held that the Commission could not, in considering an application for authority to issue securities for refunding purposes, use as a standard for its approval "the actual value of the company's property and its earning ca-

[12] 264 N. Y. 17, 189 N. E. 764 (1934).
[13] 167 App. Div. 286, 153 N. Y. Supp. 344 (1st Dept. 1915).

pacity" and could not compel it to reduce its book cost accordingly.

In confirming the action of the Commission in the *Dry Dock* case, the Court of Appeals said:

"While, therefore, the Commission was wrong in applying the test of the actual value of the company's property and its earning capacity as a criterion for its approval of the issue of these new securities, it was right in refusing to approve their issue until the relators had proven that the securities sought to be refunded represented actual investments for the company's capital account. . . ."[14]

Other cases where the courts held that the Commission has no power to compel a company to write off book entries which would alter the actual cost of its property are Matter of *Lockport Light Heat and Power* v. *Maltbie*[15] and *People ex rel. Kings County Lighting Co.* v. *Straus*.[16]

During the period when these cases were being decided by the courts, the court itself called attention to the fact that the amendment of the law was not a judicial function but appeal must be made to the legislature. For instance, in *Matter of Staten Island Edison Corp.* v. *Public Service Commission*,[17] the Court said:

". . . The cases which have been cited need not be reviewed. We consider them in *harmony* with the ruling which is here made, while the statement of the purposes for the Public Service law and the Commission is here applied and followed. (*People ex rel. D. & H. Co.* v. *Stevens*, 197 N. Y. 1; *People ex rel. Binghamton L., H. & P. Co.* v. *Stevens*, 203 N. Y. 7; *People ex rel. New York Edison Co.* v. *Willcox*, 207 N. Y. 86; *People* v. *N. Y. C. & H. R. RR. Co.*, 138 App. Div. 601; *aff'd*, 199 N. Y. 539; *People ex rel. Dry Dock, etc., R.R. Co.* v. *Publ. Serv. Comm.*, 167 App. Div. 286)".

The Public Service Commission, during this whole period, attempted to obtain legislation designed to confer upon the Commission the power which it had attempted to exercise by conditions attached to its orders. Notable attempts were made in 1918, 1930, 1931, 1937. All of these measures failed of enactment.[18]

[14] *Id.* at 308, 309, 153 N. Y. Supp. at 357.

[15] 257 App. Div. 11, 12 N. Y. S. 2d 595 (3d Dept. 1939).

[16] 178 App. Div. 840, 166 N. Y. Supp. 196 (1st Dept. 1917).

[17] 263 N. Y. 209, 218, 188 N. E. 713, 716 (1933).

[18] Recommendation in Public Service Commission Ann. Rep. (2d Dist. 1918), in 9 N. Y. Legislative Documents XII (1919); SEN. INT. 1435, Pr. 1665, 2036; ASS. INT. 1811, Pr. 2065, 153rd Sess., N. Y. Legislature (1930); SEN. INT. 655, Pr. 685, 1355,

Legislation designed to confer upon the Commission, the power it attempted to exercise by the conditions attached to its orders, was also introduced in 1937[19] and failed of passage just as had earlier bills to the same effect.

In 1938, legislation looking toward the conferring upon the Commission of such authority was introduced[20] and again did not pass.

In 1939 the Commission recommended that

"*. . . the Commission should be empowered to require the companies to maintain reserves in order that depreciation shall be currently shown on their books as well as original cost,* and a bill giving the Commission adequate power in this direction should be enacted."[21]

In each of these years and through 1949, with the exception of 1942 and 1945, bills were introduced in the Legislature to confer such power upon the Commission and *each time they were rejected.*[22]

IV. THE ROCHESTER CASE: THE FIGHT AGAINST THE UNIFORM ACCOUNTING ORDER AND THE THEORY OF "ABORIGINAL" COST

WE now come to the most striking example of the use of the irrelevant condition and the defiance by the Public Service Commission of the Legislature and of decisions of the courts, and the principles laid down in judicial decisions. This was the famous litigation involving two separate cases: *Rochester Gas & Electric Corporation* v. *Maltbie.*[23]

154th Sess., N. Y. Legislature (1931); SEN. INT. 639, Pr. 683; Ass. INT. 1011, Pr. 1063, 160th Sess., N. Y. Legislature (1937).

[19] SEN. INT. 639, Pr. 683; Ass. INT. 1011, Pr. 1063, 160th Sess., N. Y. Legislature (1937).

[20] SEN. INT. 15, Pr. 15, 1436; Ass. INT. 15, Pr. 15, 161st Sess., N. Y. Legislature (1938).

[21] Public Service Commission, Ann. Rep. (1939), in 14 N. Y. Legislative Documents 42 (1940).

[22] SEN. INT. 275, Pr. 280; Ass. INT. 427, Pr. 436, 162nd Sess., N. Y. Legislature (1939); SEN. INT. 1150, Pr. 1332; Ass. INT. 1484, Pr. 1588, 163rd Sess., N. Y. Legislature (1940); Ass. INT. 271, Pr. 271, 164th Sess., N. Y. Legislature (1941); SEN. INT. 36, Pr. 36; Ass. INT. 76, Pr. 76, 166th Sess., N. Y. Legislature (1943); Ass. INT. 970, Pr. 1036, 167th Sess., N. Y. Legislature (1944); SEN. INT. 357, Pr. 357; Ass. INT. 409, Pr. 409, 169th Sess., N. Y. Legislature (1946); SEN. INT. 1566, Pr. 1713; Ass. INT. 1763, Pr. 1868, 170th Sess., N. Y. Legislature (1947); SEN. INT. 305, Pr. 305, 171st Sess., N. Y. Legislature (1948); SEN. INT. 366, Pr. 1055; SEN. INT. 1207, Pr. 1262; Ass. INT. 1412, Pr. 1450, 172nd Sess., N. Y. Legislature (1949).

[23] 273 App. Div. 114, 76 N. Y. S. 2d 671 (3d Dept. 1948), *aff'd* 298 N. Y. 867, 84 N. E. 2d 635 (1949), Financing Case; 273 App. Div. 202, 63 N. Y. S. 2d 771 (3rd

This case was a direct outcome of an attempt by the Board of Public Utility Commissioners to substitute an accounting method of rate regulation for the methods theretofore used and to substitute a new and entirely different theory for those which had been recognized by the courts and the commissions as applicable in such rate making up to that time.

At the time when *Smyth* v. *Ames*,[24] was decided by the Supreme Court of the United States there had been two main attempts to devise a formula for rate making. One recognized, that the company which had had to raise money and provide facilities on a rising market to meet the needs and demands of the service, owed a duty to its stockholders and investors who provided the capital to see that they got a fair return on that capital. If the company was to maintain its service and keep up with the growth of demand, it would have to make investments in a market of rising costs, even though the revenue derived from the service would not provide sufficient return to meet the expectations of those who put the venture capital into the enterprise.

The prudent investment theory was a recognition that the investor was not only justly entitled to a fair return, but the customer who expected the service would, in the long run, be benefited if the company could command capital to finance improvements. An essential of such ability to finance was the recognition of the justice of a fair return to the investor for the risk he took when he made his investment.

On the other hand, the fair value theory of rate making recognized that the state could always obtain the title to the property by condemnation and payment of its fair value. Therefore, the amount which could be earned as a return on that sum (i.e., the payment of its fair value) would be a measure of a fair return on the capital risked in the enterprise.

These two theories were opposed to each other at times of extreme fluctuations in the level of prices. When *Smyth* v. *Ames*[25] was decided, the level of prices was down and the railroad's rails could have been replaced for less than they originally cost. Therefore,

Dept. 1946), *app. den.*, 271 App. Div. 760, 64 N. Y. S. 2d 920 (3d Dept. 1946) Water Rights Case.

[24] 169 U. S. 466, 18 S. Ct. 418, 42 L. Ed. 819 (1898), *modified*, 171 U. S. 361, 18 S. Ct. 888, 43 L. Ed. 197 (1898).

[25] See note 24 *supra*.

William Jennings Bryan and his associate counsel argued that the railroads would only be entitled to earn what would be a moderate return on the *cost to reproduce* their properties. At the time of the inflation and great rise in the level of all costs in the first World War, those who contended for lower rates were shouting for original cost, diminished, nevertheless, by the deduction of any investment which by hindsight proved to be unproductive over-building.

These were two well understood and recognized theories of rate making. In the 1930's, a new and novel theory was devised and forced upon the companies by Federal regulating authorities and by State public utility commissions, especially in the inflationary period of World War II.

This was the outcome of the perennial struggle of regulatory commissions to devise a mechanical formula by which adjustments in rates could be automatically made, either by increases or decreases without destroying inducements to the investor sufficient to enable the utilities companies to raise the capital necessary to keep up with the demands of the consumers. All such formulas had failed because no mechanical formula successfully anticipated changes in conditions nor measured the demands on the service.

In many cases, the formula used did not measure *the value of the service* to the public realistically. Neither the prudent investment nor fair value method, took into account competitive services nor changes in the value of the dollar as a medium of exchange. Neither made any provision for the effects of competition either with the service or in the financial market. Both were based on the assumption that public utilities were monopolies immune from competition.

A condition that the company must maintain its service regardless of the loss, would be the type of irrational or irrelevant condition that the courts would not enforce under ordinary conditions as a matter of common justice.

Neither would the courts be favorable to the argument that, although the title to one's property could not be taken for public use without just compensation for its fair value, nevertheless, its use could be so taken.

Some other justification for such an injustice must be found.

To meet this obstacle, an ancient fiction was resorted to. If property was "dedicated to a public use", it could easily be assumed that the owner was consenting to any limitation the public might put

upon his own use. He was said to have contracted away his constitutional right to compensation on its fair value then or in the future.

This fiction could be made more appealing by coupling it with the obvious fact that actual books well kept would give a true statement of costs, less speculative than an estimate (disregarding, of course, loose bookkeeping methods and changes in the medium of exchange at different periods when dollars succeeded tobacco, or gold coin of definite standard supplanted other currencies).

The new formula devised by public utility and railroad commissioners, through their organizations, was doubtless a further effort to meet the desirable end of prompt adjustment of changes in rates to changed costs by freezing one element, viz. the rate base on which net return could be calculated. Undoubtedly many believed book values were inflated and that lower rates to domestic consumers were desirable from the public point of view. Certainly lower rates to the domestic consumer would conform to the principles of democratic price fixing and help to develop a mass market. At the same time, we must not forget the fact that public utility commissioners are human and that lower domestic rates appeal to the part of the public that has the most votes.

There seemed to be a theory that stockholders were villains who ought to be punished, ignoring the fact that if promoters, banks, investment bankers and bond and stock-salesmen had over-reached some trusting innocents, as well as some gullible speculators, they had disposed of their stocks which had long since passed into the hands of investors and innocent purchasers for value.

In any event, a new formula to measure the rate base on which the company was entitled to earn a fair return was devised as a substitute for the cost of reproduction and the prudent investment formulae. Thus capitalization could be revised, net earnings could be reduced and *rates also*. By an accounting order, it was then sought to compel the existing utility to substitute for its own costs, the cost incurred by some predecessor at the time when the property was first devoted to public use, and to write off all excesses into suspense accounts to be amortized under direction of the commissions and under their orders, from time to time. This was the theory of *aboriginal* cost, so called because some well supplies were still being used which had been acquired by the pioneers from the *aborigines*.

The prudent investment theory was speculative because the ac-

tual costs of a company could be reduced by the hindsight of the regulatory body which would substitute its idea of what was a prudent expenditure for that of the directors responsible for incurring the costs at the time they actually were incurred. All excess over what these regulatory bodies thought prudent, could be disallowed as capital investment and no earnings on them permitted. Even more speculative in many cases was the value obtained by estimating the reproduction cost of the existing plant. In case after case engineering valuations contained absurdities. Instead of using modern ditching machines, the estimator assumed that all ditches would be dug by hand. Instead of modern casting processes they assumed that obsolete methods used when the pipes were laid would still be used. This theory was vehemently and cogently assailed as too speculative by those who were interested in getting rates reduced.

On the other hand, the "vice of the aboriginal cost theory" was that it ignored the actual costs incurred by the companies then being regulated and substituted for them the costs incurred so long ago that no accurate determination could be made of what actually was incurred. How could a water company determine the cost of well supplies bought from the Indians for powder, shot and rum? How could that medium of exchange be translated into current dollars?

Consider the plight of a family who owned an extensive acreage surrounding a woodland lake, which they used as a water supply for themselves, relatives, friends and neighbors. They built a longer main than was necessary for the riparian cottages, installed a pump and extended the service to the families of their coachmen, butlers and other retainers. When the jurisdiction of the New York Public Service Commission was extended to cover water companies, they were horrified to find that they were considered a public utility, bound to serve all comers at rates based on the cost of the property at the time it was first "devoted to public use!"

These costs were difficult to determine, since the bookkeeping had been sketchy, most of them had been treated as operating expenses, some had been shared among some of those served, some had not—all had been far lower than those current for pumps, pipe, labor.

Fortunately, a court moved by a sense of justice disregarded certain precedents to the contrary and held that the enterprise was not a public utility (case unreported). It was then sold to a corporation

which expanded the service and fixed its rates to cover its own costs and profit. What it and its customers consider the fair value of the services has not so far been challenged and the questions of: When the "devotion to public service" occurred; what is the aboriginal cost; how donated property should be treated; discrimination avoided by eliminating free service to those who sold rights of way and other easements for special considerations; and many other difficult problems have been ignored and left undetermined by the regulatory body.

Aboriginal cost is often just as speculative and unjust as a rate base obtained through other formulas.

When the accounting order seeking to impose this new aboriginal cost theory of ascertaining a rate base was issued by the New York Public Service Commission, the validity of the order was attacked in the courts of New York. It was held invalid and unconstitutional by the Appellate Division and the case was carried to the Court of Appeals for final decision and affirmed. The Appellate Division held the order was beyond the power of the Commission to make and unconstitutional because it deprived the companies of their property arbitrarily. *Matter of New York Edison Co.* v. *Maltbie,*[26] sometimes referred to as the "Uniform Accounts Case."

In that instance, the Commission attempted to set up in a "suspense account" the difference between the cost of property to the Company and its "Original Cost" (i.e., the cost of such property to the person first devoting it to the public service), and provided that such difference should "be written off over such period and in such manner as the Commission may by order prescribe".[27]

Also the Commission sought to impose generally on all companies theories of "straight-line" depreciation.

The Appellate Division and the Court of Appeals held each and every one of these requirements invalid and unconstitutional.

In striking down these requirements, Presiding Justice Hill of the Appellate Division said:[28]

"The power vested in the Commission to prescribe uniform methods of keeping accounts and records (Pub. Serv. Law, Sec. 66, subd. 4) does not include the power to compel a corporation to write off from its book value a loss which it has not sustained, or to give up a part

[26] 244 App. Div. 685, 281 N. Y. Supp. 223 (3d Dept. 1935), *aff'd* 271 N. Y. 103, 2 N. E. 2d 277 (1936).

[27] *Id.* at 688, 281 N. Y. Supp. 223, 226.

[28] See note 26 *supra* at 688, 281 N. Y. Supp. at 226.

of its constitutional rights. If as has been said 'the actual cost of the property—the investment the owners have made—is a relevant fact' (*Los Angeles Gas & Electric Corp.* v. *Railroad Comm.*, 289 U. S. 287, 306) a corporation cannot be compelled to make entries upon its books calculated to conceal such relevant fact. It follows that the Commission had no power to impose such condition. (*People ex rel. Iroquois Gas Corp.* v. *Public Service Commission*, 264 N. Y. 17, 21). The foregoing was written concerning a condition which the commission sought to impose as to the purchase of the property of one utility corporation by another. If it lacks power as to one transaction it also lacks power to enforce by a general rule such a condition as to all similar transactions."

In spite of the decision in the Uniform System of Accounts case and the many preceding cases disapproving and nullifying irrelevant and objectionable conditions on constitutional grounds, the Public Service Commission used the device to compel the companies to adopt the system and establish this new method of rate making.

Whenever any company came before the Commission for approval of a security issue or a consolidation or some other project which took on more of the character of a privilege than a right, the Commission in approving the application, would attach a condition that the company should accept the *aboriginal* cost accounting theory and rewrite its books in accordance therewith.

The management in each case was confronted with the same serious dilemma, as the daughter who asked her mother for leave to go in swimming, and was told she could do so if she did not go near the water.

They had three alternatives. They either had to (1) abandon the proposed financing; (2) write off on their books a large portion of their capital investment; or (3) fight the invalid condition in the courts at great expense and delay. The first and second alternatives might be fatal because during the delay, favorable financing markets would be lost and the confidence of the investors in the safety of their investments shaken. On the other hand, to accept the condition would result in definite loss to the existing security holders of the Company by destroying the value of the equities underlying their securities.

Many companies yielded to the pressure and accepted the conditions imposed upon them by the Commission.

The Rochester Gas & Electric Corporation adopted the third

alternative and litigated the right of the Commission to attach such conditions to its order.

Its controversy with the Public Utility Commission came before the courts a number of different times. Sometimes only technical matters of procedure were involved, but in two cases the Court of Appeals passed upon the merits of issues involving principles of constitutional law and of equity and justice. These two were the "Water Rights" case and the "Financing" case.

In the former case, the Commission in 1943 ordered the company to write off $3,832,171 which it had paid for water rights. The Appellate Division annulled the Commission's order and denied leave to appeal.[29]

About the same time the company applied to the Commission for leave to issue bonds to fund bank loans and to pay for improvements to its plant, which it deemed essential to its service. This was the "Financing" case.[30]

The Commission approved of the financing by the bond issue but only on condition that the company should adopt the devices disapproved in the "Uniform Accounts" case, *People ex rel. New York Edison Company* v. *Maltbie*.[31]

By these devices, the Company would have been compelled to reduce its book costs by the difference between actual cost and "aboriginal" cost, viz., $6,900,000 (including $3,832,171 paid for water rights); and also to adopt the "straight line" method of depreciation.

Both the Appellate Division and the Court of Appeals held these conditions void and of no effect.

The astonishing thing is that, despite this victory, the procedure used by the Public Utility Commission was effective with other companies. At the time when its orders were being made, the press was full of criticisms of the Commission. The cases were discussed not only in the financial columns of the New York daily papers but in such technical journals as Telephony, Barron's National Business and Financial Weekly, and the Public Utilities Fortnightly.

[29] Matter of Rochester Gas & Electric Corp. v. Maltbie, 271 App. Div. 202, 63 N. Y. S. 2d 771 (3d Dept. 1946), *app. denied,* 271 App. Div. 760 64 N. Y. S. 2d 920 (3d Dept. 1946).

[30] Matter of Rochester Gas & Electric Corp. v. Maltbie, 273 App. Div. 114, 76 N. Y. S. 2d 671 (3d Dept. 1948), *aff'd* 298 N. Y. 867, 84 N. E. 2d 635 (1949).

[31] See note 26 *supra.*

Finally, Benjamin in his monumental report to the Governor of New York on Administrative Adjudication in New York,[32] discusses the reasons why companies in case after case had bowed to the demands of the Commission in security cases because they were forced to by the need of funds and the necessity of "meeting a market."

Public Utilities Fortnightly said with reference to the attitude taken by the New York Public Service Commission in finance cases:

"The issue (over the compulsory increase of the depreciation reserve (which has the same effect as a write-off) and the making of arbitrary write-offs of certain kinds of property) has arisen principally in the State of New York where the public service commission (though not 'led' by the F. P. C.) has been following a particularly strong policy. The commission has long wrangled with leading utilities in the state (Consolidated Edison Company, Niagara Hudson Power Corporation, New York State Electric & Gas Corporation, and others) over valuation and accounting questions. It has followed . . . policy of withholding or delaying approval of mergers, refinancing, etc., until concessions could be wrung from utilities with regard to plant accounting adjustments.

. . .

"A more immediate issue has been the Rochester Gas & Electric Corporation request for approval of a financing program both for refunding and new money purposes. *As the price of approval* the Commission proposed (among other adjustments) that $6,658,171 'questioned' items be written out of earned surplus and that some $10,700,000 should be added to depreciation reserve. . . . The most important issue arises over the questions of writing out of plant account an item of $3,832,171 for water rights. The Commission in 1943 (Case 9552) had ordered this write-off but the Appellate Division (a state court) a year ago annulled the commission's order and denied permission to appeal to the Court of Appeals."[33]

(Here the writer quoted from the opinion in the above referred to case involving the cost of water rights recorded on its books, and continued:)

"The company therefore, feels that this amount can properly remain on the books.

. . .

"The point to be emphasized in connection with the water rights case is that it goes beyond the theory of original cost and even of prudent

[32] Benjamin, *Administrative Adjudication in the State of New York,* 2 Supplementary Reports on the Dept. of Public Service, 104, 105 (1942).

[33] PUBLIC UTILITIES FORTNIGHTLY, July 17, 1947, 109, 110.

investment. *The item in question was fully paid for by a utility* company and has not been proved to be a bad investment."[34] (Italics supplied.)

The New York Times, commenting on the concern of the utility industry in this State over financing problems, stated:

"Public utility security analysts have been finding it difficult to interest some large investment trusts in the securities of New York utilities because, it was said, of the 'vindictive' attitude on the part of the State commission.[35] Such alleged punitive action by the P. S. C. it was asserted, was detrimental to the earning power of State utilities."

In referring to the rejection by the Commission of a plan of recapitalization and sale of Staten Island Edison Corporation, the writer remarked:

". . . it (the Commission) stated its objection to the 'general attitude of GPU and the corporations represented by counsel'. It also expressed resentment at resorts to the courts by GPU. Rochester Gas & Electric and Staten Island Edison for relief from commission rulings considered onerous or illegal."
"Rochester Gas had challenged the right of the Commission to make approval of a perfectly legal and orthodox financing operation contingent upon accepting an accounting method which the Commission otherwise had no power to impose. It went to the courts and was upheld, and apparently the judicial rebuff to the Commission rankled."[36]

Telephony in July 31, 1948, said in connection with the decision of the Appellate Division appeal in the Rochester Gas and Electric Case:

"But it was a costly victory for the company. Market conditions have so changed that it now stands to lose millions of dollars in price advantage for its securities, as compared with what it would have received had the original petition for commission approval been promptly granted as it should have been. That is a pretty expensive brand of regulation. The commission is taught a lesson but the utility company has to pay for it."[37]

In its brief before the Court of Appeals the counsel for the Rochester Company discussed the disadvantages the company had

[34] *Id.* at 110.
[35] Editorial Page, N. Y. Times, May 9, 1948.
[36] See note 35 *supra.*
[37] TELEPHONY, July 31, 1948, at 24.

suffered during the lengthy litigation over the illegal order of the Public Utility Commission. Among other things they stated:

". . . bankers advanced the Company, while the case was pending, on short-term unsecured obligations, more than $12,500,000, at favorable interest rates. And the preferred stockholders of the Company expressly consented to the Company's exceeding its short-term borrowing capacity as established in its charter. In addition, the Securities and Exchange Commission authorized the extension of the Company's short-term borrowing capacity to permit such borrowing."[38]

Unless the corporation had been well established and possessed of great resources and unusual credit, it could never have afforded to make the fight even if it could have met the legal expenses.

Even after the decision of the Court of Appeals the Public Service Commission in its order entered in 1949 attempted to evade the decision of the Court and special proceedings had to be taken to force it to make the order conform to the decision of the highest court in the state. It was not until 1949 that the Company was able to get its books of account established in such a way that it could accomplish its future financing, and, only then, by a compromise on the period during which amortization of certain items in their capital accounts was to be accomplished.

No other company duplicated this fight of the Rochester Co. The utilities acquiesced because in addition to the disadvantage and cost of fighting orders of the Commission, there were advantages to be gained by complying with its requirements. Apparently no company could afford to incur its displeasure. The favorable interest rates which then prevailed enabled many companies to reduce their costs by reducing their overheads. Consolidations which were approved by the Commission enabled costs to be further reduced and greater revenues to be obtained through widening markets. Later, approvals had to be obtained for various matters important to the service, for example: change from artificial gas to natural gas required six different orders from the Commission approving, among other things, changes in the unit used in measurement of the unit on which rates were based, financings, new rate schedules, accounting entries—and many other matters. This change to natural gas alone enabled many companies to meet competition with other fuels,

[38] Brief for petitioner-respondents, p. 30, Rochester Gas & Electric Corp. v. Maltbie, 298 N. Y. 867, 84 N. E. 2d 635 (1949).

avoiding the fate which befell the street railroads. It must also not be forgotten that large issues of securities in the period from 1940 on, and their distribution on a seller's market brought profits to promoters, underwriters and others. All of these advantages outweighed the disadvantages of the delay and expenses of litigation and turned people who would otherwise have been fighters into "appeasers", in contrast to the pioneers addressed by Henry Clay a hundred years before. Certainly freedom of contract as well as other liberties in dealing with property were impaired by the encroachment of regulation and regimentation just as that statesman foresaw would always be the consequence of appeasement.

It was not because the Spirit of '76 is dead in this country but because managements felt more was to be gained by negotiation than by litigation. After all, the War of 1812 was pretty indecisive and in most wars many years of cold war succeed the fighting and long years have to elapse before diplomatic negotiation can achieve all the desired ends for which the wars were fought.

V. CONCLUSION

I CAN think of no better way to bring out the full significance of the foregoing study, than to quote the conclusions of Dean Pound and Justice Jackson in their authoritative articles on administration procedure.

Dean Pound in his article on judicial process in action says:

"Administrative as contrasted with judicial application of law is characteristically a matter of discretion. Cases are assumed to be unique and are sought to be decided solely on the particular circumstances of the particular case. This theory of application, which is appropriate to the application of standards, tends to be carried out in the whole field of administrative activity. *In the absence of the checks which make tolerable the relatively small margin now allowed for judicial discretion, the wide scope for personal judgment of administrative officials which has come to be* allowed in recent years raises serious as well as difficult problems."[39] (Italics supplied.)

In his posthumously published Godkin lecture (which was never delivered), Justice Jackson, speaking of Administrative tribunals, says: "They constitute a headless (fourth branch) of the Govern-

[39] Pound, *Judicial Process in Action*, 1 N. Y. L. F. 31 (1955).

ment, a haphazard deposit of irresponsible agencies and uncoordinated powers."[40]

The lawyer practicing before these administrative tribunals must share the misgivings of these great masters of jurisprudence. Nevertheless, although he approaches the problems pragmatically rather than philosophically, he must have observed that many of these new tribunals as they mature, gain a feeling of responsibility and in the realization that the practical solution of the problems cannot be reached merely by seeking what is expedient, but by finding and applying principles of justice, equity and fair dealing. It is the high duty of the profession to assist in that great task so that the rights of individuals and the interests of society can be adjusted and recognized.

To quote further from Justice Jackson's fine treatise:

". . . the administrative tribunals clearly are here to stay and probably to increase in number and powers. The values affected by their decisions probably exceed every year many times the dollar value of all money judgments rendered by the federal courts. They also affect vital rights of the citizen. There have been instances of excessive zeal and abuse of power. The same may be said of the judiciary. My own belief is that every safeguard should be thrown about the process of administrative adjudication so that its fact-finding will be honest, unprejudiced, neutral, and competent. It should be isolated from the prosecuting function. As a prosecutor, the body serves a constituency and promotes an interest. As a judge, it should know no constituent and serve no interest except justice. But in time we shall see these defects in the administrative process corrected, and the process will help supply the shortcomings we have found in the three original branches."[41]

It is fitting to ponder these profound observations, expressed with such lucidity and tremendous authority.

[40] JACKSON, THE SUPREME COURT IN THE AMERICAN SYSTEM OF GOVERNMENT, 52 (1955).

[41] *Id.* at 51.