Smyth v. Ames in State Courts, 1942 to 1952

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Smyth v. Ames\textsuperscript{1} imposed upon the regulatory process the doctrine that a public utility has a judicially enforceable, constitutional right to a "reasonable return" upon the "fair value" of its operating property. Based upon eminent domain theory,\textsuperscript{2} the "fair value" rule implied at least the pretense (and in practice was apt to mean) that to be constitutionally valid rate regulation must keep investors in at least as favorable a financial position as they would enjoy if they were unregulated and yet retained their monopolistic status. This judicial casuistry resulted in high charges and widespread consumer resentment—important factors in the broad movement toward public ownership that followed.

In enunciating this position the court listed seven factors "for consideration" and recognized that there might be "other matters to be regarded" in estimating "fair value."\textsuperscript{3} There was no indication of what these "other matters" might be, their relationship to the listed factors, nor of the relative weight to be attached to any of the items mentioned. Subsequent decisions, however, severely limited administrative discretion by giving "reproduction cost" (an item not listed in the Smyth case) a controlling position.\textsuperscript{4} Because in general our economy has been characterized by a rising level of prices, reproduction cost favored utilities. Regulatory bodies and consumers have tended accordingly to emphasize actual, historical cost—the "prudent investment" principle being merely a refinement of the latter. The recent Hope case\textsuperscript{6} illustrates the vast rate differences implicit in the choice of approach. There the company’s

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1. 169 U. S. 466 (1898).
2. Id. at 522-26.
3. Id. at 546-7.
4. This development culminated in McCordle v. Indianapolis Water Co., 272 U. S. 400 (1926).
depreciated reproduction cost figure was $66,000,000.7 The Federal Power Commission’s depreciated "actual legitimate cost" figure was $33,712,526.8 On the basis of a 6½ per cent return the implicit rate differential is over 2 million dollars per year.

Thanks to the "Roosevelt Court" the "fair value merry-go-round" has now been abandoned by the federal judiciary. The Pipeline case9 held that "the Constitution does not bind rate-making bodies to the service of any single formula or combination of formulas," and that if a rate order, "as applied to the facts . . . and viewed in its entirety, produces no arbitrary result, our inquiry is at an end."10 While these and other remarks in the opinion clearly suggest a new attitude, they are not necessarily at odds with the Smyth decision! For all that appears in the Pipeline case the rates there in question may have been sustained merely because they were not in fact "confiscatory" under "fair value" doctrine. In that view Pipeline might mean simply that regulating agencies were to have greater freedom in using valuation formulas, but they would still be required to find a "fair value" rate base via one or more of the elements mentioned in the "hodge-podge" of Smyth v. Ames.

In 1944 this problem was settled by the Hope case:

... rate-making is indeed but one species of price-fixing. Munn v. Illinois, 94 U. S. 113, 134. The fixing of prices, like other applications of the police power, may reduce the value of property which is being regulated. But the fact that value is reduced does not mean that the regulation is invalid. Block v. Hirsh, 256 U. S. 135, 155-157; Nebbia v. New York, 291 U. S. 502, 523-539, and cases cited. It does, however, indicate that "fair value" is the end product of the process of rate-making not the starting point as the Circuit Court of Appeals held. The heart of the matter is that rates cannot be made to depend upon "fair value" when the value of the going enterprise depends upon earnings under whatever rates may be anticipated.11

This substitution of the police power for eminent domain as the constitutional foundation for rate regulation means that "it is the

7. Id. at 597.
8. Id. at 600.
10. Id. at 586. In this (and the Hope case), the Court was dealing with statutory rate-making standards. But it noted (at page 586) that "the Congressional standard prescribed by this statute coincides with that of the Constitution, and that courts are without authority under the statute to set aside as too low any 'reasonable rate' adopted by the Commission which is consistent with constitutional requirements."
11. 320 U. S. at 601 (1944).
result reached not the method employed that is controlling. . . . Moreover, the Commission's order does not become suspect by reason of the fact that it is challenged. It is the product of expert judgment which carries a presumption of validity. And he who would upset the rate order . . . carries the heavy burden of making a convincing showing that it is invalid because it is unjust and unreasonable in its consequences. . . . Rates [as here] which enable the company to operate successfully, to maintain its financial integrity, to attract capital, and to compensate its investors for the risks assumed certainly cannot be condemned as invalid, even though they might produce only a meager return on the so-called 'fair value' rate base."12

That was the end of the Smyth "fair value" doctrine in the federal courts. Administrative regulation of rates was resurrected as a possible alternative to public ownership of "natural monopolies." But the Smyth case still haunts the states. If this were true only with respect to state court interpretations of the Fourteenth Amendment—as seems to be the case in Washington, Vermont, and Minnesota—the matter would be subject to correction by the federal judiciary. But 8 out of the other 12 state supreme courts that have dealt with the problem have found that all or part of Smyth v. Ames is imbedded (and permissibly so) in state law.13 Thus it is beyond the reach of the Pipeline and Hope decisions. For they indicate merely that the Smyth approach is not a constitutionally required ingredient in rate-making. It is still a permissible ingredient.14 The same self-denying ordinance that blocks extensive court "protection" of investors from the terrors of rate regulation, similarly prevents judicial intrusion on behalf of consumers. There is no evidence that the old double standard which served the utilities so well is to be reversed in favor of their customers.

States requiring full adherence to fair value doctrine

In Pennsylvania, Ohio, North Dakota, South Dakota, Minnesota, and Massachusetts15 the doctrine of Smyth v. Ames is in full bloom—together with the related Ben Avon16 rule that where con-

12. Id. at 602, 605.
13. See below.
15. In Norfolk v. Chesapeake & Patomac Tel. Co., 192 Va. 292, 64 S. E. 2d 772 (1951), and PSC v. Indianapolis Ry. Co., 225 Ind. 30, 72 N. E. 2d 434 (1947) the Virginia and Indiana Supreme Courts respectively recognized that Hope presented a challenge, but cautiously avoided meeting it.
fiscation is alleged the utility is entitled to have that issue determined "independently" by the courts.

In 1943 the Superior Court of Pennsylvania held that the "legislative mandate in this commonwealth is that the rate base is fair value ... except that for the determination of temporary rates ... original cost less accrued depreciation may be used. ... As late as 1939, this court pointed out, the cost of reproducing the property has consistently been held not only a relevant, but also an essential element in the ascertainment of its 'fair value' for rate-making purposes." A few months after the Hope decision the same court observed that prudent investment is excluded "under the law of this state. ... Reproduction cost is still an important and essential element" of fair value in Pennsylvania. Subsequent decisions through 1951 are to the same effect.

Some three years after Hope the Supreme Court of Ohio observed that "on several occasions this court has held that the General Assembly in delegating rate-making power to the Public Utility Commission has limited the Commission in the valuation of physical property, other than land, for rate-making purposes, to reproduction cost as of a date certain less observed depreciation. ..." In support of this the court quoted from an earlier Ohio case which had rejected prudent investment "because the Legislature has adopted the principle of the rule set out in Smyth v. Ames ...." It was then observed that for a number of years after the adoption of this legislation cities were satisfied and utilities were inclined to comply. Now due to higher prices cities are disposed to complain. "If the original interpretation was sound, it still remains so, even though economic conditions have changed in the meantime. If the statute has become outmoded, the remedy must be attained through the legislative branch of the government and not in the courts."22

The highest court of North Dakota observed in 1944 that "In

21. Ibid.
22. Id. at 183, 74 N. E. 2d at 79.
the former appeal in this case... we held that the fair value formula as set out in Smyth v. Ames... had been adopted by the Legislature of this State in 1919... There can be no doubt today, but that, insofar as the federal courts are concerned, the 'ghost of Smyth v. Ames had been laid... That circumstance, however, has no bearing upon the question now before us. We are concerned with the law of this state as enacted in 1919.  

As indicated above the Minnesota Supreme Court still adheres to Smyth doctrine. It along with Vermont's and Washington's are apparently the only courts which predicate that position upon the supposed requirements of the Fourteenth Amendment. In In re Application of Minneapolis Street Railway,24 decided some five years after Hope, the city contended inter alia that an "emergency or temporary rate increase must not be more than sufficient to meet fixed charges and operating expenses."25 After casually mentioning that Minnesota legislation required rates to be based on "fair value,"26 the court rejected the city's contention on purely constitutional grounds:

In fixing an emergency or temporary street railway rate of fare, the commission has the power to fix it in such an amount as will produce revenue not only necessary to meet fixed charges and operating expenses, but also sufficient to yield a reasonable return on the fair value of the property devoted to street railway use. As a matter of law, a rate of fare in such an amount is required because a lesser one would be confiscatory and violative of due process... This rule is a well-established one, applicable generally to fixing rates of public utilities.27

The three cases cited in support of these propositions make it clear that the "due process" referred to is that of the Fourteenth Amendment. There is not the slightest indication that the Minnesota Supreme Court had ever heard of either Pipeline or Hope.

In a South Dakota case28 the utility commission and the trial court ("reviewing" the matter independently), both started their "fair value" inquiry with the utility's book cost. They differed as to the adjustments which should be made thereto. The state Supreme Court upheld the trial court's position in an opinion which by liberal quotations from Chief Justice Hughes in the

24. 228 Minn. 435, 37 N.W. 2d. 533 (1949).
25. Id. at 440, 37 N. W. 2d. at 537.
26. Id. at 438, 37 N. W. 2d. at 534.
27. Id. at 442, 37 N.W. 2d. at 537.
St. Joseph Stock Yards case manages to read both "fair value" and Ben Avon doctrine into the state constitution's due process clause. There is no mention whatsoever of Pipeline or Hope and consequently no need for reconsidering Ben Avon in the light which they cast.

In a far more sophisticated manner the Massachusetts Supreme Court arrived at the same result fully conscious of the problems involved:

the Declaration of Rights guarantees to an owner, who alleges that confiscation of his property will result from a rate order of the department, a fair opportunity for submitting that issue to a court for determination upon its own independent judgment as to both law and facts. . . . the rates must yield a fair return upon the fair value of the property. . . .

It is unnecessary for us to undertake to estimate the effect upon the doctrine of the Ben Avon case of certain relatively recent cases in the Supreme Court of the United States. [citing Pipeline and Hope inter alia] . . . We do not rest our decision upon a violation of the Fourteenth Amendment. . . .

The case is the more interesting because while the regulatory agency claimed that it had followed its long established "prudent investment" practice, the Supreme Court observed that the agency's order "is virtually barren of findings which reveal the principles underlying [its] conclusions." Moreover the court thought it not clear that the agency had in fact followed, or could properly rely upon, the "prudent investment" approach. The regulatory agency has professed to adhere to its [prudent investment] rule notwithstanding the statement of the Supreme Court of the United States and of this court that the rates must be sufficient to yield a fair return on the value of the property. . . . It is unnecessary to expiate upon this aspect of the case, as in any event the order, as will be seen, is confiscatory.

Then comes the ironical ending. As though taking double care to make its decision appeal-proof, but perhaps only to avoid unnecessary commitment, the Massachusetts Supreme Court phrased its conclusion in language consonant with the Hope position:

. . . irrespective of whether the earnings permitted by the order were, or should have been, proportioned to any rate base,

31. Id. at 94, 84 N. E. 2d at 819.
32. Id. at 95, 84 N. E. 2d. at 820.
33. Ibid.
whatever may have been the theory upon which such rate base was, or should have been determined, the order . . . is confiscatory.  

It would not be accurate to say that Georgia still adheres to Smyth doctrine. That has not yet been decided. But in a 1949 decision the Georgia Supreme Court was so unaffected by developments in the federal judiciary that it was still able to base a Ben Avon conclusion upon the Fourteenth Amendment. Not even mentioning Hope, it presumably saw no threat to Ben Avon from that quarter, or any other.  

The Supreme Court of the United States in many cases has held that, where a public service commission or board prescribes rates under which the utility company affected claims that its property will be confiscated, the State must provide a fair opportunity for submitting the issue to a judicial tribunal for determination upon its own independent judgment as to both law and facts, otherwise the order would be void because in conflict with the due process clause of the Fourteenth Amendment.

Similarly the Wisconsin Supreme Court has given some hints but has not clearly committed itself either for or against "fair value." In the famous Two Rivers case the state Public Service Commission, relying upon Hope, announced that there will be a determination and finding of neither a rate-base nor of a rate of return for the purposes of this proceeding. . . . The rates herein prescribed are estimated and intended to afford approximately an annual net profit of a determined number of dollars which we think it reasonable for the utility to enjoy from the operation of its business.

Three factors which the commission said it considered essential considerations in reaching its conclusion were (1) estimated future operating expenses "(2) The value of any class of [the] utility's service, where that value constitutes the limitation upon and practical equivalent of the rates charged therefore. (3) A reasonable profit which is proper for the utility to enjoy under all relevant facts and circumstances.

34. Id. at 102, 84 N. E. 2d. at 824.
36. See, for example, Rd. Com. of Texas v. Rowan & Nichols Oil Co., 310 U. S. 573 (1940), 311 U. S. 614 (1941), 311 U. S. 570 (1941).
37. 55 S. E. 2d 618, at 627 (1949).
40. Ibid.
In an opinion in which Chief Justice Rosenberry joined, the Wisconsin Supreme Court held that the "present method of the Commission is improper and must be abandoned." Quoting at length from Hope's case, it was observed that

From that recital of facts it appears that the Federal Power Commission had at least some basis upon which it was figuring the fair return for the Hope Gas Company. The Public Service Commission in this case appears to have carried the theory which it spelled out of the Hope Case several steps further, and determined to keep the entire basis a secret. . . .

How can the commission or the reviewing court or the utility or the public determine whether the profit is proper unless the commission makes specific findings of the "relevant facts and circumstances"? The commission must determine what those are and set them forth as required by law. Those essential facts which control each case will then determine the rate base [emphasis added].

The reference to a "rate base" sounds ominous, but it is so out of place in the context of the entire opinion that it may have been merely a matter of rhetorical inadvertency. The explicitness which the court required of the commission is not necessarily at odds with the new federal approach. But doubtless some will feel that the Wisconsin Supreme Court is not friendly to the idea that it should merely look at the administrative end result and sustain it unless the utility "carries the heavy burden of making a convincing showing that it is invalid because it is unjust and unreasonable in its consequences."

States "accepting" Pipeline but not Hope

Alabama, Idaho, and New Jersey legislation is held to require the finding of a rate base. At least in the cases of Idaho and New Jersey this interpretation of the legislative will is questionable. But in all three states there is a linguist acceptance of the Pipeline idea that no "single formula or combination of formulas" is controlling.

In the original hearing of its only relevant case the Alabama Supreme Court took pains to indicate a friendly attitude toward Pipeline. Although the commission had made no specific rate base finding, its negative order was upheld on the ground that since

41. 252 Wis. 481, 32 N. W. 2d 247, 249 (1948).
42. Id. at 484, 32 N. W. 2d at 248.
43. See Esser, State Laws in Relation to the Hope Natural Gas Decision, 34 P. U. Fort. 69 (1944).
the utility had petitioned for an increase it must, but had not, carried the burden of establishing the "value of a proper rate base." Upon rehearing, however, the case was remanded in the face of vigorous dissent, to enable the utility to submit further evidence.

While Idaho judicial language is studded with Pipeline expressions and while it has upheld rates based fundamentally upon original cost, it observes that "whether the decision in Smyth v. Ames has been modified by subsequent cases is unnecessary to discuss." Unnecessary because the "company, having based its application for a rate increase in accordance with the Commission's [original cost] formula, and the Commission, having before it all the elements of original cost, cost of reproduction and other items necessary for a rate-making basis, cannot be said to have erred when the value fixed in determining a just and reasonable return was based on the lesser amount [emphasis added]."

All of the New Jersey opinions mouth Pipeline doctrine. In one case an original cost rate base was sustained against a utility's argument in favor of reproduction (and book) cost, and against a city's argument in favor of "reproduction cost grounded on average prices." But the fact is all of these were "considered" by the commission. And the New Jersey Supreme Court, in response to the utility's argument that would have made it controlling, observed that "depreciated reproduction cost is but a factor to be considered in the fixation of a rate [emphasis added] ..."

In a later case the regulating body had granted a rate increase predicated upon book value. On appeal on behalf of consumers Chief Justice Vanderbilt, for the court, observed that the "Board is not bound to and, indeed, should not use any single formula or combination of formulae in arriving at a proper rate base. ..." There had been some evidence that the company's books of account did not accurately reflect its investment costs, though this

45. Id. at 152, 47 So. 2d at 465.
46. Id. at 152, 155, 157, 47 So. 2d at 465, 468, 470.
48. Ibid.
49. Ibid.
51. Id. at 365, 26 A. 2d at 76.
53. Id. at 217, 74 A. 2d at 591.
had not been a major item in the proceeding. The case was re-
manded on the ground that it was improper to arrive at “a fair
value based solely upon a utility's books of account.”

It is noteworthy that while New Jersey's, like Idaho's, accept-
ance even of the narrow interpretation of the Pipeline case seems
more apparent than real, deviation has not been disadvantageous to
consumers. Indeed in the last mentioned New Jersey case the
Supreme Court's refusal to accept the administrative choice of
valuation formulas meant annulment of a rate increase. A lone
dissent without opinion may mean that the majority position is
being questioned from within the court.

The Vermont Supreme Court's position is more complicated.
It cites Smyth v. Ames and other pre-Pipeline cases in support of
the proposition that "it is shown by all the cases . . . that in order
to reach a fair judgment of rates . . . it is necessary that a proper
rate base and allowable expenses be determined." Then it goes
on to say, "The much discussed case of . . . Hope . . . did not
change this rule for . . . this case did not reject judicial right of
review as to reasonableness of rates and, obviously, if it be held
that no yardstick is necessary whereby to test this question then
judicial review as to reasonableness of rates would become utterly
meaningless." This quite obviously indicates a misunderstanding
of the new federal position. Not stopping to explain what it thought
the Hope case does mean, the court remanded so that the com-
mision might make findings as to a "rate base and expenses."

But less than a year later the same court upheld a commission
order based on a 1943 Federal Power Commission original cost
finding. The utility did not contest use of that valuation formula,
but it did object to the use of a twelve month period ending on
April 30, 1949, as a "test year" upon which to predicate revenue
and expense adjustments. In the utility's view a later test period
should have been chosen. The court quoted at length from Pipe-
line in support of the proposition that "commissions are not bound
to the service of any single formula or combination of formulas,"
that they are free to make "pragmatic adjustments" and that if

54. Ibid.
55. Central R. Co. of N. J. v. Dept. of Public Utility Commissioners,
7 N. J. 247, 81 A. 2d 162 (1951).
(1949).
57. Ibid.
58. Petition of Central Vermont Public Service Corp., 116 Vt. 206,
71 A. 2d 576 (1950).
the rate-order "viewed in its entirety, produces no arbitrary results" judicial inquiry is at an end.59 Moreover, "where an administrative agency has [such] authority to choose the criteria determinative of an issue of fact, it may reject evidence which has no materiality in view of the criteria adopted."60 Taken together the two cases seem to indicate that while a "fair value" rate base is still required in Vermont, the method of arriving at it is to be left to administrative discretion.

Arguing before the Supreme Court of Washington, the State regulatory body contended that only its methods, not its rates, had been "disapproved" by the lower court. It then cited West Ohio Gas Co. v. Public Service Commission61 (without mention of Pipeline) in support of the proposition that, absent a finding of confiscation, the rates must be sustained. In short the result not the means of reaching it should control. Proceeding on the assumption that "the doctrine of the Smyth case has been consistently followed by the Supreme Court and by state courts, including the courts of the state of Washington"62 the answer was that "While a court might uphold rates fixed by a regulatory authority if it appeared that the rates would allow the utility, all things considered, a fair return, even though the authority in its proceedings had committed error, no court is obliged to follow that method, and it seems clear that such a method would be followed only in exceptional cases."63 This seems quite clearly to repudiate the Pipeline idea that, if a rate order "viewed in its entirety, produces no arbitrary result our [judicial] inquiry is at an end."

The rate order was remanded because among other reasons it had been predicated upon what the court considered an improper depreciation allowance. But it is noteworthy that Pipeline language was cited in support of the regulatory agency's freedom to use whatever valuation approach it deemed appropriate for arriving at a "fair value" rate base.64 In fact original cost (as evidenced by the company's books) had been used.65 The company did not object to this procedure though it did introduce, and presumably the regulatory body "considered," reproduction cost evidence.66

59. Id. at 209, 71 A. 2d at 578.
60. Id. at 210, 71 A. 2d at 579.
61. 294 U. S. 63 (1935).
63. Id. at 222, 142 P. 2d at 510.
64. Id. at 235, 142 P. 2d at 520.
65. Id. at 232, 142 P. 2d at 514.
66. Ibid.
States accepting the Hope doctrine

The Supreme Courts of Utah, New Mexico, Oklahoma, and New Hampshire apparently accept the full Hope doctrine. Utah Power and Light Co. v. Public Service Commission\(^6\) is easily the leading state case on the point. There the Commission had initiated a hearing to reduce the Company's rates and proceeded to do so on a prudent investment (cost) basis. On appeal the Company contended in its original brief that it had both a constitutional and a statutory right to have its rate base established in relation to value as distinguished from cost, and that it was entitled to a reasonable return on present "fair value." When the Hope decision appeared the Company abandoned its constitutional, and vigorously pressed, its statutory argument\(^6\)—citing earlier Utah cases and particularly the Pennsylvania cases (see above).\(^6\) After carefully tracing the judicial history of the rate-making problem Chief Justice Wolfe, for the Court, rejected the Company's construction of Utah's statutes. He observed that the legislature had given full rate-making power to the Commission, subject only to "procedural due process" and the requirement that rates be "just and reasonable."

At the time of Smyth v. Ames a rate could not be just and reasonable in the constitutional sense unless it permitted a fair return on fair value. This concept has, as pointed out above, been overruled. It would be contrary to common sense to hold that the legislature meant "just and reasonable" only as defined by the courts at the time of Smyth v. Ames and to hold that the legislature would, in order to authorize the Commission to use prudent investment, be required to reenact the statute saying that it meant 'just and reasonable' as that term is construed today. To the contrary, it must be assumed that the legislature contemplated that the concept of that which is 'just and reasonable' might change with social trends. Possibly that is why the legislature did not prescribe any definite formula to be applied to every case without variation. The term 'just and reasonable' is not an absolute. ... The Commission did not err in refusing to fix rates upon a fair value base.\(^7\)

Citing and quoting from this opinion, the New Hampshire Supreme Court held that, "We do not consider that the statutory requirement that rates shall be 'just and reasonable' was an enact-
ment into law of the fair value doctrine of *Smyth v. Ames*..." But, it continued, the relief furnished by *Hope* does not "relieve the commission of the duty to make findings of fact essential to permit review of its conclusions." On the latter point—similar to that stressed by the Wisconsin and Idaho courts and by Mr. Justice Frankfurter in his *Hope* dissent—the case was remanded to the Commission.

In what appears to be essentially dicta the Supreme Court of New Mexico, citing *Pipeline* and *Hope*, has observed that the doctrine of *Smyth v. Ames* "while followed for many years, has been criticized so severely by later decisions that it has but little, if any, value in determining a formula for rate making." Several pages of discussion that follow show quite obviously that the Court went out of its way to indicate full acceptance of the Hope doctrine.

In a reasonably clear-cut decision upholding a depreciated book value rate base against an attack predicated upon the state and national constitutions Oklahoma in 1951 joined the *Hope* procession.

**Conclusion**

The paucity of appeals to the courts may mean that some utility commissions are not attempting to depart from the old doctrines. Apart from two state supreme courts that carefully avoided the issue (Virginia and Indiana), only fifteen have had occasion to reconsider *Smyth v. Ames* in the light of *Pipeline* and (or) *Hope*. Six of these (Minnesota, Massachusetts, Pennsylvania, Ohio, North Dakota, and South Dakota) failed to make any concessions to the new federal court position. Three more (Alabama, Idaho, and New Jersey) accommodated their language, if not their decisions, to *Pipeline*, while two more (Vermont and Washington) after some initial difficulty seem to have accepted at least the narrow interpretation of that case. Only four (Utah, New Mexico, Oklahoma, and New Hampshire) appear to have broken with

72. Id. at 359, 64 A. 2d at 15. See also Petition of Central Vermont Utility Public Service Corp., 71 A. 2d 576 (1950).
73. 320 U. S. 591, 624, 627-628 (1944).
76. Compare the position of the Georgia and Wisconsin Supreme Courts, above.
the old tradition in favor of the views expressed by the federal Supreme Court in the *Hope* case.

In view of the "persistence of substantive due process in the states" with respect to other forms of business regulation, it is noteworthy that only in Massachusetts, Vermont, Washington, and Minnesota is the restrictive position based clearly on constitutional grounds. In all other instances the narrow view is found to be imbedded in legislation—where it is subject to removal by legislative action.