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RECENT CASES

Conflict of Laws—Mexican Bilateral Divorce Decree Recognized Even Though Neither Party was a Mexican Domiciliary At Time of Divorce

In 1962, plaintiff brought an action to annul his marriage on the ground that his wife's divorce from her former husband was invalid. Plaintiff and defendant had been married in New York in 1956. In 1954, defendant's former husband, one Felix Kaufmann, had obtained a Mexican divorce from her on grounds not recognized in New York.[1] To do so, Kaufmann entered Juarez, Mexico, presented his divorce petition together with a certificate attesting to his registration in the official register of residence of Juarez,[2] and returned to the United States on the same day. Defendant appeared by attorney on the following day, and, submitting to the jurisdiction of the court, admitted the allegations of the complaint. The decree of divorce[3] was entered the same day, and defendant subsequently married plaintiff. The trial court, in the instant case, granted judgment for the plaintiff,[4] holding that the Mexican tribunal had no power to grant the divorce decree since neither party to the action had established domicile[5] in Mexico. The appellate division reversed, upholding the bilateral divorce decree.[6] On appeal to the Court of Appeals of New York, *held*, affirmed. A balanced public policy requires that a bilateral Mexican divorce be recognized even though (1) neither party is domiciled within that jurisdiction, and (2) the only relation-

1. The decree was obtained in the First Civil Court, District of Bravos, City of Juarez, State of Chihuahua, Mexico, on grounds of ill treatment and incompatibility of character. New York courts will not grant a divorce on these grounds, adultery being the sole ground for divorce there. See N.Y. Dom. Rel. Law § 170.

2. The New York Supreme Court determined that the applicable Mexican statutes authorized the Mexican court to exercise in personam jurisdiction predicated upon "residence" of at least one of the parties to the divorce action. The statutes specify that "residence" is proved by personal registration with the Municipal Clerk at the City Hall. The judgment in the principal case was recognized as valid by the Republic of Mexico. Rosenstiel v. Rosenstiel, 43 Misc. 2d 462, 473, 251 N.Y.S.2d 565, 577 (Sup. Ct. 1964).

3. This is called a bilateral Mexican divorce. Either both parties are before the court, or one party is physically present and the other appears by counsel. Neither party is a Mexican domiciliary. See Berke, *The Present Status of Mexican Divorces*, 36 N.Y.S.B.J. 111, 112 (1964).

4. Rosenstiel v. Rosenstiel, 43 Misc. 2d 462, 251 N.Y.S.2d 565 (Sup. Ct. 1964).

5. Physical presence in a place and the intent to make one's fixed and permanent home "forthwith" in that place are the elements of domicile. Goodrich, Conflict of Laws 41-43 (4th ed. 1964).

6. Rosenstiel v. Rosenstiel, 21 App. Div. 2d 635, 253 N.Y.S.2d 206 (1st Dep't 1964).

ship between the marriage status of the parties and that jurisdiction is composed of one party's statutory "residence" based on brief contact and the other party's voluntary appearance by attorney before the decree-rendering court.[7] *Rosenstiel v. Rosenstiel*, 16 N.Y.2d 64, 209 N.E.2d 709, 262 N.Y.S.2d 86 (1965).

In order for a court to have jurisdiction of a divorce action, it is generally required that at least one of the parties be domiciled within the territorial jurisdiction of the court.[8] Indeed, the United States Supreme Court has said that a divorce decree of one state need not be given "full faith and credit"[9] in a sister state unless at least one of the parties was domiciled within the decree-rendering state at the time of the action.[10] The traditional rationale for this theory is that a divorce action is a proceeding in rem.[11] The marriage status is considered to be the res and its location is the domicile of either[12] of the married parties.[13] This view has lost much of its former

7. See also Wood v. Wood, 41 Misc. 2d 95, 245 N.Y.S.2d 800 (Sup. Ct. 1963), *modified*, 22 App. Div. 2d 660, 253 N.Y.S.2d 204 (1st Dep't 1964), *aff'd*, 16 N.Y.2d 64, 209 N.E.2d 709, 262 N.Y.S.2d 86 (1965) (companion case in which court upheld Mexican bilateral divorce even though plaintiff did not acquire a certificate of residence).

8. Mr. Justice Frankfurter's frequently quoted dictum stated the rule in this way: "Under our system of law, judicial power to grant a divorce—jurisdiction, strictly speaking—is founded on domicile. . . . The framers of the Constitution were familiar with this jurisdictional prerequisite, and since 1789 neither this Court nor any other court in the English-speaking world has questioned it. . . . The domicile of one spouse within a state gives power to that State, we have held, to dissolve a marriage wheresoever contracted." Williams v. North Carolina, 325 U.S. 226, 229-30 (1945). See GOODRICH, *op. cit. supra* note 5, at 256-57; 2A NELSON, DIVORCE AND ANNULMENT § 21.01 (2d ed. 1961); RESTATEMENT (SECOND), CONFLICTS OF LAWS §§ 110-13 (Tent. Draft No. 1, 1953).

9. U.S. CONST. art. IV, § 1.

10. Williams v. North Carolina, 317 U.S. 287 (1942). There can be inquiry into the jurisdictional facts when the divorce is granted ex parte. Williams v. North Carolina, *supra* note 8. Participation by a party in the action, either by appearance or cross petition, will preclude him from attacking the decree. Coe v. Coe, 334 U.S. 378 (1948); Sheerer v. Sheerer, 334 U.S. 343 (1948); Davis v. Davis, 305 U.S. 32 (1938). Third parties will also be precluded where those through whom they claim are precluded or where an attack would be barred in the rendering state. Cook v. Cook, 342 U.S. 126 (1951); Johnson v. Muelbeger, 340 U.S. 581 (1951).

11. See 2 BISHOP, MARRIAGE AND DIVORCE § 164 (6th ed. 1881). A scholar notes: "Building upon Story's concept of domicile, Joel Bishop in 1852 started to formulate his 'status' theory of marriage which in time jelled into the notion that the marriage was a *res* and that divorce was in the nature of an *in rem* proceeding." Foster, *For Better or Worse? Decisions Since Haddock v. Haddock*, 47 A.B.A.J. 961, 963 (1961).

12. American courts have long recognized the ability of either spouse to establish his separate domicile. See, *e.g.*, Cheever v. Wilson, 76 U.S. (9 Wall.) 108, 124 (1869); Phelps v. Phelps, 241 Mo. App. 1202, 246 S.W.2d 838 (1962).

13. "In that the divorce suit is treated as in rem, is necessary for the forum to have judicial jurisdiction over the matrimonial status. Since this status is intangible, some fictitious basis for getting the res before the court had to be devised. Moreover, it was necessary for the connecting link for the forum to be sufficient under the due process clause. . . . [T]raditionally domicile has been used in this country." Sumner, *Full Faith and Credit for Divorce Decrees*, 9 VAND. L. REV. 1, 4 (1955). See, *e.g.*,

vitality,[14] and for purposes of establishing jurisdiction, more emphasis is now placed on the idea that the state of domicile has a special interest in the marriage status and a right to control the relationship because of the moral, social, and economic consequences attendant thereto.[15] For purposes of the competence of state courts, most state divorce statutes employ the term "residence"[16] rather than domicile. However, for purposes of jurisdiction, it is usually understood that the inherent nature of divorce proceedings requires that at least one of the parties actually be domiciled within the state.[17]

Although the "full faith and credit" clause has no application to decrees rendered in foreign countries, most foreign divorce decrees will be honored by the various states.[18] When recognition is withheld, it is usually because the decree is found to contravene the forum state's public policy.[19] In regard to Mexican divorces,[20] the courts of

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Warner v. Warner, 219 Minn. 59, 17 N.W.2d 58 (1944) (marriage status is the subject matter of the court's jurisdiction).

14. "[I]t does not aid in the solution of the problem presented by this case to label these proceedings as proceedings *in rem.* Such a suit, however, is not a mere *in personam* action. Domicil . . . is recognized . . . as essential in order to give the court jurisdiction which will entitle the divorce decree to extra-territorial effect. . . ." Williams v. North Carolina, *supra* note 10, at 297.

15. See, *e.g., id.* at 298 (state has a legitimate concern in marital status of its domiciliaries); Alton v. Alton, 207 F.2d 667, 673 (3d Cir. 1953) (there is mutual intimate concern between state and its domiciliaries); Fearon v. Treanor, 272 N.Y. 268, 273, 5 N.E.2d 815, 816 (1936) (successful marriages constitute fundamental basis of state's general welfare); GOODRICH, *op. cit. supra* note 5, at 256; Lorenzen, *Haddock v. Haddock Overruled,* 52 YALE L.J. 341 (1943); Note, 16 VAND. L. REV. 1185, 1189 (1963). A divorce action has been characterized as a three party action in which the state is always involved. Trammel v. Vaughan, 158 Mo. 214, 222, 59 S.W. 79, 81 (1900).

16. "Residence" is readily distinguishable because it requires only physical presence at an established habitat without any intention to make a home there. 2A NELSON, *op. cit. supra* note 8, § 21.14; see note 5 *supra.*

17. 2A NELSON, *op. cit. supra* note 8, §§ 21.12, 21.14; see Carter v. Carter, 147 Conn. 238, 240-41, 159 A.2d 173, 175-76 (1960); Martin v. Martin, 253 N.C. 704, 706, 118 S.E.2d 29, 31 (1961). The required period of residence is not essential to domicile, but is merely a statutory requirement apart from domicile. Stimson, *Jurisdiction in Divorce Cases: The Unsoundness of the Domiciliary Theory,* 42 A.B.A.J. 222, 294 (1956). Apart from the so-called "servicemen's statutes" explained in Note, *supra* note 15, at 1194, only an Arkansas statute has frankly substituted "residence" for domicile in all divorce cases. ARK. STAT. ANN. § 34-1208.1 (1962). The Arkansas Supreme Court upheld the statute in Wheat v. Wheat, 229 Ark. 842, 318 S.W.2d 793 (1958). *But see* Alton v. Alton, *supra* note 15 (Virgin Islands statute dispensing with domicile held unconstitutional).

18. Courts often explain such recognition as being an application of the principles of comity. "'Comity' . . . is the recognition which one nation allows within its territory to the legislative, executive or judicial acts of another nation, having due regard both to international duty and convenience, and to the rights of its own citizens or of other persons who are under the protection of its laws." Hilton v. Guyot, 159 U.S. 113, 164 (1895).

19. See Christopher v. Christopher, 198 Ga. 361, 31 S.E.2d 818 (1944); Rosenbaum v. Rosenbaum, 309 N.Y. 371, 130 N.E.2d 902 (1955); Martens v. Martens, 284 N.Y. 363, 31 N.E.2d 489 (1940). The courts also give other reasons for the non-

most states hold as a matter of public policy that at least one of the parties must be a Mexican domiciliary at the time of the divorce. For example, all are in agreement that mail-order decrees[21] are legal nullities.[22] Similarly, Mexican ex parte decrees are denied effect when no domicile is proved.[23] However, there is a difference of judicial opinion regarding a bilateral divorce decree[24] in which neither party is a domiciliary of Mexico. Three of the four states[25] that have considered the question find such decrees contrary to their public policies and hence invalid.[26] New York courts, however, have consistently looked only to the decree to see that Mexican jurisdictional requirements were satisfied,[27] and have refused to consider whether bonafide domicile of either party existed.

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recognition of foreign divorce decrees; most of them are actually interrelated with the forum's public policy. For instance, decrees have been refused recognition in these circumstances: where the decree was wanting in integrity, Lotz v. Lotz, 49 N.Y.S.2d 319 (Sup. Ct. 1944); where the foreign court had no jurisdiction to render the decree, Hansen v. Hansen, 255 App. Div. 1016, 8 N.Y.S.2d 655 (2d Dep't 1938); where neither party was a domiciliary of the foreign country, Bobala v. Bobala, 680 Ohio App. 63, 33 N.E.2d 845 (1940); and where the decree was obtained by fraud, Ryder v. Ryder, 2 Cal. App. 2d 426, 37 P.2d 1069 (3d Dist. 1934).

It has been observed that courts often utilize the concept of pubic policy as a cloak for provincialism or as a substitute for analysis. Paulsen & Sovern, *"Public Policy" in the Conflict of Laws*, 56 COLUM. L. REV. 969, 1016 (1956). Properly speaking, courts of the forum should refuse to enforce foreign decrees only when they "violate some fundamental principle of justice, some prevalent conception of good morals. . . ." Loucks v. Standard Oil Co., 224 N.Y. 99, 111, 120 N.E. 192, 202 (1918) (Cardozo, J.).

20. An enlightening exposition of Mexican divorce law is contained in Comment, 33 FORDHAM L. REV. 449, 462-64 (1965).

21. Mail order decrees are those granted in an action in which neither party appears physically and both submit to the jurisdiction of the court. See Caldwell v. Caldwell, 298 N.Y. 146, 81 N.E.2d 60 (1948).

22. See, *e.g.*, Tonti v. Chadwick, 1 N.J. 531, 64 A.2d 436 (1949); Caldwell v. Caldwell, *supra* note 21.

23. See, *e.g.*, Rosenbaum v. Rosenbaum, *supra* note 19; Davis v. Davis, 80 Ohio L. Abs. 303, 156 N.E.2d 494 (C.P. 1959).

24. See note 3 *supra*.

25. New Jersey, New Mexico, New York, and Ohio.

26. The lack of domicile of either party was held fatal to the validity of the decree in each case. Warrender v. Warrender, 79 N.J. Super. 114, 190 A.2d 684 (App. Div. 1963), *aff'd mem.*, 42 N.J. 287, 200 A.2d 123 (1964); Golden v. Golden, 41 N.M. 356, 68 P.2d 928 (1937); Bobala v. Bobala, 68 Ohio App. 63, 33 N.E.2d 845 (1940). Each of these forums has been faced with this problem only once.

27. See, *e.g.*, Heine v. Heine, 231 N.Y.S.2d 239 (Sup. Ct. 1962), *aff'd mem.*, 19 App. Div. 2d 695, 242 N.Y.S.2d 705 (2d Dep't 1963); Weibel v. Weibel, 37 Misc. 2d 162, 234 N.Y.S.2d 298 (Sup. Ct. 1962); Busk v. Busk, 229 N.Y.S.2d 904 (Sup. Ct.), *modified mem.*, 18 App. Div. 2d 700, 236 N.Y.S.2d 336 (2d Dep't 1962); Laff v. Laff, 5 Misc. 2d 554, 160 N.Y.S.2d 933 (Sup. Ct.), *aff'd mem.*, 4 App. Div. 2d 874, 166 N.Y.S. 2d 678 (2d Dep't 1957); Caswell v. Caswell, 111 N.Y.S. 2d 875 (Sup. Ct.), *aff'd mem.*, 117 N.Y.S. 2d 326 (1st Dep't 1952). The New York courts have upheld dozens of these Mexican bilateral divorces. It has been estimated that over 200,000 New Yorkers have obtained Mexican divorces. N.Y. Times, July 8, 1964, p. 34, col. 2. In fact, the only cases holding bilateral Mexican divorces invalid have done so

The court of appeals[28] noted that, in compliance with the Mexican jurisdictional requirements, Kaufmann was physically present in the jurisdiction, and that the defendant voluntarily submitted to Mexican judicial authority.[29] Thus, on the theory that the marriage status moves from place to place with either spouse, the Mexican court was held to have acquired jurisdiction over the marriage.[30] The court rejected domicile as an indispensable prerequisite to jurisdiction, commenting that it had earlier dispensed with the need for domicile in certain other types of divorce situations.[31] In conclusion, the court reasoned that since the New York public interest is not prejudiced more by "quickie" Mexican divorces than by "quickie" Nevada divorces,[32] recognition of bilateral Mexican divorces as a matter of comity offends no public policy of the state.[33] The concurring and dissenting opinions[34] would hold this divorce invalid. Judge Scileppi, dissenting, felt that New York public policy demands that for purposes of divorce foreign courts should not be found to have acquired jurisdiction, unless one of the parties to the divorce is a domiciliary of the foreign country, or unless there is at least a "relationship of substantial permanence" between the decree-rendering nation and the marital status.[35] Both the concurring and the dissenting judges reasoned

because defendants lacked adequate representation by counsel. See Molnar v. Molnar, 131 N.Y.S.2d 120 (Sup. Ct.), *aff'd mem.*, 284 App. Div. 948, 135 N.Y.S.2d 623 (1st Dep't 1954); MacPherson v. MacPherson, 1 Misc. 2d 1049, 149 N.Y.S.2d 525 (Sup. Ct. 1956).

28. Judge Bergan wrote the majority opinion in which three other members of the court fully concurred. Chief Judge Desmond rejected the validity of the Mexican divorce, but concurred with the opinion because he felt that only prospective effect should be given to invalidation. Judge Scileppi agreed with Desmond, but felt that the rule voiding such divorces should apply to the instant case as well as to any prospective cases.

29. Rosenstiel v. Rosenstiel, 16 N.Y.2d 64, 209 N.E.2d 709, 711-12, 262 N.Y.S.2d 86, 89-90 (1965).

30. "[A]lmost universally jurdisdiction is acquired by physical and personal submission to judicial authority and in legal theory there seems to be ground to admit that the Mexican court at Juarez acquired jurisdiction over the former marriage of the defendant." *Id.*, at 209 N.E.2d at 712, 262 N.Y.S.2d at 90.

31. *Ibid.* New York will take jurisdiction of a matrimonial action without regard to domicile if the marriage was contracted in New York. N.Y. DOM. REL. LAW § 170; see, *e.g.*, David-Zieseniss v. Zieseniss, 205 Misc. 836, 129 N.Y.S.2d 649 (Sup. Ct. 1954). The court of appeals recognized a judgment of divorce granted in France on the ground of adultery even though the parties were not domiciliaries of France. Gould v. Gould, 235 N.Y. 14, 138 N.E. 490 (1923).

32. Such a sister-state divorce is often obtained by means of a synthetic domicile established by purely formal gestures.

33. The court distinguished this case from those involving mail-order decrees or ex parte decrees, in which domicile is not established, or in which there is no personal service of process and submission to the court's jurisdiction by the defendant. Such decrees are still held to be void. Rosenstiel v. Rosenstiel, 16 N.Y.2d 64, 209 N.E.2d 709, 711, 262 N.Y.S.2d 86, 89 (1965); see notes 21-23 *supra*.

34. See note 28 *supra*.

35. Rosenstiel v. Rosenstiel, *supra* note 29, at 76, 209 N.E.2d at 717-18, 262 N.Y.S.2d at 97.

that the compelled acceptance of Nevada decrees provides no reason for the voluntary acceptance of divorces inimical to the state's valid interest. Furthermore, recognition of these divorces is violative of New York's restrictive divorce policy,[36] and amounts to the writing of a new state policy which conflicts with the 160-year-old single-ground divorce statute.[37]

Although the court of appeals faithfully followed twenty-seven years of almost unbroken lower court precedent,[38] this opinion seems contrary to New York's divorce policy as enunciated by that state's legislature, and appears to run counter to the better-reasoned views as to a state's proper interest in the lives of its citizens. *Rosenstiel* is contrary to legislative policy because it allows the easy circumvention of the state's highly restrictive divorce statute. Legislative controls enforcing such policy can be evaded by any New Yorker willing to invest in a one day trip to Juarez.[39] However, the argument is made that a pragmatic consideration of the effect of the ancient divorce statute should be made by the courts. The statute's strict rules, long criticized[40] and probably not attuned to modern attitudes and mores, has caused an exodus of couples with unhappy marriages to forums having more lenient divorce provisions.[41] Judicial recognition of these foreign divorces may be viewed as a compensating factor[42] which adjusts the unique New York statute to modern realities.[43] It may be significant that despite the legislature's awareness of this migratory divorce practice, it has yet specifically to reprimand the courts for their recognition of such decrees.[44] Still, judicial

36. It was felt that New York's prior policy had been to restrict the availability of divorce by not allowing "casual and consensual" divorces, and in so doing to "preserve the family unit." *Id.* at 80, 209 N.E.2d at 720, 262 N.Y.S.2d at 101.

37. It was felt that the statute was defeated because it was now easily evaded. *Id.* at 73, 209 N.E.2d at 715, 15, 262 N.Y.S.2d at 94-95. See N.Y. DOM. REL. LAW § 170. Judge Desmond ruefully noted that acceptance of these divorces put New York "in the uneasy and inappropriate position of sole acceptor of Mexican 'quickie' divorces." Rosenstiel v. Rosenstiel, *supra* at 72, 209 N.E.2d at 714, 262 N.Y.S.2d at 93.

38. See note 27 *supra*. It has been suggested that the conception of marriage as a status, with its corresponding jurisdictional requirement based on domicile, has never been fully accepted in New York. SIEGEL, COMMENTARY ON THE DOMESTIC RELATIONS LAW 15-16 (1964).

39. The average expenditure is about $500. Time, July 25, 1965, p. 62.

40. "New York has divorce laws of unusual stringency considerably mitigated by perjury and collusion. . . . [I]n at least a third of the divorces granted in this State the infidelity is fictitious. . . . These things are the natural consequences of a divorce law which is out of harmony with the present opinion of a large part of the public. . . ." N.Y. Times, April 22, 1922, p. 8, col. 3. A modern commentator characterizes the statute as being "cruel and inhuman" because of its disregard of psychological reality. SIEGEL, *op. cit. supra* note 38, at 18-19.

41. See note 27 *supra*.

42. See Comment, *supra* note 20, at 465.

43. SIEGEL, *op. cit. supra* note 38, at 18.

44. See Rosenstiel v. Rosenstiel, *supra* note 6, at 638, 253 N.Y.S.2d at 209 (appellate division felt that legislature's inaction is significant).

sanctioning of such conduct is apt to foster disrespect for the law; and it certainly discriminates against those lacking the resources for such a maneuver. Any problems caused by the statute can, and should, be remedied by the people, acting through their legislature,[45] but the likelihood of any liberalization of the divorce statute is lessened by the continued acceptance of easily obtained foreign divorces.[46] It must be acknowledged that the court's failure to require that there be at least a "relationship of substantial permanence"[47] between the decree-rendering forum and the marriage status largely destroys the effectiveness of any worthy controls imposed by the New York statute.[48] New York's vital interest in the marriage status of its citizens is in danger of being forfeited because of the voluntary acceptance of divorces rendered by a forum having no such interest.[49] The minority judges seem to have best satisfied the basic value judgments of a rational state divorce policy by their insistence that New York's full control of this marriage not be defeated by the failure to demand a substantially permanent relationship between Mexico and the marriage status of Mr. and Mrs. Kaufmann.

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45. See Comment, 39 CORNELL L.Q. 293, 302-03 (1954). "No Court is licensed to write a new State policy, however attractive or convenient." Rosenstiel v. Rosenstiel, *supra* note 29, at 73, 209 N.E.2d at 715, 262 N.Y.S.2d at 94 (Desmond, J., concurring).

46. "[T]he easier it is made for those who through affluence are able to exercise disproportionately large influence on legislation, to obtain migratory divorces, the less likely it is that the divorce laws of their home states will be liberalized . . . so as to affect all." Sheerer v. Sheerer, *supra* note 10, at 370 n.18 (Frankfurter, J., dissenting).

47. Rosenstiel v. Rosenstiel, *supra* note 29, at 86, 209 N.E.2d at 717, 262 N.Y.S.2d at 97 (Scileppi, J., dissenting). The dissent's refusal to demand technical domicile avoids some of the difficulties inherent in the application of that concept. See Williams v. North Carolina, *supra* note 10, at 258 (Rutledge, J., dissenting) (few legal conceptions afford such possibilities for uncertain application as domicile); Sumner, *supra* note 13, at 14 (no longer a practical base for divorce jurisdiction).

48. See Comment, *supra* note 45, at 302. It is obvious that the New York legislature cannot control the marital status of New York citizens as it ostensibly intended to with the enactment of N.Y. DOM. REL. LAW § 170.

49. The Mexican law pays little heed to the maintenance of the marriage or reasons for its dissolution. Rosenstiel v. Rosenstiel, *supra* note 29, at 71, 209 N.E.2d at 714, 262 N.Y.S.2d at 92 (Desmond, J., concurring). The concepts of domicile and marriage "status" are unimportant in the Chihuahua Law of Divorce. Comment, *supra* note 20, at 463; see Lorenzen, *supra* note 15, at 352-53.

Constitutional Law–Section 504 of LMRDA a Bill of Attainder

Defendant was convicted of violating section 504 of the Labor Management Reporting and Disclosure Act of 1959,[1] which prohibits a member of the Communist Party from serving on the executive board of a labor organization. Defendant openly belonged to the Communist Party during his three terms as a board member of Local 10, International Longshoremen's Union. The Ninth Circuit Court of Appeals, reversing the district court, held that section 504 violated the first amendment by infringing upon freedom of association and the fifth amendment by failing to require specific intent as an element of the crime[2]. On certiorari from the Supreme Court, *held*, affirmed. A penal statute which names with particularity the persons or group on whom its sanction is to fall is a bill of attainder whether the purpose of the sanction is retributive or preventive.[3] *United States v. Brown*, 381 U.S. 437 (1965).

The interpretive history of the constitution's bills of attainder clauses may be divided into two parts. The first began with *Fletcher v. Peck*[4] when the Supreme Court adopted what has come to be known as the "functional" approach,[5] the concept being that the bills of attainder clauses were intended to be very broad prohibitions upon the power of the legislature to punish particular persons or members of an easily identifiable group without the benefit of a judicial trial.[6] Such a view explicitly rejected the contention that "bill of attainder" was capable of narrow historical definition or that the bills of attainder clauses were

1. Labor Management Reporting and Disclosure Act of 1959 (Landrum-Griffin Act) § 504, 73 Stat. 536, 29 U.S.C. § 504 (1964), is entitled "Prohibition against certain persons holding office; violations and penalties." It states: "No person who is or has been a member of the Communist Party . . . shall serve (1) as an officer, director, trustee, member of any executive board . . . of any labor organization . . . during or for five years after the termination of his membership in the Communist Party. . . ." There is a similar provision for certain classes of convicted felons.

2. United States v. Brown, 334 F.2d 488 (9th Cir. 1964), *aff'd*, 381 U.S. 437 (1965).

3. The Court stated that it was unnecessary to consider the first and fifth amendment arguments since decision on the basis of the bills of attainder clause terminated the case. 381 U.S. at 440.

4. 10 U.S. (6 Cranch) 87 (1810). The Court extended, by dictum, the bills of attainder clauses to include bills of pains and penalties.

5. See Note, 72 YALE L.J. 330, 333 (1962). Under the functional approach a court is to look to the results which followed the enactment of a bill of attainder historically, and compare them to the act in question to determine if the bills of attainder clauses are applicable.

6. Cummings v. Missouri, 71 U.S. (4 Wall.) 277 (1866). Thus, a legislative requirement that a person take an expurgatory oath as a condition precedent to preaching in the state was struck down since, having found as to defendant's failure to take the oath, a court would necessarily find defendant guilty. As the legislature had passed the requirement, this amounted to a legislative trial without judicial safeguards.

technical restrictions on the rule-making powers of the legislatures and looked, instead, to the historical results which followed when a bill of attainder was passed.[7] Legislative bodies could make only rules of general applicability, and it was left to the courts to determine what persons fit the general rule. A single exception to the prohibition against naming particular persons or groups was made where general characteristics were expressed by shorthand designation.[8] The second period began with *American Communications Ass'n v. Douds*,[9] where the constitutional definition of bill of attainder was significantly narrowed.[10] The theory of interpretation became a "literal" one on the basis that "bill of attainder" is an historically defined term and the founding fathers intended only to prohibit such legislation as came within the historical definition.[11] *Douds* limited the applicability of the bills of attainder clauses to legislative enactments punishing particular persons or members of an easily identifiable group, which enactment was retributive rather than preventive; was absolute in its operation; and which operated retroactively.[12] *Flemming v. Nestor*[13] further limited the applicability of the bills of attainder clauses by holding that mere denial of a privilege, as opposed to a right, did not constitute punishment for the purpose of interpreting the bills of attainder clauses.[14]

In the instant case, the majority states that the basic purpose of the constitutional prohibition of bills of attainder is to insure a separation of powers.[15] To implement this purpose the Court embraced the broad rule laid down in *United States v. Lovett*[16] that "legislative acts, no matter what their form, that apply either to named individuals or to easily ascertainable members of a group in such a way as to inflict punishment on them without a trial, are bills of attainder prohibited by the Constitution."[17] Moreover, punish-

7. *Id.* at 322.

8. Hawker v. New York, 170 U.S. 189 (1898) (qualifications set up for obtaining a medical license without which one could not practice); Dent v. West Virginia, 129 U.S. 114 (1889) (convicted felons barred from practice of medicine).

9. 339 U.S. 382 (1950) (Communists barred from holding union office).

10. See Note, *supra* note 6. Under the literal approach a bill of attainder is a legislative enactment punishing particular persons or members of easily identifiable groups. The purpose of the act must be retributive, the terms unconditional and the operation retroactive.

11. Green v. Shumway, 39 N.Y. 418, 430-31 (1868) (dissenting opinion).

12. *Supra* note 9.

13. 363 U.S. 603 (1960) (OASDI payments terminated to aliens deported because of Communist Party membership).

14. *Id.* at 617.

15. 381 U.S. at 442-43.

16. 328 U.S. 303, 315-16 (1946) (Congressional act prohibiting payment of further salaries to three named federal employees held to constitute a bill of attainder).

17. 381 U.S. at 448-49.

ment is defined broadly by the Court to include acts which are preventive in nature, as well as those which are retributive.[18] The majority concludes that Congress is limited by the bill of attainder clauses to the making of rules of general applicability;[19] while Congress possesses full legislative authority, the task of adjudication must be left to the courts.[20] In his dissenting opinion, Mr. Justice White adhered to the more recent authority which restricted the applicability of the bills of attainder clauses.[21] He felt that for the purpose of interpreting these clauses, the definition of punishment should be limited to acts the purpose of which was retributive.[22] He also suggested that "Communist" is only a "shorthand designation" for a part of a group likely to cause political strikes; that action against a portion of a broader group has been sanctioned repeatedly;[23] and that the ability of the legislature to use shorthand designations has also been upheld.[24] In discussing the possible ramifications of the holding in the instant case, Mr. Justice White suggested that the conflict of interest statutes[25] have been invalidated by the holding in the instant case.[26] The majority, however, stated that its opinion would have no bearing on the conflict of interest statutes since these statutes deal with general characteristics rather than a specific group of people.[27]

The legislative function is limited to the enactment of the broad rules that will be used by the judiciary. It is the function of the judiciary, on the other hand, to determine in a particular case whether a general rule is applicable. In the instant case, the legislative finding that a member of the Communist Party was one of the group likely to cause political strikes, presupposes a specific finding of fact. While it might well be argued the Communists are likely to cause political strikes, the possibility of controversy over this point in a particular case prohibits legislative action; its determi-

18. *Id.* at 458.
19. *Id.* at 461.
20. *Supra* notes 11 & 17.
21. 381 U.S. at 478 (dissenting opinion).
22. 381 U.S. at 447.
23. 381 U.S. at 474 (dissenting opinion), citing Railway Express Agency, Inc. v. New York, 336 U.S. 106, (1949); Semler v. Oregon State Bd. of Dental Examiners, 294 U.S. 608 (1935); New York *ex rel.* Bryant v. Zimmerman, 278 U.S. 63 (1928); Patrone v. Pennsylvania, 232 U.S. 138 (1941). See also Williamson v. Lee Optical Co., 348 U.S. 483 (1955).
24. Williamson v. Lee Optical Co., 348 U.S. 483 (1955) (unlicensed persons forbidden to fit lenses for glasses except as directed by licensed optometrist; the broad classification includes those unqualified to fit glasses); Board of Governors of Fed. Reserve Sys. v. Agnew, 329 U.S. 441 (1947) (securities broker prohibited from serving as director of member banks in Federal Reserve System; the broad classification includes those subject to conflicting interests in such positions).
25. 18 U.S.C. §§ 205, 208 & 281 (1964).
26. 381 U.S. at 465 (dissenting opinion).
27. *Id.* at 453-54.

nation is reserved by the bills of attainder clauses to the judiciary. Mr. Justice White's analogy of the statute in the main case to the conflict of interest statutes[28] fails. In those statutes, Congress has legislated in broad terms and there is no condemnation of a particular group. All men are subject to the temptations attendant to concurrent holding of two positions where the powers of one position may be used to the benefit of the other; and all men are barred from the holding of certain concurrent positions.[29] The Court properly recognized the advisability of giving more latitude to a statute regulating the business affairs of government than to a statute having the effect of political discrimination. Perhaps the most important aspect of the instant case is that *American Communications Ass'n v. Douds*[30] is overruled as to its narrow definition of the term "punishment": that term now includes acts which are preventive in nature as well as those which are retributive. The distinction between right and privilege made in *Flemming v. Nestor*[31] was also rejected. If, in the future, the Court is presented the questions of whether a legislative act must be retroactive[32] and absolute[33] in order to be found a bill of attainder, it is likely that the answer will be "no" as to those requirements also. The return to the "functional" approach would then be complete.

28. 18 U.S.C. §§ 205, 208 & 281 (1964).

29. Receipt of compensation by members of Congress, officers and others in matters affecting the government is prohibited by 18 U.S.C. § 281 (1964); officials and employees of the government, Congressmen and Senators are prohibited from aiding prosecution of a claim against the government by 18 U.S.C. § 205 (1964); interested persons may not act as government agents by virtue of 18 U.S.C. § 208 (1964); persons involved in issuance, flotation, underwriting, public sale or distribution of securities are barred from positions in member banks of the Federal Reserve System due to 12 U.S.C. § 78 (1964).

30. *Supra* note 9.

31. *Supra* note 13.

32. See text accompanying note 9 *supra.*

33. *Ibid.*

Corporations–DeFacto Merger–Dissenters' Rights –Construction of Merger and Amendment Statutes

Defendant, an Iowa corporation, and Needham Packing Company, a Delaware corporation, sought to combine by means of a "Plan and Agreement of Reorganization" which required substantial charter amendments.[1] These amendments, if accepted, would have transferred control of the combined Rath-Needham Corporation to the former Needham shareholders, cut in half the book value of the former Rath shares, and given the former Needham shares dividend liquidation preference over those of Rath.[2] In compliance with Iowa statutes regulating charter amendments,[3] the proposed action[4] was submitted to Rath shareholders and was approved by the required majority[5] of outstanding shares of Rath. Plaintiffs, minority shareholders of Rath,[6] brought this suit in Iowa to enjoin defendants

1. The Plan and Agreement of Reorganization (hereinafter called the "plan") provided that Rath would: (1) amend its articles of incorporation to double the number of shares of its common stock, to create a new class of preferred shares, and to change its name to Rath-Needham Corporation; (2) issue to Needham 5.5 shares of Rath-Needham common stock and 2 shares of Rath-Needham 80¢ preferred stock for each 5 shares of Needham common stock, in exchange for all of Needham's assets, properties, business, name and good will, (except for a liquidation fund to be used to pay expenses in carrying out the agreement); (3) assume all debts and liabilities of Needham Packing Co.; and (4) elect two Needham officers and/or directors to the Rath-Needham board of directors. In return Needham agreed to: (1) transfer all its assets to Rath (2) cease using its name; (3) distribute the new Rath-Needham shares to its shareholders; (4) liquidate and dissolve the corporation; and (5) turn over to Rath its business records and accounts. Rath v. Rath Packing Company, 136 N.W.2d 410, 412 (Iowa 1965).

2. The practical results of the plan's implementation would have been that: (1) 1,000 Needham shareholders would own approximately 54% of the newly-formed Rath-Needham corporation; (2) the new book value of Needham's old shares would be increased about 4 times, while the new book value of Rath's old shares would be decreased about one-half; (3) in the event of liquidation, shares held by the old Needham shareholders would be preferred to the old Rath shares; and (4) due to issuance of preferred shares only to the old Needham shareholders, those shareholders would be preferred to Rath's in dividend distribution. *Ibid.*

3. IOWA CODE ANN. §§ 496A.17, -.18, -.55, -.56, -.59, -.60 (Supp. 1962). Section 496A.55 authorizes charter amendments, and §§ 496A.56, -.59, -.60 set forth the procedure for amending the charter. Sections 496A.17, -.18 establish guide lines for the issuance of new shares.

4. The "plan" was submitted for shareholder approval in the form of two proposals. The first provided for amending the charter to authorize a class of 80¢ preferred stock, and to increase the authorized number of common shares from 1,500,000 shares of $10.00 par value to 3,000,000 shares of no par stock. The second proposal provided that upon acquisition by Rath of the assets, property, business and good will of Needham, Rath would change its corporate name to Rath-Needham Corporation, and elect Lloyd and James Needham as two of its directors. 136 N.W.2d at 412.

5. See IOWA CODE ANN. § 496A.56 (Supp. 1962). 60.1% of the company's outstanding shares were voted in favor of the two proposals submitted. 136 N.W.2d at 412.

6. Of the 993,185 outstanding shares of Rath Packing Co., held by about 4,000 owners, somewhat more than 6,000 were owned by these four plaintiffs. *Id.* at 411.

from carrying out the plan. Plaintiffs contended that the plan constituted a de facto merger, and hence, that those provisions of the Iowa Code which regulate the execution of a merger[7] had to be satisfied.[8] The trial court held that the proposed combination *could be* accomplished under the merger sections of the Iowa Code. In the alternative, however, it could also be accomplished *solely* under the amendment sections. These two methods, said the trial court, are legally independent and of equal dignity; compliance with the proper sections under either scheme will produce a legal combination. On appeal to the Supreme Court of Iowa, *held*, reversed. The proposed plan so substantially affects the interests of minority shareholders as to require compliance with the merger sections of the Iowa statutes.[9] These sections are the only ones under which a transaction of this type may be legally consumated. *Rath v. Rath Packing Co.*, 136 N.W.2d 410 (Iowa 1965).

At common law, corporations could combine either by the process known as merger[10] or by one corporation selling its assets to another.[11] While easily distinguishable, both methods required unanimous approval of the voting shares of each of the combining corporations. The requirement of unanimous shareholder approval for a merger or sale of assets was gradually reduced until most modern statutes require approval of only two-thirds of the outstanding shares. To compensate for this reduction, however, such statutes require that certain minority protection be granted,[12] including appraisal rights.[13]

7. IOWA CODE ANN. §§ 496A.74, -.68, -.70, -.71, -.73 (Supp. 1962). Section 496A.74 authorizes mergers; § 496A.70 permits every outstanding share to be voted, whether or not such share has voting rights under the articles of incorporation, and requires an affirmative vote of ⅔ of the corporation's outstanding shares to approve a merger; § 496A.77 authorizes appraisal rights for mergers aud sales of all or substantially all of a corporation's assets.

8. Plaintiffs coutended that since this was a de facto merger, they could only receive their legislatively intended minority rights if the "plan" were accomplished under the merger provisions of the Iowa Code. 136 N.W.2d at 413. "Section 496A.77 does not give such a right of dissent [as is provided in merger or consolidation] . . . in event of adoption of an amendment of any kind, no matter how far-reaching or fundamental." IOWA CODE ANN. § 496A.55 (Supp. 1962). See note 13 *infra*.

9. The court did not expressly find the transaction to be a de facto merger; it said ". . . [T]his agreement provides for what *amounts to* a merger of Rath and Needham . . . calling it a Plan and Agreement of Reorganization does not change its essential character." 136 N.W.2d at 415. (Emphasis added.) The court later cites with approval a statement from 15 FLETCHER, CYCLOPEDIA OF CORPORATIONS § 7165.5 (1961), "[T]he courts treat the transaction as a de facto merger or consolidation so as to confer upon dissenting stockholders the right to receive cash payment for their shares." *Id.* at 417.

10. A merger consisted of a combination of two corporations, usually into a new one, with a resulting dissolution of the combining corporations.

11. A sale of assets was an outright purchase of one corporation's assets by another, resulting in dissolution and distribution of the seller corporation.

12. Such rights, rcferred to as "minority protections" in this comment, include the

On the other hand, at common law an amendment of the articles of incorporation was used only to effect internal changes in corporate form. It was an act clearly distinct from merger or sale of assets, and, as under most modern statutes, required only a majority vote for its approval. Thus, the attractiveness of the more easily approved amendment procedure was enhanced by the desire of corporations to avoid the drainage of capital which results from the satisfaction of appraisal demands. It was largely this combination of considerations that led to the utilization of hybrid procedures to effect corporate combinations. These hybrid procedures were composed of selected portions of the statutory amendment and merger provisions of the governing statutes, and were so designed as not to require the incidence of minority rights. If the participating corporations termed the transaction a "merger," minority rights were automatically required by the merger statutes. Many states, however, have recognized that the hybrid means of combination (those not termed as mergers by the parties) can also effect such fundamental changes in corporate structure that minority shareholder protections should be extended to various non-merger forms of combination. As a result, althought the ABA Model Business Corporations Act does not require that dissenters to charter amendments be granted minority rights,[14] such rights are available for specific types of amendments

requirement of a two-thirds vote in favor of merger proposals; allowance of class voting on amendments which affect that class of shares; allowance of shares to vote which are not otherwise entitled to do so, and/or the granting of appraisal rights.

13. "Rights of appraisal enable a dissenting shareholder to withdraw from a corporation rather than continue in a venture different from the one he embarked upon, or on terms different from those in the contract he originally accepted." N.Y. BUS. CORP. LAW, appendix 2, at 251 (1965). Generally, appraisal rights allow the dissenting shareholder to be paid the fair value of his shares as of the day prior to the date on which the vote on the proposed action was taken. This date is chosen because it tends not to reflect the market changes which occur due to an anticipated change in the corporate structure.

14. The dissenting shareholder section of the ABA Model Business Corporation Act provides only that:

"Any shareholder of a corporation shall have the right to dissent from any of the following corporate actions: (a) any plan of merger or consolidation to which the corporation is a party; or (b) any sale or exchange of all or substantially all of the property and assets of the corporation not made in the usual and regular course of its business, including a sale in dissolution, but not including a sale pursuant to an order of the court having jurisdiction in the premises or a sale for cash on terms requiring that all or substantially all of the net proceeds of sale be distributed to the shareholders in accordance with their respective interests within one year after the date of sale. A shareholder may dissent as to less than all of the shares registered in his name. In that event, his rights shall be determined as if the shares as to which he has dissented and his other shares were registered in the name of different shareholders. . . ." MODEL BUS. CORP. ACT § 73.

This section of the Model Act has been adopted in Alabama, Alaska, Colorado, Illinois, Iowa, Maryland, Mississippi, Nebraska, North Dakota, Oregon, South Carolina, Texas, Utah, Virginia, Wisconsin and Wyoming.

under the recently enacted New York[15] and North Carolina[16] Business Corporations Acts. Other states, while not enumerating specific types of amendments, allow such minority rights only in the case of "substantial" changes by amendment.[17] When the transaction clearly satisfies one of the above tests, or is termed a merger by the parties, minority rights are required by operation of the statute. Thus, the problem of whether these rights are to be accorded shareholders arises only when two corporations combine in such a manner that the transaction is *not* clearly identified as a "merger" by the parties, does *not* involve one of the enumerated amendments, or does *not* clearly satisfy the "substantial" test. When the question does arise, the courts employ one of three methods to justify their imposition of minority rights.[18] One such theory emphasizes the factual similarity between the challenged transaction and the customary incidents and definition of merger. Some courts employ this method to find the existence of a de facto merger[19] and to justify their imposition of minority rights.[20] Alternatively, some courts employ a theory which

15. New York includes among the enumerated amendments requiring dissenters rights those which alter or abolish a shareholder's preferential redemption, or pre-emptive rights; alter or abolish his right to vote; cause a prejudicial increase in the priorities, dividend preferences, cumulative dividend rights, or redemption and liquidation value of other classes of stock. N.Y. BUS. CORP. LAW § 806(b)(6). New York statutes, however, in line with the Model Act, no longer grant appraisal rights where a sale of assets is for cash distribution within one year.

16. North Caroliua's enumeration includes ameudments which have certain specified effects on dividends, or alter the basic nature of the corporation. This act further requires that the notice of the shareholder meeting at which the vote is to be taken include notice of § 55-113, including notification of the appraisal rights of a dissenter; and it establishes an action for damages against the corporation in the event of failure to comply with these requirements. N.C. GEN. STAT. §§ 55-101, -108, -112, -113, -119 (1965).

17. See *e.g.*, TENN. CODE ANN. § 48-712 (1964). The "substantial" test, however, does seem to reach most amendments. See, *e.g.*, Johnson v. De Soto Hardwood Flooring Co., 167 Tenn. 145, 67 S.W.2d 143 (1943), where it was held that an amendment permitting the issuance of additional stock gave rise to dissenters' rights.

18. The key source of the rights sought by this type of action are the merger statutes. These statutes generally predicate the grant of minority protection upon the finding of the existence of a merger, either real or de facto. Thus, whether the court construes the transaction to fit the merger definition, or construes the merger statutes as being the only ones applicable to the particular challenged transaction under the facts of the case, there must be an actual or implicit finding of some form of a merger.

19. A de facto merger is a combination not denominated a merger by the parties, but whose terms are found by the court to constitute a merger in fact. A de facto merger must be distinguished from a true merger which is a method of combination characterized as merger by the parties, and consummated under the merger sections of the applicable corporations statutes.

20. See Metropolitan Edison Co. v. Commissioner, 98 F.2d 807 (3d Cir. 1938) (transaction involving transfer of assets and franchises in return for assumption of debts and return and cancellation of capital stock, accompanied by dissolution of the seller, was a merger rather than a sale of assets); Applestein v. United Board & Carton Corp., 60 N.J. Super. 338, 159 A.2d 146 (1960) (dissolution of the seller,

views the problem as one of according minority shareholders their rightful common law protections in the face of combinations which are excessively disruptive of minority interests.[21] The third group justifies their imposition of minority rights by construing the merger sections as being the only ones applicable under the facts of the particular case.[22] This view emphasizes statutory construction as opposed to the factual similarity theory, which stresses an examination of the factual situation.

After quoting with approval four definitions of merger,[23] Chief Justice Garfield held that the plan in the instant case *amounted* to a de facto merger.[24] The court then employed three alternative lines of reasoning to justify its conclusion that the plan could be consumated only under the merger provisions with their attendant protection of minority rights. First, because a merger approved by fewer than all of the shareholders is in derogation of the common

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distribution of the purchase shares, and passage of control held to be indicative of a de facto merger); Farris v. Glen Alden Corp., 393 Pa. 427, 143 A.2d 25 (1958) (when transaction results in one corporation's dissolution, assumption of the seller's liabilities by the buyer, passage of control to the survivor, and the seller's shareholders acquiring shares in the survivor, it is a merger).

21. Farris v. Glen Alden Corp., *supra* note 20, suggests as an alternative to the finding of á de faeto merger that when the nature of the corporation is changed by a combination, and plaintiff would have stock in a totally different business thrust upon him, he has a right to dissent and be allowed out of the business. See Marx v. Autocar, 153 F. Supp. 768 (E.D. Pa. 1954), where failure to file merger articles with the Secretary of State and thus complete statutory procedure for a merger, which would guarantee appraisal rights, does not preclude an action for plaintiff's appraisal rights under common law principles. *But cf.*, Heilbrunn v. Sun Chemical Corp., 37 Del. Ch. 552, 146 A.2d 757 (1958), *aff'd*, 38 Del. Ch. 321, 150 A.2d 755 (1959) (plaintiff's failure to show injury precluded him from being granted appraisal rights).

22. See *e.g.*, Bloch v. Baldwin Locomotive Works, 75 Pa. Dist. & Co. R. 24 (1950). "(D)efendant has not brought himself within the terms of the statute. Therefore, the dissenting shareholder stands helpless to protect his rights unless and until some way is found to determine whether a merger is *in fact* taking place. The court of equity has been given . . . authority . . . to determine . . . the fair value of a dissenting shareholder's shares of stock. We see no reason, therefore, why equity should not also have authority to determine whether or not a merger has *in fact* taken place, where the statute is not followed by the corporation involved." The court then found that the challenged transaction must give rise to appraisal rights.

23. 136 N.W.2d at 415. The court cites the following definitions: (1) "[A] merger exists where one corporation is continued and the other is merged with it, without the formation of a new corporation, from a sale of the property and franchises of one corporation to another." (2) "A merger of corporations consists of a combination whereby one of the constituent corporations remains in being—absorbing or merging in itself all the other constituent corporations." (3) "[A] merger signifies the absorption of one corporation by another, which retains its name and corporate identity with the added capital, franchises and powers of a merged corporation." and "[Merger] is the uniting of two or more corporations by the transfer of property to one of them, which continues in existence, the others being merged therein." *Ibid.*

24. *Supra* note 9.

law, the court concluded that the rule of strict construction requires that legislative authority to merge be "clearly, distinctly and expressly conferred."[25] Although the merger sections of the Iowa Code expressly confer such power, the amendment sections have no such express authorization for a combination or a merger-type transaction.[26] Second, the court stated that statutory provisions which specifically treat a subject must prevail over those which treat the subject generally.[27] The merger sections provide specifically for corporate combinations, while the amendment sections make no such specific reference to any form of combination. Third, the court reasoned that the rule requiring all parts of a statute to be given effect dictates that the amendment sections and the merger sections be interpreted to refer to distinct types of transactions.[28] The court concluded that it was unreasonable to ascribe to the legislature an intent to provide, in the same statute, an alternative method of corporate combination which permitted the evasion of the specific rights protected in the merger sections.[29] Therefore, this plan, which *amounted to* a de facto merger, must comply with the procedures and safeguards set forth in the merger sections of the Iowa Code.[30]

The court in this case employed the statutory construction method[31] to justify its imposition of minority rights, rather than employing the de facto merger method which requires an examination of the characterizing elements of the challenged transaction. As both theories are ultimately founded upon the term "merger,"[32] a grant of minority rights is thus conditioned upon the characterization of a transaction as a form of a merger, either real or de facto. The utilization of such an ill-defined and ambiguous term as "merger," as a standard to determine when minority rights should be granted,

25. 136 N.W.2d at 415.

26. The court concluded that, at best, the amendment sections might be said to contain *implied* merger authority; but even this is insufficient, since nothing less than expressed authorization will justify such a derogation of the common law. *Id.* at 416.

27. The court cited the following rule of construction: "[W]here one section of a statute treats specially and solely of a matter, that section prevails in reference to that matter over other sections in which only incidental reference is made therein. . . ." *Ibid.*

28. The court reasoned that the special merger provisions are a qualification of the general amendment provisions, and hence that merger must refer to a transaction entirely distinct from an amendment. *Ibid.*

29. "The legislature could hardly have intended to vest in corporate management the option to comply with the requirements . . . or to proceed without such compliance." 136 N.W.2d at 417.

30. The court found it unnecessary to examine the question of the effect of a requirement in Rath's charter that a two-thirds vote was necessary to effect a merger, but added by way of dictum that it perhaps afforded the plaintiffs additional grounds for relief. *Id.* at 418.

31. See text accompanying note 22 *supra*.

32. See note 16 *supra*.

encourages hybridization of the forms of corporate combination. This hybridization in turn creates a potential for the denial of these rights.[33] The struggle with which the courts are confronted in attempting to justify the imposition of minority rights is indicative of the lack of a suitable standard for determining when corporate combinations are such as may require that the minority shareholder be protected. In reality, the need for minority protections arises when a proposed combination will cause an alteration of the fundamental intra-corporate relationships. Hence, the presence of these potential effects—any substantial alteration of the fundamental nature of the corporation,[34] or of the shareholders' relationships with it—[35] would provide a more appropriate test to determine when minority rights should be granted. This test would provide for minority rights whenever *any* proposed alteration of the corporate structure (not necessarily only a combination) would force shareholders to engage in a substantially different corporation or corporate venture, or to participate on substantially different terms than those which he originally accepted. Against the obvious shareholder interests favoring such a test must be balanced the contrary corporate interests favoring maximum freedom from the constrictions on corporate activity which are implicit in minority rights. For example, the threat of utilization of minority rights enables small groups of shareholders to bloat their influence in corporate control battles.[36] Such a threat can prohibit a small corporation from absorbing a larger one when an adverse effect on the shareholders' interests is necessary as an inducement for the bargain.[37] The implicit threat that minority rights may

33. Hybrid combinations may accomplish the same results as a merger, but without the incidence of minority rights. If no aspect of the transaction requires the allowance of minority rights, and the procedural requirements of the merger statute are not satisfied, then the resulting hybrid combination need not be characterized as a merger by the parties, and minority rights need not be granted. If, however, the transaction is challenged, and the court finds some form of a de facto merger, or finds the merger statutes to be applicable to this combination, then minority rights must be granted. See note 20 *supra*.

34. The nature of the corporation refers to its function as a production or holding company, its primary product (transportation, steel, etc.), or any of the other essential characteristics of any given company. Changes in the basic nature would include—in addition to changes in the above—changes in the total output of the products of the company, both in quantity and/or variety, etc.

35. For types of shareholder interests and relationships potentially affected, see notes 15 & 16 *supra*.

36. The threat of demanding appraisal satisfaction with the consequent drain on capital provides a weapon for use in forcing management to the minority shareholders' viewpoint. Two-thirds voting requirements often result in expensive and time-consuming proxy battles, neither of which is beneficial to the corporation. The threat of a proxy battle for corporate control is itself a powerful weapon for minority use.

37. The shareholder, faced on the one hand with a dilution in his interests by the corporation, and on the other with a substantial reduction in the market value of his shares due to anticipation of the proposed action, may find it in his best interest to

be invoked also reduces the confidence of corporate management in its position relative to its shareholders. Such confidence is highly desirable if management is to bargain effectively in potential combination situations.[38] Lastly, if minority rights were actually invoked, satisfaction of appraisal demands could well remove the corporate capital necessary to consummate the proposed transaction.[39] The choice, then, seems to be one of emphasizing either maximum freedom for corporate activity, or the ability of the shareholder to protest effectively, and, if still dissatisfied, to withdraw from the corporation without financial loss. A court, faced with this choice, is also faced with additional problems of attempting to formulate a just solution in a particular case, and of attempting to provide certainty in the law. The proposed standard is sufficiently flexible to allow a just solution for both parties; yet its emphasis on the substantive effect of the proposed transaction on a shareholder provides both parties with a standard which is relatively easy to determine. This resulting ease of application adds certainty to the law and predictability to shareholder-corporation relations, and permits a degree of justice that should be satisfying to all parties concerned.

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attempt to block the combination. The instant case provides an excellent example of such market devaluation in anticipation of a combination. The plaintiff's $10 par stock dropped to a point where it was selling for only about one-half the price of Needham, the corporation to be absorbed.

38. The ability to bargain with full confidence is of the utmost importance in obtaining a favorable bargain. If the directors must fear minorities within their own corporation, the strength of their bargaining position must be materially reduced, as they can no longer make and receive offers, and the like, with the necessary freedom of action and definiteness of position.

39. Many corporations which are forced by inadequate capital reserves to seek a merger, are manifestly unable to settle substantial appraisal demands without sustaining a critical drain of capital. Such a drain may be sufficient to prohibit the combination or may remove the capital necessary to make the combination advantageous.

Criminal Law–Search and Seizure–Standing Granted for Dyer Act Prosecutions Without Allegation of Possession

Defendant was convicted in Wyoming of knowingly transporting a stolen vehicle across state lines, in violation of the Dyer Act.[1] The automobile had been searched by the FBI without a warrant, and the information obtained was used to determine that the car was stolen. Prior to trial, the federal district court denied defendant's motion to suppress evidence obtained by an unauthorized search in violation of the fourth amendment.[2] The Court of Appeals for the Tenth Circuit reversed. On petition for rehearing the government alleged that defendant lacked standing to challenge the search. *Held*, a prosecution for a Dyer Act violation is one for possession, and as such gives standing to invoke the fourth amendment. *Simpson v. United States*, 346 F.2d 291 (10th Cir.), *rehearing denied*, 346 F.2d 295 (1965).

The federal protection against illegal search and seizure is a personal right, protecting only those with the proper interest.[3] Such interest or standing is necessary to challenge the admissibility of illegally obtained evidence. Standing traditionally requires a possessory interest in the searched premises, or ownership or possession of the thing seized.[4] In the past, certain "crimes of possession," such as the possession of contraband, presented a dilemma to the accused under this rule; for to assert possession and obtain standing meant confessing guilt, while denial of possession resulted in the admissibility of evidence obtained in what may have been an unlawful search.[5] In *Jones v. United States*,[6] the Supreme Court met this

1. "Whoever transports in interstate or foreign commerce a motor vehicle or aircraft, knowing the same to have been stolen, shall be fined not more than $5000, or imprisoned not more than five years, or both." 18 U.S.C. § 2312 (1964).

2. Two searches had in faet been made, both of which the court found to be clearly unlawful. They were without warrant and not justifiable as incident to the arrest since the automobile was remote in location, and the federal investigation was on a state arrest. The fruits of the unlawful searches included all of the information used in the prosecution. There was some question as to the propriety of the arrest, but the court did not decide the point. Simpson v. United States, 346 F.2d 291, 293-94 (10th Cir. 1965).

3. "There can be little disagreement with the basic premise . . . the rights assured by the fourth amendment are personal rights and may be invoked only by 'the person whose rights have been invaded . . . .' Coon v. United States, 36 F.2d 164, 165 (10th Cir. 1929)." Edwards, *Standing To Suppress Unreasonably Seized Evidence*, 47 Nw. U.L. REV. 471-72 (1952).

4. See United States v. Pisano, 193 F.2d 361, 365 (7th Cir. 1951) (possession of narcotics); Coon v. United States, *supra* note 3 (search of non-leased premises). See also 59 MICH. L. REV. 444 (1961).

5. See Judge Hand's famous expression of this dilemma, Connolly v. Medalie, 58

problem squarely, forbidding the government's assertion of such contradictory positions. There the defendant, charged with a crime of possession, was automatically granted standing without an allegation of possession.[7] Subsequent decisions have applied this exception to the standing requirement.[8] It may be noted that problems of standing are avoided in California by excluding all illegally obtained evidence, regardless of whether it was obtained in violation of the particular defendant's constitutional rights.[9]

In the instant case, the definition of "crime of possession" was extended to include violations of the Dyer Act. In its first opinion, the court found standing in defendant's claim of a possessory interest in the automobile.[10] On petition for rehearing, however, the majority found no need for defendant to claim any possessory interest, as the nature of the prosecution conferred standing to challenge evidence obtained in the searches. The court held that as in *Jones*, possession was sufficient to convict; therefore, no allegation of a possessory interest was required.[11] The dissent correctly pointed out, however, that mere *possession* of a stolen car is not a Dyer Act violation; *knowingly transporting* a stolen vehicle in interstate commerce constitutes the crime.[12] This argument would take the instant case out of the *Jones* exception and require the defendant to have a possessory interest in the automobile to obtain standing.

In extending *Jones*, the court demonstrated a desire to protect the defendant under the fourth amendment. "Crime of possession," however, was unfortunately and inaccurately stretched to include Dyer

F.2d 629-30 (2d Cir. 1932); see generally 14 VAND. L. REV. 418 n.6 (1960) (list of courts of appeal decisions previously applying the dilemma). *But see* United States v. Dean, 50 F.2d 905 (D. Mass. 1931) (the only court refusing to permit this situation).

6. 362 U.S. 257, 263-64 (1960).

7. "The same element in this prosecution which has caused a dilemma, *i.e.*, that possession both convicts and confers standing, eliminates any necessity for a preliminary showing of an interest in the premises searched or the property seized, which ordinarily is required when standing is challenged . . . ." *Id.* at 263.

8. Henzel v. United States, 296 F.2d 650-51 (5th Cir. 1961) (possession of fraudulent corporate records); Coutreras v. United States, 291 F.2d 63, 65 (9th Cir. 1961) (possession of marijuana); United States v. Festa, 192 F. Supp. 160, 164 (D. Mass. 1960) (possession of papers in violation of the Wagering Tax Act).

9. People v. Martin, 45 Cal. 2d 755, 290 P.2d 855 (1955). For a discussion of the rule, see Note, 9 STAN. L. REV. 515, 535 (1957).

10. Simpson v. United States, *supra* note 2, at 294.

11. *Id.* at 295.

12. The majority held that possession was sufficient to infer guilt on the basis of Reese v. United States, 341 F.2d 90, 92 (10th Cir. 1965). The dissent criticized this inference as merely fixing the quantum of proof necessary to create a jury question. Simpson v. United States, *supra* note 2, at 300 (dissenting opinion). It might be noted that one case relied upon by the dissent on another issue was vacated by the Supreme Court one month before the rehearing, but after the first opinion in the instant case. Murray v. United States, 333 F.2d 409 (10th Cir. 1964), *vacated*, 85 Sup. Ct. 1345 (1965).

Act violations. Unlike possession of narcotics, mere possession of a stolen automobile will not support a conviction. Yet the exclusion of the illegally seized evidence was the correct result. The court's reasoning dramatically reflects the difficulties presented by an adherence to the traditional possessory interpretation of standing. A more desirable alternative would be to adopt the California procedure, making inadmissible all illegally obtained evidence regardless of the defendant's possession.[13] Under such a rule, future decisions would not turn on a further redefinition of crimes of possession, but would look to the real interest of the defendant in not having such evidence admitted against him. Law enforcement officers could no longer trade the release of one criminal able to challenge evidence for a conviction of a third party not having a so-called possessory interest.[14] Courts could apply a clearly defined, workable standard in contrast to the now complex and ill-defined rule of standing. Two objections to such a change are apparent: the burden which would be placed upon law enforcement agencies in obtaining evidence, and the judge-made prohibition against the assertion of third-party rights. When the increased difficulty of securing evidence is balanced against the desirability of protecting the rights of the accused, the burden of obtaining evidence legally does not seem unduly harsh. California law enforcement has not been hampered by the rule.[15] In recent years, the Supreme Court has increasingly permitted third-party assertion of constitutional rights where a "fundamental right"[16] would otherwise have been unprotected. The liberty of parents to direct the education of their children was held properly asserted by two private schools.[17] A Caucasian successfully relied upon the invasion of fourteenth amendment rights of a non-Caucasian to defend the breach of a racially-restrictive covenant.[18] And a doctor had standing to attack a state contraceptive law by asserting the rights of a husband and wife to whom he had given advice.[19] Protection from unlawful search and seizure seems no less a fundamental right than those cited above. Courts unable to rationalize assertion of third-party rights could alternatively find an individual right which would give standing to challenge the admissibility of evidence. This right would be based on the risk of conviction, *i.e.*, a personal interest in being free from

13. See note 9 *supra* and accompanying text.

14. For a discussion of this point and the suggested rule change, see 59 MICH. L. REV. 444-46 (1961).

15. Note, *supra* note 9, at 537.

16. Barrows v. Jackson, 346 U.S. 249, 257 (1952).

17. Pierce v. Society of Sisters, 268 U.S. 510 (1925).

18. Barrows v. Jackson, *supra* note 16.

19. Griswold v. Connecticut, 381 U.S. 479 (1965).

prosecution by illegally seized evidence.[20] By either rationale, a complete exclusionary rule would end the confusion surrounding "interest" in the property seized or the premises searched and the significance of the crime being "one of possession." The unworkable fiction of standing would be abolished, and fourth amendment rights would finally be accorded adequate protection.

Damages–Restitutionary Relief for Breach of Contract Granted Under the Tucker Act to a Government Contractor

Plaintiff, Acme Process Equipment Co., was awarded a Government contract for the manufacture of 75 mm. recoilless rifles.[1] Shortly thereafter the Government cancelled the contract,[2] and Acme instituted this suit in the Court of Claims under the Tucker Act,[3] alleging an unjustifiable breach of contract.[4] Rather than ask-

20. This criminal law rule would be analogous to the standing requirement of "adversely affected interests" common in administrative law. See Administrative Procedure Act § 10, 60 Stat. 243 (1946), 5 U.S.C. § 1009(a) (1964) ("any person suffering legal wrong . . . or adversely affected or aggrieved"); Federal Communications Act § 12, 72 Stat. 945 (1958), 47 U.S.C. § 402(b) (1964) ("any . . . person who is aggrieved or whose interests are adversely affected"); Federal Aviation Act § 1009, 72 Stat. 796 (1958), 49 U.S.C. § 1489 (1964) ("all persons interested in or affected by"); DAVIS, ADMINISTRATIVE LAW §§ 199-209 (1951) (critique of standing requirements in administrative law). A defendant in a criminal prosecution would undoubtedly be "aggrieved" by the introduction of unlawfully obtained evidence, the public interest being adverse to that of the defendant. Such an approach would revitalize the exclusionary rule of Weeks v. United States, 232 U.S. 383 (1914), properly giving all defendants the right to be free from prosecution by illegally seized evidence, and affording a logical alternative to the rule permitting assertion of fundamental third-party rights.

1. Acme in its first venture as a defense contractor had been awarded a contract for the production of elevating and traversing assemblies. When the Government cancelled this contract for its own convenience, Acme sued and recovered its costs. Acme Process Equip. Co. v. United States, 347 F.2d 538 (Ct. Cl. 1965). This comment is devoted solely to the damages aspect of Acme's suit of the 75 mm. recoilless rifle contract.

2. The Government claimed that violations of certain statutes and covenants by Acme rendered the contract voidable. Acme Process Equip. Co. v. United States, 347 F.2d 509, 514-28 (Ct. Cl. 1965). Since Acme remained unreimbursed for the majority of its investment in performance of the contract, cancellation had the effect of financially crippling Acme.

3. The Tucker Act, 28 U.S.C. § 1491 (1964), provides that "the Court of Claims shall have jurisdiction to render judgment upon any claim against the United States founded either upon the Constitution, or any Act of Congress, or any regulation of an executive department, or upon any express or implied contraet with the United States, or for liquidated or unliquidated damages in cases not sounding in tort."

4. Acme alleged the Government cancelled the contract solely to enable it to escape

ing the usual compensatory damages, which, by putting Acme in its post-contract condition, would inadequately compensate for the large losses it incurred prior to the wrongful cancellation, Acme sought restitutionary relief based on its actual costs.[5] The Government contended that this relief was not available under the Tucker Act and that even if it were, recovery could not exceed the value of the goods Acme had delivered and must not exceed under any circumstances the contract rate. *Held,* where the Government unjustifiably breaches its express contract, restitutionary relief is available under the Tucker Act, the amount of which relief is measured by the reasonable value of the contractor's services and is not controlled by the contract price.[6] *Acme Process Equipment Co. v. United States,* 347 F.2d 509 (Ct. Cl. 1965).

Prior to the enactment of the Tucker Act in 1887, the doctrine of sovereign immunity required that the federal government not be brought into court for breach of contract without its consent.[7] The Tucker Act empowered the Court of Claims,[8] *inter alia,* "to render judgment on any claim against the United States founded . . . upon any express or implied contract with the United States . . . ."[9] Since

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an undesirable contract for obsolete weapons without cost. The court concluded that two reasons existed for the cancellation: obsolescence of the 75 mm. rifle and suspicion of Acme's fraud.

5. Since projections showed that it could have reduced the large losses suffered had it been permitted to complete the contract, Acme argued that damages placing it in its post-contract position would not be sufficient compensation for such injuries sustained due to the wilful breach of the Government. These losses resulted from the heavy initial expenditures required to transform Acme's operating basis from a civilian market to the field of Government defense procurement. Among these expenses were those incurred for plant conversion, retooling of all plants, training of new personnel and similar items enabling Acme to successfully modify its system of operation.

6. The case was remanded to the trial commissioner for a determination of the reasonable value of Acme's services.

7. For an excellent discussion of the effect that sovereign immunity has had on the available remedies against the United States, see Note, 70 HARV. L. REV. 827 (1957).

8. The Court of Claims Act of 1855, 10 Stat. 612, which established the Court of Claims, was the first waiver of governmental immunity. For detailed treatment of the changes made by the Tucker Act in the court's jurisdiction, see Dooley v. United States, 182 U.S. 222, 223-24 (1901); United States v. Jones, 131 U.S. 1, 15-18 (1888); H.R. REP. No. 1077, 49th Cong., 1st Sess. 4 (1886).

9. 28 U.S.C. § 1491 (1964). Although the statute's reference to implied contracts has repeatedly been interpreted to encompass only contracts implied in fact and not contracts implied in law, *i.e.,* quasi-contracts, the Court of Claims has exercised jurisdiction in situations where a contract very similar to quasi-contract formed the basis of the dispute. See, *e.g.,* New York Mail & Newspaper Transp. Co. v. United States, 139 Ct. Cl. 751, 154 F. Supp. 271, *cert. denied,* 355 U.S. 904 (1957) (recovery on contract for rental by government of pneumatic tubes); Hughes Transp., Inc. v. United States, 128 Ct. Cl. 221, 121 F. Supp. 212 (1954) (recovery of freight charges in motor vehicle contract). *But see* Sutton v. United States, 256 U.S. 575 (1921) (no recovery on Government coutract for dredging and excavating); Hickman v.

the United States has thus given its consent to be sued on implied and expressed contracts, the same remedies are available to the plaintiff suing the Government for breach of such contracts as would be available were the plaintiff suing an individual.[10] It is well settled that restitution, specific performance, and damages are available as alternative remedies for breach of contract.[11] In awarding the remedy of damages, the court puts the party in the position it would be if the contract had been fully performed, *i.e.*, its post-contract position; but restitutionary relief restores the innocent party to his *status quo ante, i.e.*, his pre-contract position.[12] Although litigation under the Tucker Act has resulted in restitution being granted for the breach of implied contracts,[13] until the present case restitution has not been allowed under the act for the breach of an express contract.[14] In determining the proper measure of restitutionary relief, a majority of courts hold that the reasonable value of the part performance rendered under the contract controls recovery,[15] and that such amount is not limited by the contract rate where the breach occurred before the plaintiff had rendered complete performance.[16]

United States, 135 F. Supp. 919 (W.D. La. 1955) (no recovery for contract implied in law to pay for mineral rights). See generally Mewett, *The Quasi-Contractual Liability of Governments*, 13 U. TORONTO L.J. 56-63 (1959); Note, 49 VA. L. REV. 773, 833-51 (1963).

10. See, *e.g.*, United States v. Standard Rice Co., 323 U.S. 106 (1944); Perry v. United States, 294 U.S. 330, 352 (1935); *In re* Floyd Acceptances, 74 U.S. (7 Wall.) 666, 675 (1868).

11. That restitution is simply one remedy for breach of contract is recognized by the courts as well as the legal scholars. See *e.g.*, Southern Painting Co. v. United States *ex rel.* Silver, 222 F.2d 431 (10th Cir. 1955) (recovery of reasonable value of services performed before wrongful discharge); United States *ex rel.* Susi Contracting Co. v. Zara Contracting Co., 146 F.2d 606 (2d Cir. 1944) (recovery for work performed in an airport construction contract with the United States); Pelletier v. Masse, 49 R.I. 408, 143 Atl. 609 (1928) (recovery of value of materials furnished in a construction contract). See also 5 CORBIN, CONTRACTS §§ 1102-21 (1964) [hereinafter cited as CORBIN]; 5 WILLISTON, CONTRACTS §§ 1454-85 (rev. ed. 1937); RESTATEMENT CONTRACTS §§ 347-57 (1932).

12. For commentary on this distinction, see *e.g.*, McDonald v. Kansas City Bolt & Nut Co., 149 Fed. 360 (8th Cir. 1906); Dooley v. Stillson, 46 R.I. 332, 128 Atl. 217 (1925); see generally 5 CORBIN, § 1102; 5 WILLISTON, *op. cit. supra* note 11, § 1454; RESTATEMENT, CONTRACTS §§ 326, 347 (1932).

13. See, *e.g.*, New York Mail & Newspaper Transp. Co. v. United States, *supra* note 9, at 276.

14. See note 21 *infra*.

15. See, *e.g.*, Chicago v. Tilley, 103 U.S. 146 (1880); Houston Lumber Supply Co. v. Wockenfuss, 386 S.W.2d 330 (Tex. Civ. App. 1965); *In re* Voss' Estate, 20 Wis. 2d 238, 121 N.W.2d 744 (1963); RESTATEMENT, CONTRACTS § 347 (1932). For a summary of authority, see 5 WILLISTON, *op. cit. supra* note 11, § 1459, at 4077 n.6.

16. See, *e.g.*, United States *ex rel.* Susi Contracting Co. v. Zara Contracting Co., *supra* note 11; Johnston v. Star Bucket Pump Co., 274 Mo. 414, 202 S.W. 1143 (1918) (recovery on construction contract for work done allowed beyond contract price); Clark v. Mayor of New York, 4 N.Y. 339 (1850) (recovery on public works contract not confined to contract rate); 5 CORBIN § 1112, at 597 n.51, §1113, at 602

The minority view, however, regards the contract rate as the maximum recovery, making no exception for the case where part performance has been stopped short of full performance by a wilful breach.[17] In measuring the reasonable value of the services rendered, the actual cost is often used by the court;[18] however, a reduction of recovery will generally be allowed if the defendant is able to prove that the costs incurred by the plaintiff were excessive.[19]

In the instant case, the court, after determining that the Government had unjustifiably cancelled its contract, devoted its attention to the question of Acme's claim for restitutionary relief.[20] Judge Davis pointed out that although restitution is one of the three available remedies for breach of contract, "no past contractor has successfully sought [under the Tucker Act] restitutionary relief for the breach of an express contract."[21] However, he reasoned that since the Tucker Act grants the Court of Claims jurisdiction over suits on express contracts with the United States and does not expressly preclude this form of relief, there existed no jurisdictional bar to the availability of restitutionary relief. While the Government cited several cases in support of denying a *quantum meruit* recovery,[22] the court distinguished these on the grounds that in each case restitution

n.58. However, it is clear that where the plaintiff has completely performed the contract, the contract rate controls the recovery. See, *e.g.*, Dermott v. Jones, 69 U.S. (2 Wall.) 1 (1864); Higgins v. Desert Braemar, 219 Cal. App. 2d 744, 33 Cal. Rptr. 527 (1963); 5 CORBIN § 1110.

17. See, *e.g.*, Keeler v. Clifford, 165 Ill. 544, 46 N.E. 248 (1897) (contract price limiting recovery in a severable grading contract); Noyes v. Pugin, 2 Wash. 653, 27 Pac. 548 (1891) (recovery by an architect for services limited to pro rata share of contract). For additional cases, see 5 CORBIN § 1113, at 603 n.59; see generally Palmer, *The Contract Price as a Limit on Restitution for Defendant's Breach*, 20 OHIO ST. L.J. 264 (1959).

18. See, *e.g.*, United States *ex rel.* Susi Contracting Co. v. Zara Contracting Co., *supra* note 11, at 611; United States *ex. rel.* Arc & Gas Welder Ass'n, Inc. v. Blount, 182 F. Supp. 648 (D. Md.), *aff'd sub nom.* Arc & Gas Welder Ass'n Inc. v. Green Fuel Economizer Co., 285 F.2d 863 (4th Cir. 1960), *cert. denied*, 366 U.S. 919 (1961); United States *ex rel.* Wander v. Brotherton, 106 F. Supp. 353, 354-55 (S.D.N.Y. 1952).

19. *Cf.* Barrett Co. v. United States, 273 U.S. 227, 235 (1927); United States v. Behan, 110 U.S. 338, 345-46 (1884). Most cases hold that where the costs are due to inefficiency or extravagance, they are excessive.

20. 347 F.2d at 528-38. The case is divided into two sections: (1) Cancellation of the contract, and (2) Acme's damages. As stated in note 1 *supra*, this comment deals only with the latter.

21. 347 F.2d at 529. There appears to be no authority stating that restitution can not be granted for breach of an express contract, but only cases which in dictum reject this form of relief after holding that there had been no breach. See note 22 *infra* and accompanying text.

22. *Quantum meruit* is used here as being synonymous with restitutionary relief in that the amount of recovery is the reasonable value of services given. The following cases were those cited by the Government: Lacchi Constr. Co. v. United States, 102 Ct. Cl. 324 (1944); Frazier-Davis Constr. Co. v. United States, 100 Ct. Cl. 120 (1943); Steel Products Eng'r Co. v. United States, 78 Ct. Cl. 410 (1933).

had been considered only after the court had found that the contract had not been breached, and their conclusions on this question were merely dicta and not controlling.[23] The court also rejected the Government's contention that even if restitution were available, Acme could not qualify for such relief since the contract was for the "production and delivery of finished articles," for the breach of which only damages may be given.[24] It held that the Government had misconceived the nature of the contract, which was in reality a contract not only for a finished product but also for its manufacture, in which case restitution is available.[25] Thus, the court found no authority requiring it to deny restitutionary relief to a contractor injured by the Government's breach of an express contract.

As to the *amount* of recovery, the court refused to limit it to the value of goods Acme had delivered prior to the cancellation, *i.e.*, the benefit received by the Government. Judge Davis concluded that restitution is permitted not to prevent the *breaching* party from retaining an unjust enrichment but "to restore the *innocent* party to its pre-contract *status quo*."[26] Thus, the Government's failure to use or receive the rifles had no effect on the decision, especially since it was the sole wrongdoer. Finally, the court rejected the contract rate as a limitation on recovery, finding that the best means to restore Acme to its pre-contract *status quo* was to permit recovery based on its actual costs, provided that recovery would be appropriately reduced if those costs were excessive.[27]

In allowing restitutionary relief for breach of an express contract, the Court of Claims broadened the remedies available to the government contractor under the Tucker Act.[28] The factual situation in the

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23. 347 F.2d at 529 n.28.

24. 347 F.2d at 529. The *Restatement* makes the following comment: "If the performance required was the production and delivery of a finished article, and the defendant wrongfully prevents completion and delivery of the article, the plaintiff cannot get judgment for the reasonable value of his work and labor in preparation to perform. . . . Such work is not in itself requested or received by the defendant." RESTATEMENT, CONTRACTS § 347, comment *c* (1932).

25. 347 F.2d at 529-30. The court emphasized that Acme is to *"furnish* and deliver" the rifles and that therefore the Government had in effect requested the labor and services reqnired to produce the product.

26. 347 F.2d at 530. See 5 Corbin § 1112; RESTATEMENT, CONTRACTS § 347, comment *a* (1932). However, when the plaintiff is in default, it is clear that recovery is limited to the unjust enrichment of the defendant. See Schwasnick v. Blandin, 65 F.2d 354 (2d Cir. 1933).

27. 347 F.2d at 530; see note 19 *supra*.

28. Although the line of reasoning followed by the court in permitting recovery was direct and logical, it provided no hint as to the policy underlying the refusal to allow this equitable relief to previous plaintiffs. Such reluctance seems to have been based on the traditional view that the Tucker Act granted jurisdiction only for those actions "not sounding in tort"; therefore, no quasi-contractual recovery could be obtained by waiving a tort claim and suing in contract for restitution. See Schillinger

instant case, that is, the heavy losses which could have been substantially lowered had the defendant permitted the completion of the contract,[29] vividly demonstrated the need for restitutionary relief which would restore the injured party to his pre-contract position; it granted the court an opportunity to establish, on a firm basis, the remedy of restitutionary recovery for breach of express contracts. This extension is sound and well supported. One may speculate that in the future the court will similarly permit recovery of *reliance damages*, which are awarded as compensation for injuries caused by a plaintiff's reliance on a breaching party's promise.[30] Such damages are not inconsistent with restitutionary relief and should logically be permitted under the rationale used by the court in the instant case. Undoubtedly, where a plaintiff comes into court in good faith having been severely injured by the wrongful action of the Government, such relief should be available to him.

Federal Employers' Liability Act—Applicability of "In Whole or in Part" Rule of Proximate Cause to Employer's Efforts To Prove Contributory Negligence

Plaintiff brought suit under the Federal Employers' Liability Act[1] in the United States District Court for the Eastern District of Texas to recover for injuries sustained while performing his duties as an employee of the defendant railroad.[2] Under the FELA, the burden was on the plaintiff to prove that the railroad's negligence contributed

v. United States, 155 U.S. 163 (1894). These cases involving "waiver of tort" were not parallel to cases such as the instant one. However, the court permitted restitution as a remedy only after the Supreme Court held that the phrase "not sounding in tort" referred solely to the last class of cases mentioned in the act, *i.e.*, claims for liquidated or unliquidated damages, and not to contract situations. See Dooley v. United States, *supra* note 8; see generally Tretter, *Quasi-Contractural Recovery Against the Government*, 42 CORNELL L.Q. 278 (1957). Thereafter, although the court established restitutionary relief for breach of implied contracts, see New York Mail & Newspaper Transp. Co. v. United States, *supra* note 9, until the instant case it refused to permit such relief in express contract situations.

29. This conclusion was based on projections made by Acme itself. 347 F.2d at 528.

30. *Compare* Security Stove & Mfg. Co. v. American Ry. Express Co., 227 Mo. App. 175, 51 S.W.2d 572 (1932) (recovery of reliance damages), *with* Johnston v. Star Bucket Pump Co., *supra* note 16 (recovery in *quantum meruit*). For an excellent discussion of the applicability of the reliance interest, see Fuller & Perdue, *Reliance Interest in Contract Damages*, 46 YALE L.J. 52 (1936).

1. 35 Stat. 65 (1908), as amended, 45 U.S.C. §§ 51-60 (1964).

2. He was repairing a broken cable on an overhead door in the defendant's warehouse when the door kicked backwards and knocked him off the ladder.

"in whole or in part" to his injury.[3] When the defendant railroad sought to mitigate damages by proving contributory negligence, it was also given the benefit of the "in whole or in part" rule for purposes of proving such negligence.[4] On appeal to the United States Court of Appeals for the Fifth Circuit, *held*, the FELA provides for a single standard of causation which gives both plaintiff and defendant the benefit of the "in whole or in part" rule in showing proximate cause.[5] *Page v. St. Louis Southwestern Ry.*, 349 F.2d 820 (5th Cir. 1965).

The Federal Employers' Liability Act, enacted in 1908, gives the railroad employee[6] a cause of action against his employer based on a system of comparative negligence.[7] Designed as a response to the substantial risks inherent in railroad work, the act attempts to distribute the expense of human injury equitably between the injured employee and the railroad.[8] Although a cause of action under the FELA retains many features of a common law negligence action,[9] the common law defenses have been either greatly modified or abolished by the comparative negligence system, which diminishes plaintiff's recoverable damages in proportion to the amount of negli-

3. Under the FELA the common law definitions of proximate cause have been altered, and a railroad is liable in damages for injuries resulting "*in whole or in part* from the negligence of any of the officers, agents, or employees of such carrier, or by reason of any defect or insufficiency, due to its negligence, in its cars, engines, appliances, machinery, track, roadbed, works, boats, wharves or other equipment." 35 Stat. 65 (1908), as amended, 45 U.S.C. § 51 (1964). (Emphasis added.)

4. Plaintiffs contended that Congress had intended for the employer-defendants to be restricted to the common law definitions of proximate cause in their efforts to prove contributory negligence. At common law proximate cause had no exact definition, but included a mixture of such concepts as natural and probable consequences, foreseeability of harm, the "but for" rule, and the substantial factor test. For a discussion of these concepts, see PROSSER, TORTS §§ 41, 49 & 50 (3d ed. 1964).

5. The case was reversed and remanded on grounds relating to the admissibility of evidence.

6. The 1908 Act applied only to railroad workers, but in 1920 its provisions were extended to seamen. 41 Stat. 1007 (1920), 46 U.S.C. § 688 (1964).

7. "That in all actions hereafter brought against any such common carrier by railroad . . . to recover damages for personal injuries to an employee, or where such injuries have resulted in his death, the fact that the employee may have been guilty of contributory negligence shall not bar a recovery, but the damages shall be diminished by the jury in proportion to the amount of negligence attributable to such employee: *Provided*, That no such employee who may be injured or killed shall be held to have been guilty of contributory negligence in any case where the violation by such common carrier of any statute enacted for the safety of employees contributed to the injury or death of such employee." 35 Stat. 66 (1908), as amended, 45 U.S.C. § 53 (1964).

8. See Sinkler v. Missouri Pac. R.R., 356 U.S. 326, 329 (1958); see generally Griffith, *The Vindication of a National Public Policy Under the Federal Employers' Liability Act*, 18 LAW & CONTEMP. PROB. 160 (1953). State courts have concurrent jurisdiction with the federal courts in these actions. 36 Stat. 291 (1910), as amended, 45 U.S.C. § 56 (1964).

9. This is in contrast to cases under the various workmen's compensation statutes, in which an injured employee need not prove negligence or a causal relationship between the negligence and the injury. See Note, 49 CORNELL L.Q. 542 (1964).

gence attributable to him.[10] As he is thus unable to interpose contributory negligence as a complete bar, the employer has a complete defense only when he is able to show that the negligence of the injured employee[11] or the negligence of a third party[12] was the sole proximate cause of the injury.[13]

Initially, the courts were very reluctant to deviate from common law rules in FELA cases, but the progression of decisions reflects a recognition on the part of the courts that the special features of the FELA action make it significantly different from a common law action for negligence. The United States Supreme Court[14] had little difficulty in defining negligence under the FELA in terms of the common law standard of "lack of due care under the circumstances;"[15] however, the definition of proximate cause has been more troublesome. In *Brady v. Southern Ry.*,[16] the Court adopted a common law definition of proximate cause for FELA cases when it declared that, "it must appear that the injury was the natural and probable consequence of the negligence or wrongful conduct and that it ought to have been foreseen in the light of the attending circumstances."[17] In the decade following this decision, however, there developed a trend to liberalize the requirement of causal connection.[18] Finally, in *Rogers v. Missouri Pacific R.R.*,[19] the Supreme Court admitted that it was not applying common law standards in FELA cases and held that for the purpose of finding negligence on the part of an employer, the test of proximate cause is whether "employer negligence played any part, even the slightest, in producing the injury or death for which damages are sought."[20] This rule obviously makes it easier for the injured employee

10. See note 7 *supra*. The fellow servant doctrine has been abolished as a defense in that the negligence of a co-employee is imputed to the employer. Chesapeake & O. Ry. v. De Atley, 241 U.S. 310 (1916). Although the defense of assumption of risk was available initially, the 1939 amendments abolished it. 53 Stat. 1404 (1939), 45 U.S.C. § 54 (1964); see Tiller v. Atlantic Coast Line R.R., 318 U.S. 54 (1943).

11. Chicago, St.P., M. & O.R.R. v. Arnold, 160 F.2d 1002 (8th Cir. 1947); Lovejoy v. Monongahela Connecting R.R., 137 F. Supp. 42 (W.D. Pa. 1955); Crowder v. Atchison, T. & S.F. Ry., 117 Cal. App. 2d 568, 256 P.2d 85 (1953).

12. Rhinelander v. St. Louis-San Francisco Ry., 257 S.W.2d 655 (Mo. 1953).

13. In the instant case the verdict was for the defendant. Apparently, the jury found that the railroad was in no way responsible for plaintiff's injuries, and that plaintiff's own negligence was the sole proximate cause of his injuries.

14. The determination of what constitutes negligence under the FELA is a federal question. Urie v. Thompson, 337 U.S. 163, 172 (1949); Ellis v. Union Pac. R.R., 329 U.S. 649 (1947); Bailey v. Central Vt. Ry., 319 U.S. 350 (1943). Hence the rule of Erie R.R. v. Tompkins, 304 U.S. 64 (1938), has no application.

15. Tiller v. Atlantic Coast Line R.R., *supra* note 10, at 67.

16. 320 U.S. 476 (1943).

17. *Id.* at 483, quoting Milwaukee & St.P. Ry. v. Kellogg, 94 U.S. 469, 475 (1877).

18. See DeParcq, *A Decade of Progress Under the Federal Employers' Liability Act*, 18 LAW & CONTEMP. PROB. 257, 271 (1953).

19. 352 U.S. 500 (1957).

20. *Id.* at 506. In Gallick v. Baltimore & O.R.R., 372 U.S. 108 (1963), Mr. Justice

to prove proximate cause with respect to the employer's negligence. In recent litigation, employers have sought the benefit of this "in whole or in part" causation concept in their efforts to prove contributory negligence. In *Missouri-Kansas-Texas R.R. v. Shelton*,[21] the Texas Court of Civil Appeals held that, in the absence of clear statutory language giving the employer the benefit of the new rule, the common law concept of proximate cause must prevail. In *Ganoti v. New York Central R.R.*,[22] however, the Sixth Circuit Court of Appeals held for the railroad saying that, if the Congress had intended to make a distinction between proximate cause for purposes of proving the railroad's negligence and proximate cause for purposes of proving the employee's contributory negligence, express words to that effect would have been used.

In the instant case, after carefully distinguishing negligence from causation, the court noted that "ordinary prudence" is the standard of care for both the employee and the railroad, and outlined three reasons why there should likewise be a single standard of causation. First, the court doubted that a differentiation between types of proximate cause would have any practical effect on the jury since it is doubtful that the jurors would understand the judge's distinctions.[23] Secondly, the court advanced the theory that the overriding congressional objective was improved safety in general, rather than simply the elevation of the railroad's operational standard of care.[24] It concluded that a common application of the new rule of causation would impose on both employer and employee a higher standard of performance and thus would be consistent with the congressional hope of improved safety.[25] Thirdly, the court suggested that a comparative negligence system, by its very nature, requires that there be a single standard of causation. The abolition of contributory negligence as a complete bar to recovery necessarily implied a rejection of the common law definitions of proximate cause[26] in favor of a simplified structure in which damages would be shared by the railroad and the injured

White quoted the above passage and deleted the phrase "even the slightest." *Id.* at 116. Perhaps the *Gallick* Court felt that the *Rogers* Court had extended the "in whole or in part" concept too far. At any rate, it appears that "in part" is not to be translated as "in the slightest."

21. 383 S.W.2d 842 (Tex. Civ. App. 1964).

22. 342 F.2d 767 (6th Cir. 1965).

23. Page v. St. Louis S.W. Ry., 349 F.2d 820, 824 (5th Cir. 1965).

24. Plaintiff insisted that to allow the railroad greater ease in shifting part of its economic loss to the injured employee would tend to make the railroad less diligent in its operating practices.

25. Page v. St. Louis S.W. Ry., *supra* note 23, at 824.

26. Apparently, the court is saying that, unless there are express words to the contrary, it will be assumed by virtue of the comparative negligence arrangement that it was the congressional purpose to circumvent the traditional refinements incident to the common law concept of contributory negligence.

employee in proportion to their respective faults. Referring to this new arrangement as a system of comparative fault, the court concluded that, if it is to work, "the basis of comparison has to be the same."[27]

The principal objective of the FELA was to alleviate the plight of the injured railroad employee by shifting a large portion of his loss to the railroad. To some extent this objective is frustrated by allowing the employer the benefit of the "in whole or in part" rule of causation for it is obviously easier for a jury to find contributory negligence under this rule. On the other hand, the ability of the comparative negligence system to achieve an equitable result would be hampered if the railroads are forced to operate under anything other than the "in whole or in part" rule. The FELA system of comparative negligence was conceived for the purpose of distributing the loss equitably between the parties in relation to the extent that their respective acts of negligence were contributing factors. It is difficult to see how any equitable distribution can be made if the basis for comparison is different. An absolute application of the single standard in this comparison and distribution process might in certain situations work injustice on the injured employee; however, there will not be an absolute application because Congress has provided that there should be no inquiry into contributory negligence, and thus no reduction of damages, where the railroad's negligence consists of a violation of a safety-appliance statute.[28] With the removal of cases involving safety violations from the comparative negligence structure, the possibility of harm to the injured employee by a common application of the "in whole or in part" rule in the comparison process is greatly reduced. Thus, although the injured employee will be made to suffer to some extent by applying the single standard of causation, the equitable features of the FELA comparative negligence system will be considerably altered if the single standard is not applied. On balance, the possibility of detriment to an employee appears to be outweighed by the inherent need within the comparative negligence system for a comparison of the negligent parties on an equal basis.

27. Page v. St. Louis S.W. Ry., *supra* note 23, at 824.
28. Coray v. Southern Pac. Co., 335 U.S. 520 (1948); see note 7 *supra*.

Insurance—Reinsured Stock Insurance Company Not Liable for Assessments as Member of Reinsuring Mutual Insurance Company

A Wisconsin mutual insurance company[1] entered into reinsurance treaties[2] with defendant, a foreign stock insurance company,[3] to reinsure the liability of defendant on certain school accident policies. When the mutual was determined to be insolvent, plaintiff, Wisconsin's Commissioner of Insurance, was directed to liquidate the mutual company's assets pursuant to statute.[4] Subsequently, the defendant, Peerless Insurance Company, was assessed on the grounds that its reinsurance treaty with the mutual was an insurance "policy"[5] which established the defendant as a member of the mutual and liable for assessment under Wisconsin statutes.[6] The trial court entered judgment holding defendant liable for assessment. On appeal to the Supreme Court of Wisconsin, *held*, reversed. A foreign stock insurance company which reinsures a portion of its risk with a domestic mutual insurance company does not thereby become a policyholder-member of the mutual so as to be liable for assessment. *Peerless Insurance Co. v. Manson*, 27 Wis. 2d 601, 135 N.W.2d 258 (1965).

Most states, including Wisconsin, have enacted statutes regulating those mutual companies not limited to a particular locality. Statutes in twenty-five states specifically provide that a reinsured company is

1. A mutual insurance company is "one in which the members are both the insurers and the insured . . . whereas the purpose of a stock insurance company is primarily to earn money for the stockholders." 18 APPLEMAN, INSURANCE 79-80 (1945).

2. Reinsurance has been defined as "a contract whereby one for a consideration agrees to indemnify another wholly or partially against loss or liability by reasou of a risk the latter has assumed under a separate and distinct contract as insurer of a third party." Stickel v. Excess Ins. Co. of America, 136 Ohio St. 49, 23 N.E.2d 839 (1939). "A 'reinsurauce treaty' is an agreement between two insurance companies where one agrees to ccde and the other to accept reinsurance business pursuant to the provisions specified in the treaty." 13 APPLEMAN, INSURANCE 435 (1945).

3. "A stock insurauce company is one in which the stockholders, who need not be policyholders, contribute all the capital, pay all losses, and take the profits." 18 APPLEMAN, INSURANCE 2 (1945).

4. WIS. STAT. ANN. § 200.08 (1961).

5. Plaintiff conteuded that reinsurance fell within the Wisconsin court's definition of insurance as a "contract whereby one party agrees to wholly or partially indemnify another for loss or damage. . . ." Shakman v. United States Credit System Co., 92 Wis. 366, 374, 66 N.W. 528, 531 (1896), *approved*, Sims v. Manson, 25 Wis. 2d 110, 114, 130 N.W.2d 200, 202 (1964). Plaintiff then argued that since reinsurance and insurance were in essence the same, the holder of a reinsurance treaty was the holdcr of an insurance "policy."

6. Plaintiff relied on WIS. STAT. ANN. § 201.02(3)(d), which provides that articles of incorporation of a mutual company shall contain "the condition of membership which shall provide that each policyholder have one vote and shall be liable for a pro rata share of losses and expenses incurred during the time the policyholder has been a member of the company, unless the liability of all members is limited according to law."

not a member of the mutual that reinsures it.[7] The problem of the instant case can arise only in those states whose legislatures have not specifically resolved the question. There the decision must be reached by interpreting statutes generally authorizing and regulating mutuals. This typically entails a determination of whether a reinsurance treaty is an insurance "policy" within the meaning of the relevant statute, for if the term "policy" includes reinsurance treaties, the reinsured is a policyholder-member of the mutual and thus liable for assessment. Although no reported cases have dealt with this exact factual situation, several cases have considered whether a reinsurance contract is an insurance "policy." In *Cunningham v. Republic Insurance Co.*,[8] the court refused to allow insurance companies having reinsurance contracts with an insolvent insurance company to share in the proceeds from qualification bonds since the reinsured companies were not "policyholders" of the insolvent company. The court noted that "reinsurance contracts are not policies of insurance. Neither are they contracts of insurance, as that term is generally understood."[9] A Virginia court concluded that reinsurance contracts might technically be regarded as "policies," but that practically speaking "policy" usually suggested a contract of insurance for protection of a property owner against loss and would not include contracts of reinsurance.[10] In *Aetna Casualty & Surety Co. v. International Re-insurance Corp.*,[11] the court noted several practical and technical differences between insurance and reinsurance,[12] but concluded that the problem of

7. Ariz. Rev. Stat. Ann. § 20-715 (1956); Ark. Stat. Ann. § 66-4216 (1947); Cal. Ins. Code § 4013; Fla. Stat. § 628-301 (1961); Ga. Code Ann. § 56-1516 (1960); Hawaii Rev. Laws § 181-178 (1955); Idaho Code Ann. § 41-2829 (1948); Ill. Rev. Stat. ch. 73, § 671 (1963); Ky. Rev. Stat. § 304.171 (1963); Md. Ann. Code art. 48A, § 257 (1957); Mass. Gen. Laws Ann. ch. 175, § 20 (1959); Mich. Stat. Ann. § 24-1632 (1957); Mont. Rev. Codes Ann. § 40-4714 (1947); N.M. Stat. Ann. § 58-18-19 (1953); Okla. Stat. Ann. tit. 36, § 2115 (1958); Ore. Rev. Stat. § 739.165 (1953); P.R. Laws Ann. tit. 26, § 2909 (1958); R.I. Gen. Laws Ann. § 27-5-13 (1956); S.C. Code Ann. § 37-372 (1962); S.D. Code § 31.2916 (1939); Tex. Ins. Code Ann. art. 15.17 (1963), Utah Code Ann. § 31-9-11 (1953); Va. Code Ann. § 38-1-26 (1950); Wash. Rev. Code § 48.09.110 (1964); W. Va. Code Ann. § 3352 (1961). The wording of the statutes is rather uniform. A typical statute will provide that each policyholder of a domestic mutual insurer, other than a holder of a reinsurance contract, is a member of the mutual.

8. 127 Tex. 499; 94 S.W.2d 140 (1936).

9. *Id.* at 504, 94 S.W.2d at 142, *approved*, Stradley v. Southwestern Life Ins. Co., 341 S.W.2d 195, 198 (Tex. Civ. App. 1960).

10. Shepherd v. Virginia State Ins. Co., 120 Va. 383, 91 S.E. 140 (1917). Insurance companies reinsured by a subsequently insolvent Pennsylvania insurance company were found not to be "policyholders" and were thus unable to share ratably in the proceeds of bonds deposited under Virginia law for the protection of "policyholders."

11. 117 N.J. Eq. 190, 175 Atl. 114 (1934).

12. "First, one is a contract of direct, original insurance, insuring the original applicant; the other is a contract of re-insurance, insuring the insurer of the original applicant and indirectly insuring the latter. Second, the contract of insurance may

whether holders of reinsurance contracts were policyholders was purely one of statutory interpretation. In that case the court decided that "policyholders" did not include parties to a reinsurance contract.[13] The New York case of *Skaneateles Paper Co. v. American Underwriters Fire Insurance Co.*,[14] offers perhaps the strongest support for the view that a reinsurance treaty is in essence an insurance policy. In dictum, the court specifically indicated that an insurance company reinsured by a mutual would become thereby a member of the mutual liable for assessment.[15] The *Skaneateles* decision is not the prevailing view; the case law offers more support for limiting the definition of "policy" by excluding reinsurance agreements.[16] It is apparent that each case must turn on an interpretation of the particular state statute involved.

The Wisconsin court faced the task of distinguishing a recently decided case, *Pella Farm Mutual Insurance Co. v. Hartland Richmond*

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or may not be a contract of indemnity—the contracts of fire and life insurance are frequently not contracts of indemnity. Third . . . the reinsurance contract (at least from the standpoint of the company reinsured) is a method whereby the original insuring company takes another company into 'partnership' on the particular risk." *Id.* at 202, 175 Atl. at 121. The court also noted, however, that "from the standpoint of the reinsuring company, the contract of reinsurance is simply the issuance of another contract of insurance . . . to it, the only difference is that the insured is another insurance company instead of one of the general public." *Ibid.*

13. *Cf.* Maurer v. International Re-insurance Corp., 32 Del. Ch. 447, 86 A.2d 360 (1952), in which the court stated that while "policyholder" did not necessarily include holders of reinsurance contracts, it did so in the present case. Thus plaintiff insurance companies having reinsurance contracts with insolvent company were entitled to participate in proceeds of deposit made in trust for benefit of policyholders.

14. 61 Misc. 457, 114 N.Y. Supp. 200 (Sup. Ct. 1908).

15. This was not the exact holding of the court, however. The court decided that the subject matter of a reinsurance contract was "insured property" within the meaning of a state statute concerning the expansion of local mutuals. Such local mutuals were limited to operation in certain counties, and expansion into other counties was allowed only if the value of the mutual's insured property exceeded a certain sum. The court then said in a dictum that since the subject matter was "insured property," it would follow that "the company obtaining such reinsurance would become thereby a member of the indemnifying co-operative company and subject to pro rata liability for assessments during the life of the contract as other members because . . . the assessments must be laid 'upon all the property at that time insured.'" *Id.* at 461-62, 114 N.Y. Supp. at 204. *But see* Allison v. Fidelity Mut. Fire Ins. Co., 81 Neb. 494, 116 N.W. 274 (1908), in which the court decided that a local mutual which reinsured part of its risk with another local mutual was not liable for assessments as a member of the reinsuring company because the act of reinsuring was ultra vires where not specifically granted by statute to such local mutuals. The court's holding depended on a decision that by authorizing local mutuals to insure the property of its members, the legislature had not intended that such mutuals have the right to reinsure. This implies that the subject matter of a reinsurance contract is not "insured property" within the meaning of the particular Nebraska statue.

16. No other reported case has dealt with the exact problem decided by the Wisconsin court. It should be noted that of the cases cited above, only *Skaneateles* and *Allison* are concerned with assessment situations. Since these two cases both involved local mutual companies, which usually receive special treatment from state legislatures, the instant case is essentially one of first impression in this country.

Town Insurance Co.,[17] which held that a town mutual which reinsured part of its risk with another town mutual became a member thereof and liable for assessment.[18] The court concluded that the Wisconsin laws governing town mutuals[19] were separate and distinct from those concerning insurers in general,[20] and that the court's interpretation of chapter 202[21] in *Pella* did not govern its interpretation of chapter 201[22] in the instant case. The court rejected the argument that the statutory definition of "policy" as "every kind and form of contract of insurance"[23] included a reinsurance treaty, and that the reinsured was thus a policyholder-member of the reinsuring mutual. Such rejection was supported by noting that the state laws did not expressly equate a reinsurance treaty with an insurance contract, that the laws did not identify reinsurance with insurance, and that they did not specifically subject the reinsured company to membership in the reinsuring mutual. The allusion to "reinsurance" in at least thirteen sections in one chapter of the state statutes[24] indicated to the court that the legislature had not intended that reinsurance and insurance be treated identically. The court noted that Peerless was not treated as a member of the mutual since it had received no statements, dividends,[25] or notices of any kind from the mutual, nor had it ever cast a vote.[26] The court refused to base its holding on such practical differences between insurance policies and reinsurance treaties, however, and decided only that since reinsurance and insurance were treated separately under Wisconsin law the legislature did not intend that a stock insurance company become a policyholder of the reinsuring mutual and thus an assessable member.

The court's decision is in harmony with the twenty-five states which have resolved the question by statute. In states having no statutes

17. 26 Wis. 2d 29, 132 N.W.2d 225 (1965).

18. Pella and Hartland, both town mutuals, executed a reinsurance agreement; Pella became insolvent and sued Hartland for an assessment. The county court concluded that Hartland was not liable for an assessment as a matter of law. On appeal to the Wisconsin Supreme Court, *held*, reversed. "[A] construction that the reinsureds are members and subject to assessment is more consonant with the statutory pattern of unlimited mutuality which was fundamental to the town mutuals as originally organized." *Id.* at 40, 132 N.W.2d at 230.

19. WIS. STAT. ANN. §§ 202.01-.20 (1961).

20. WIS. STAT. ANN. §§ 201.01-.83 (1961). Peerless supported this contention by citing thirteen sections of the Wisconsin statutes dealing with insurance companies in which the legislature specifically alluded to reinsurance. 27 Wis. 2d 601, 135 N.W.2d 258, 260 n.14 (1965).

21. WIS. STAT. ANN. §§ 202-01-.20 (1961).

22. WIS. STAT. ANN. §§ 201.01-.83 (1961).

23. WIS. STAT. ANN. § 201.01(3) (1961).

24. See note 20 *supra*.

25. See WIS. STAT. ANN. § 201.135 (1961), which authorized payment of dividends at the discretion of the board of directors of the mutual.

26. See the Wisconsin statute cited note 6 *supra*.

specifically governing the problem, statutes generally regulating mutuals must provide the basis for decision, but such general statutes furnish little assistance in resolving the precise issue raised in the instant case.[27] The practical differences between a reinsurance treaty and an insurance policy offer more substantial support for the decision reached by the Wisconsin Court. Under the treaty, Peerless was not represented at meetings and received no proxy authorizations, statements or notices of any kind from the mutual. Since these rights of ordinary policyholders were denied the reinsured, it is logical to conclude that Peerless was not the holder of an insurance "policy" issued by a mutual company.[28] Public policy also seems to support the decision of the Wisconsin court. If a decision contrary to that of the principal case were adopted, the reinsured might be unwilling to enter into a treaty which would expose it to contingent assessment liability, particularly where reinsurance treaties with stock insurance companies were available. The voting rights of the reinsured would also raise significant problems. If the reinsured were held to be a member of the mutual, it would have the right to participate in management.[29] If one vote is allowed for each policy reinsured under a treaty, the degree of control of the mutual relinquished to the reinsured would deter the mutual from engaging in such treaties. On the other hand, if the reinsured is allowed to only one vote regardless of the number of policies involved and their dollar amounts, the reinsured would find no corresponding advantage to justify its exposure to the large contingent assessment liability. Thus, a decision contrary to that reached by the Wisconsin court would pose significant barriers to a mutual's accessibility to reinsurance. Finally, it is possible that such a decision would result in an assessment which would lead to the insolvency of a small reinsured company.[30] The Wisconsin court relied primarily on statutory interpretation to justify its decision, and it is unfortunate that the practical and policy considerations supporting the holding were not more strongly emphasized. As long as there are states whose statutes do not specifically resolve the question, it is possible, though unlikely, that a court will adopt a rule contrary to that of the instant case. Such a decision could

27. See, *e.g.*, Pella Farm Mut. Ins. Co. v. Hartland Richmond Town Ins. Co., *supra* note 17, at 34, 35, 132 N.W.2d at 225, 227, where the court recognized that the wording of the particular statutes involved might be interpreted as either supporting or not supporting assessment of the reinsured company.

28. For the general differences between insurance and reinsurance urged by Peerless, see 27 Wis. 2d at 60, 135 N.W.2d at 260-61.

29. See the Wisconsin statute cited note 6 *supra*.

30. "Adequate reinsurance facilities . . . are conceded to be of the utmost importance to the stable operation of the insurance industry. Reinsurance is particularly important for smaller or newer organizations." HENSLEY, COMPETITION, REGULATION AND THE PUBLIC INTEREST IN NONLIFE INSURANCE 17 (1962).

possibly be justified by a technical analysis of statutory language,[31] but would be contrary to the practical operation of reinsurance treaties and to public policy considerations as well. The obvious solution is to resolve the question by statute before it arises, as twenty-five states have already done.

Taxation—Federal Income Tax—Business Purpose Test for Deductibility of Rental Payments in a Trust-Leaseback Arrangement

Taxpayer and wife conveyed certain realty including the husband's medical office building in trust[1] to a local bank,[2] naming their four minor children as income beneficiaries.[3] The trust, which was irrevocable and to last for a period of eleven years, assured the grantors the power to appoint a successor trustee in the event of resignation, the power to approve and settle the accounts of the trustee,[4] and the right to receive the assets upon the termination of the trust. Taxpayer then leased the building from the trustee for a term of eleven years at an annual rental of 1500 dollars, and, two years later, conveyed[5] his reversionary interest to his wife. During the three years in question, which were subsequent to this conveyance, taxpayer paid the trustee rent in the amount of 1500 dollars and, in his tax returns for these years[6], claimed these payments as deductions under section 162(a)(3).[7] The Commissioner refused to allow the de-

31. See note 27 *supra* and the authorities cited therein.

1. The trust agreement specifically stated the grantors' intention to create a short-term Clifford Trust for the benefit of the grantors' minor children and to have any provision of the trust declared void if it violated the Clifford sections of the Code. For a discussion of the Clifford Trust, see note 11 *infra.*

2. According to the terms of the trust, the trustee was to "hold, manage and protect the Trust Estate in accordance with its best judgment and discretion . . . [with] . . . every power and authority over the Trust Estate that it would have as an individual who was the absolute owner thereof." Alden B. Oakes, 44 T.C. 524, (1965).

3. The trust provided that in case of death of any of the minor beneficiaries the unexpended or accumulated income would go to the deceased beneficiary's estate. *Ibid.*

4. The trustee reserved the power to have its accounts settled by a court of competent jurisdiction. *Ibid.*

5. The consideration for the conveyance was the payment of $100 plus "other goods and valuable considerations." *Id.* at 2663.

6. During the years in question, 1959, 1960, and 1961, petitioners filed a joint income tax return.

7. Int. Rev. Code of 1954, § 162(a)(3): "(a) In General.—There shall be

ductions on the ground that the leaseback was merely a method of assigning income to family members.[8] On petition to the Tax Court, *held*, absent elements of control reserved by the grantor-lessee, his rental payments to a valid irrevocable trust are deductible as ordinary and necessary business expenses, upon the showing of a *post-gift* business purpose. *Alden B. Oakes*, 44 T.C. 524 (1965).

The family trust-leaseback consists of a transfer of property to a trust for the benefit of the grantor's family, with the grantor then leasing the property from the trust. The tax benefits derived from such a transaction can be substantial if the grantor is in a high income tax bracket and the beneficiary is in a low one.[9] The validity of intra-family shifting of income received judicial scrutiny in *Helvering v. Clifford*.[10] There the taxpayer declared himself trustee of certain of his securities for five years, and appointed his wife the beneficiary. In ignoring the trust and holding the trust income taxable to the grantor as personal income, the Supreme Court reasoned that the taxpayer retained control over the fund, including the right to the reversionary interest, and, thus, for tax purposes, was the true owner. Subsequently codified, the Clifford rules provide that rental payments to certain short-term trusts[11] are taxable as income to either

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allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including—

(3) Rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, or property to which the taxpayer has not taken or is not taking title or in which he has no equity."

8. The deficiency notice stated: "It is held that the claimed deduction for rent paid to a trust, created by you, for the use of the trust property under a leaseback agreement is not allowable since the trust and leaseback agreement are merely a means of assigning income to family members, and is not deductible under any section of the Code."

9. See Note, 38 N.Y.U.L. Rev. 740 (1963). That the leaseback arrangement involves members of the same family does not by itself invalidate the deduction of rental payments. Such a transaction does, however, receive close scrutiny by the courts. See 4 Mertens, Law of Federal Income Taxation § 25.111 (rev. ed. 1960). When such a transaction has not utilized a trust, the tendency has been to disallow the deduction. See, *e.g.*, White v. Fitzpatrick, 193 F.2d 398 (2d Cir. 1951), *cert. denied*, 343 U.S. 928 (1952), wherein a husband who gave his wife patent rights necessary for his business and a sum of money sufficient to purchase the business property, while at the same time retaining control over both the patents and the property, was denied deductions for royalty and rental payments. See generally Cohen, *Transfers and Leasebacks to Trusts: Tax and Planning Considerations*, 43 Va. L. Rev. 31, 37-40 (1957).

10. 309 U.S. 331 (1940).

11. See Int. Rev. Code of 1954, §§ 671-78. The trust must comply with the following requirements: (1) No reversionary interest in the grantor may take effect within ten years; § 673(a) (for charities, the period is two years (§ 673(b)). (2) The beneficial enjoyment of the corpus or the income may not be subjeet to a power of disposition by the grantor without the consent of any adverse party. § 674 (a). (3) Certain restrictions are placed on the administrative powers of the grantor. § 675. (4) The trust must be irrevocable. § 676. (5) The trust income may not, without the consent of any adverse party, be distributed to the grantor, held or accumulated

the trust or the beneficiary, but not to the settlor. However, the Clifford sections of both the Code and the regulations[12] deal only with the taxation of the trust income and not the deductibility of the rental payments. Consequently, a settlor seeking the deduction of rental payments as "business expenses" must satisfy the requirements of section 162(a)(3) and, in addition, prove the reasonableness of the payments.[13] In determining whether the deductions are both "ordinary and necessary" and thus for a "business purpose," the courts, guided more by "substance" than "form,"[14] have measured the validity of the transaction by several factors. The emphasis of the early cases was on the prearrangement,[15] which was considered indicative of both sham and lack of a business purpose. On the other hand, *Skemp v. Commissioner*[16] and *Brown v. Commissioner*[17] indicate that prearrangement by itself will not preclude deductibility of rental payments. A second, and far more important factor, has been

for future distribution to the grantor, or applied to the payment of premiums on policies of insurance on the life of the grantor (with certain exceptions). § 677. (6) The income must not be applied to pay a prior obligation of the grantor. § 678(c).

12. Treas. Reg. §§ 1.671-.678 (1956). Section 1.671-1(c) states the Treasury positiou as follows: "Likewise, these sections have no application in determining the right of a grantor to deductions for payments to a trust under a transfer and leaseback arrangement."

13. See Kirschenmann v. Westover, 225 F.2d 69 (9th Cir.), *cert. denied*, 350 U.S. 834 (1955); W. H. Armston Co. v. Commissioner, 188 F.2d 531 (5th Cir. 1951), *affirming* 12 T.C. 539 (1949). See generally 4 MERTENS, *op. cit. supra* note 9, § 25.111.

14. According to one writer, "Superficially the issue appears to be whether payments are "required" for the use of the property; but fundamentally the issue is whether the requirement is sufficiently substantial to withstand the scrutiny of tho courts willing to disregard form in order to interpret the statute equitably, particularly when transfers among related taxpayers are made with tax avoidance as the obvious motive." Cohen, *supra* note 9, at 32. See Rev. Rul. 54-9, 1954-1 CUM. BULL. 20.

15. In Johnson v. Commissioner, 86 F.2d 710 (2d Cir.), *affirming* 33 B.T.A. 1003 (1936), the husband taxpayer granted a $400,000 gift to his wife, who in turn delivered the check to a trustee. The husband, in accordance with a loan provision in the trust, then executed a demand note to the trustee for the same amount, and attempted to claim a deduction for the interest payments. In disallowing the deductions and holding the interest payments gratuitous, the court viewed the gift, trust, and loan as a single transaetion amounting to a sham. This same reasoning was subsequently adopted in the leaseback cases. See, *e.g.*, Helen C. Brown, 12 T.C. 1095 (1949), *rev'd*, 180 F.2d 926 (3d Cir.), *cert. denied*, 340 U.S. 814 (1950).

16. 168 F.2d 598 (7th Cir. 1948), *reversing* 8 T.C. 415 (1947). There the petitioner-physician conveyed his clinic to an independent trustee for the benefit of his wife and children. The trust was irrevocable for a period of twenty years, unless prior to that time both the settlor and his wife died. Upon termination, the trust property was to be distributed to the settlor's children. On the same day that the trust was executed, the settlor leased the propery for ten years at $500 per month. In reversing the Tax Court, the Seventh Circuit held the rental payments deductible as business expenses.

17. 180 F.2d 926 (3d Cir.), *cert. denied*, 340 U.S. 814 (1950). Rents and royalties paid by the taxpayers to the independent trustee of two irrevocable trusts for the benefit of the settlors' children were held deductible.

the courts' reluctance to allow the deductions when the trustee is not independent. In many cases in which the taxpayer has been successful,[18] the trustee has been someone other than the settlor, although the question of just how independent the trustee must be has not been resolved.[19] A third persuasive factor has been the retention of the reversionary interest by the grantor. Again, in the decisions upholding deductibility, the grantor has not retained the reversionary interest,[20] whereas in two recent cases decided against the taxpayers, the grantors or their estates were the designated remaindermen.[21] In the same two decisions, the trusts were revocable after a ten year period. Also, certain cases[22] have disallowed the deductions on the ground that the taxpayer retained an equity in the trust property. This theory, based upon a literal reading of section 162(a)(3), has been criticized,[23] and has not been widely utilized.[24] As a general rule, the courts, prior to the decision in *Van Zandt v. Commissioner*,[25] tended to measure the validity of the business purpose in light of the foregoing factors. In *Van Zandt*, however, the court, in examining the rental payments made by the physician-taxpayer for the use of the trust property, merely noted the lack of an independent trustee and the retention of the reversionary interest,[26] and stressed the absence of any basic, underlying

18. See, *e.g.*, Brown v. Commissioner, *supra* note 17; Skemp v. Commissioner, *supra* note 16; John T. Potter, 27 T.C. 200 (1956); Albert T. Felix, 21 T.C. 794 (1954), *nonacq.*, 1956 INT. REV. BULL. No. 43, at 7. In Van Zandt v. Commissioner, 341 F.2d 440 (5th Cir. 1965), *affirming* 40 T.C. 824 (1963), a case decided against the taxpayer, the trustee was not independent.

19. In John T. Potter, *supra* note 18, the trustees were the grantor's wife, father, and attorney. The use of the grantor's attorney as the trustee has been quite common. See Brown v. Commissioner, *supra* note 17; Consolidated Apparel Co. v. Commissioner, 207 F.2d 580 (7th Cir. 1953). For the view that the trustees in both *Brown* and *Skemp* were not really independent, see Note, 65 HARV. L. REV. 1250 (1952).

20. Brown v. Commissioner, *supra* note 17; Skemp v. Commissioner, *supra* note 16.

21. Van Zandt v. Commissioner, *supra* note 17; Hall v. Commissioner, 208 F. Supp 584 (N.D.N.Y.) 1962). There, three physicians conveyed a one-third interest in the medical property to a trust company, naming their children as beneficiaries. The trustee then leased to each doctor the office space used by him. In disallowing the deductibility of the rental payments, the court based its decision upon the revocability of the trust, the retention of the reversionary interest by the grantors or their estates, the power of the grantors to settle the accounts of the trustee, and the grantors' retention of an equity interest in the property.

22. Kirschenmann v. Westover, *supra* note 13; Hall v. Commissioner, *supra* note 21.

23. See Froehling, *Clifford Trusts: Use of Partnership Interests as Corpus; Leaseback Arrangements*, 52 CALIF. L. REV. 956, 976 (1964). The writer could find no justifiable reason for discriminating against the rental of property by one who possesses an ownership interest in the property other than his leasehold interest. Such a rule would have an adverse effect on many business transactions, such as precluding the lessor of a master supermarket from being a subtenant of his lessee.

24. See text accompanying notes 29 & 30 *supra*.

25. *Supra* note 18.

26. *Ibid.*

business purpose as the ground for disallowing the deduction. Viewing the leaseback as a single transaction, the court reasoned that there was no business purpose for the creation of the trust other than the desire to effect a tax reduction.

In the instant case, the court, in upholding the deductibility of the rental payments, distinguished *Van Zandt* on two principal grounds. The primary distinction was the independence of the trustee. This independence was not impaired by the grantors' power to appoint a successor trustee in the event of resignation.[27] Secondly, the court pointed to the lack of a reversionary interest in the taxpayer. The fact that the trust agreement provided for the return of the assets to the grantors upon the termination of the trust was not controlling in view of the subsequent conveyance of the husband's undivided one-half interest in the remainder to his wife prior to the tax years in question.[28] In addition, the court noted the absence of any retained equity in the property. According to the court's definition of equity,[29] the taxpayer, upon relinquishing his reversionary interest, ceased to have an equity in the property within the meaning of section 162(a)(3).[30] Having distingushed *Van Zandt,* and not objecting to tax advantages per se,[31] the court refused to consider the *Van Zandt* requirement that the gift itself be motivated by a business purpose. Under the factual situation presented in the case, the true test of business purpose should be the necessity of the rental payments *after* the making of the gift. Viewed in this light, the petitioner, following the establishment of the trust, was in need of a medical office, and since the rental payments were reasonable, the taxpayer complied with the Code requirements that the expenses be "ordinary and necessary" and "required to be made as a condition to continued use . . . of property."

The court in the principal case has, in effect, made the reasonableness of the rent, the independence of the trustee, the irrevocable nature of the trust, and the lack of a reversionary interest conclusive as to the issue of a business purpose. This result has been accomp-

27. Alden B. Oakes, *supra* note 2, at 529.

28. *Id.* at 530.

29. In defining the term equity, the court stated: "[O]ne has an 'equity' in property when he has a right to redemption, a reversionary interest, a right to specific performance, or in general any right respecting property which traditionally would have been enforceable by means of an equitable remedy." *Ibid.*

30. The court rejected the Commissioner's argument that the petitioners' power to approve and settle the account of the trustee constituted an equity within the meaning of the Code. The court pointed to the trustee's right to have the account settled by a court of competent jurisdiction. *Ibid.*

31. *Id.* at 2664. The court relied on United States v. Cumberland, 338 U.S. 451 (1950); Commissioner v. Tower, 327 U.S. 80 (1946); Gregory v. Helvering, 293 U.S. 465 (1935); and United States v. Isham, 84 U.S. 496 (1873).

lished by a liberalization, or perhaps distortion, of the business purpose test advanced in *Van Zandt*.[32] Whereas the *Van Zandt* approach appears to be a throw-back to the sham transaction doctrine voiced in *Johnson*,[33] and relied on by the Tax Court in *Brown*,[34] the present case indicates that the Tax Court henceforth will not be influenced by the motivation underlying the gift. This refusal to apply the sham transaction doctrine seems desirable, since it would appear that the divesting nature of the instant transaction constituted more than a "mere paper reallocation of income among family members."[35] That definite economic interests have been created in the grantors' children seems to have been recognized, as the Tax Court refused to disallow the deduction on the basis of the "economic reality"[36] test espoused in *Van Zandt*. Furthermore, to deny deductibility would be, in effect, to impose a double tax, in that the rental payments, chargeable under the Clifford sections as income to either the trust or the beneficiaries, would also be included in the compilation of the grantor's taxable income. While it is true that there may not be a "presumption against double taxation," there is "an inherent reluctance to impose double taxation."[37] The possibility of inequitable hardships, which was alluded to in *Skemp*[38] is apparent, since the disallowance of the deduction does not invalidate the trust for other purposes. To give legal effect to the trust arrangement, and at the same time to refuse rental deductions for failure to comply with section 162(a)(3), would produce an anomaly, for

32. See Beausang, *Tax Court in Oakes Gives New Life to Trust-Leaseback as a Tax-Saving Device*, 23 J. TAXATION 156, 158 (1965). The writer concludes that the decisions in *Van Zandt* and *Oakes* may be reconciled in that a business purpose for the whole transaction must be shown only if the elements of control are different than those present in *Oakes*. (The example given is the grantor's desire to retain the reversionary interest.)

33. *Supra* note 15.

34. *Ibid.*

35. Commissioner v. Tower, *supra* note 31, at 292.

36. The Tax Court in *Van Zandt* insisted that economic reality, rather than the validity of the documents creating the trusts, the transfer and the leases, must control. It is apparent that in the present case the Tax Court thought the transaction was economically real.

37. 1 MERTENS, *op. cit. supra* note 9, § 3.32.

38. In finding that the payments, though voluntary, were required, the court stated: "While the taxpayer voluntarily created the situation which required the payments of rent, the fact remains that the situation created did require the payments. In this case we have a valid, irrevocable trust, wholly divesting the taxpayer of any interest in the trust property, and an agreement by the taxpayer to pay the trustee a reasonable rental under a valid lease. . . . The trustee was duty bound to exact rent of the taxpayer and the taxpayer was legally bound to pay, just as much as if the taxpayer had moved across the street into the property of a third party. No one doubts that he would have had to pay rent then, and would have been entitled to deduct it even though he had voluntarily created that situation." Skemp v. Commissioner, *supra* note 16, at 600. See also Froehling, *supra* note 23, at 977.

the legal validity of the trust under trust law assures that the rental payments are "ordinary and necessary" and "required" within the meaning of the Code.

Taxation—Federal Income Tax—Transaction Giving Rise to Interest Deduction Must Have Independent Economic Significance, or Deduction Will Be Disallowed

Taxpayer won 140,000 dollars in the 1958 Irish Sweepstakes. In order to reduce her tax bill for that year, she borrowed, through an intermediary, 945,000 dollars on which she prepaid interest of 81,400 dollars in December 1958. She then claimed a deduction for the prepaid interest in her 1958 cash basis return,[1] relying on section 163(a) of the Internal Revenue Code of 1954.[2] The sum borrowed was used to puchase treasury notes[3] which served as collateral for the loan. Under the terms of the agreement, the lending banks could sell the collateral at any time and apply the proceeds of the sale to the taxpayer's account. The Commissioner disallowed the deduction and assessed a tax deficiency. On petition to the Tax Court of the United States, *held*, the Commissioner's action was correct. The deduction was properly disallowed because the prepayments did not constitute

1. Under the progressive tax rate structure, the ordinary income taxes due on taxpayer's wagering income would have been $69,600. The interest deduction claimed reduced her 1958 taxable income to $41,000, on which there would be only $13,900 in federal taxes dues. Thus, the tax savings in 1958 would have been $55,700. The following table illustrates the anticipated result of taxpayer's plan:

	1958	1959	1960	1961	Total
Net interest income	$ —0—	$11,250	$11,250	$ 5,625	$28,125
Gain on bond sales	—0—	—0—	15,000	26,250	41,250
Total income	—0—	11,250	26,250	31,875	69,375
Interest expense	81,400	—0—	—0—	—0—	81,400
Fees and commissions	6,500	—0—	—0—	—0—	6,500
Total expense	87,900	—0—	—0—	—0—	87,900
Before tax gain (loss)	(87,900)	11,250	26,250	31,875	(18,525)
Net tax saving (loss)	55,700	(1,700)	(3,800)	(3,600)	46,600
Net gain (loss)	($32,200)	$ 9,550	$22,450	$28,275	$28,075

2. Section 163(a) states: "There shall be allowed as a deduction all interest paid or accrued within the taxable year on indebtedness."

3. U.S. Treasury Notes, 1.5% series, face amount $500,000, due October 1, 1962, at 92 30/32 ($464,687) plus accrued interest of $1,875. The Treasury obligations maturing in 1962 had a yield to maturity of approximately 3.64% as opposed to taxpayer's initial true interest cost of 4.16%. U.S. Treasury Notes, 1.5% series, face amount $500,000, due October 1, 1961, at 95 6/32 ($477,812) plus accrued interest of $1,875. The Treasury obligations maturing in 1961 had a yield to maturity of approximately 3.42% as opposed to taxpayer's initial true interest cost of 4.16%.

interest on indebtedness within the intendment of section 163(a), which would limit the interest deduction to instances where there is economic substance involved in taxpayer's borrowing. *Kapel Goldstein*, 44 T.C. 284 (1965).

The language of section 163(a) allows taxpayers a deduction for interest expense on indebtedness paid during the taxable year without regard to the nature of the expense. Judicial interpretation of section 163(a) has narrowed its scope in three ways. *Goodstein v. Commissioner*[4] held that the giving of a note by a cash basis taxpayer did not constitute an interest payment for the purpose of section 163(a). *Lynch v. Commissioner*[5] held that a loan made by a vendor-creditor to his vendee-debtor in order to allow the vendee to carry obligations which in turn served as collateral for the loan did not constitute indebtedness for the purpose of section 163(a). While *Goodstein* and *Lynch* dealt with factual situations where taxpayer and the creditor had colluded, *Knetsch v. United States*[6] disallowed an interest deduction in an arm's length transaction where the taxpayer systematically borrowed against the increment to cash value on single premium annuity contracts and used the proceeds of these loans to pay, in part, interest expense on loans against these contracts. *Knetsch* looked to the policy decision of *Gregory v. Helvering*[7] which requires the

4. 267 F.2d 127 (1st Cir. 1959), *affirming* 30 T.C. 1178 (1958). The Tax Court held that the transaction lacked substance and profit motive, other than tax avoidance, and disallowed the deduction. While the Court of Appeals affirmed on the narrower ground that the giving of a note by a cash basis taxpayer did not constitute a payment, the case is frequently cited in support of the sham transaction doctrine. The Court of Appeals was convinced that no genuine indebtedness existed between taxpayer and his alleged creditor.

5. 273 F.2d 867 (1st Cir.), *affirming* 31 T.C. 990 (1959). The decision of the Court of Appeals in this case was narrower than that of the Supreme Court in *Knetsch*, *infra* note 6, for, in *Lynch*, the transaction between taxpayer and the vendor-creditor were admittedly collusive.

6. 346 U. S. 361 (1960). Knetsch purchased from an insurance company 10 single premium annuity bonds to mature 30 years from issue date. Face amount was $4,000,000. Purchase price was $4,004,000. Knetsch paid insurer $4,000 and signed non-recourse notes for the balance, securing the loan with the cash value of the bonds. Interest on the notes was at 3½%; the bonds bore interest of 2½%. Each year, Knetsch borrowed substantially all the increase in cash value which he then applied to his payments of interest. Knetsch surrendered the bonds after two years. He had paid insurer $81,570 more than he had borrowed. His "interest payments" totalled $290,570 ($143,465 in 1953 and $147,105 in 1954). Had the plan worked, Knetsch's tax savings would have been $233,297. The record does not indicate that the transaction was other than an arm's-length bargain. See also Carpenter v. Commissioner, 322 F.2d 733 (3d Cir. 1963), *affirming* 21 CCH Tax Ct. Mem. 975 (1962) (transaction without economic substance disregarded for tax purposes).

7. 293 U.S. 465 (1935). This case involved a reorganization under chapter 234 of the 1924 Act. Revenue Act of 1924, ch. 234, § 203(c), 43 Stat. 256. Taxpayer had complied with this provision and was attempting to utilize the non-recognition provision of chapter 852. Revenue Act of 1928, ch. 852, § 112(9), 45 Stat. 818. Taxpayer had marketable securities transferred from her wholly owned corporation to a corporation newly created for just this purpose, it having no other business

activity for which the taxpayer seeks a deduction to be a type of activity for which Congress intended to grant a deduction.[8] An examination of "what was done"[9] in *Knetsch* led the Court to conclude that the transaction should be disregarded for tax purposes. One writer has suggested that *Knetsch* implicitly incorporated the "business purpose" doctrine of *Gregory* into the interest deduction.[10] On the other hand, the Tax Court in *L. Lee Stanton*[11] held that interest on genuine indebtedness[12] was deductible unless taxpayer colluded with another party to avoid taxes. *Stanton* was distinguished from *Goodstein* and *Lynch* on the grounds that the interest payments in *Stanton* were made to an independent lending institution.[13]

In the instant case, taxpayer had no personal dealings with the lending banks; he allowed an intermediary to set up the transactions, and neither bank ran a credit check on the taxpayer. The court implied that these steps are necessary under generally accepted procedures of sound financial management. As the banks had the exclusive discretion to apply the proceeds of sale of the notes to the taxpayer's account, the taxpayer never had uncontrolled use of either the money or the securities. These factors led the court to conclude that the banks were looking to the notes, rather than to the taxpayer, to recover the funds which the banks had supplied, and that the "interest" paid by taxpayer was a fee to the bank for providing the facade of a loan transaction. Further, absent tax savings inuring from the prepayment of interest, there was no anticipation of commercial or economic gain from the transactions entered into by taxpayer. Therefore, the transactions were not in substance

interests. The newly created corporation was then liquidated to enable taxpayer to sell the securities received in liquidation, and thus realize a substantial long-term capital gain. The Court held this transaction to be substantially a dividend payment by the former corporation to petitioner, thus denying her the desired capital gain treatment.

8. *Id.* at 469. See Chisolm v. Commissioner, 79 F.2d 14-15 (2d Cir. 1935), for a contemporary appraisal of the significance of *Gregory* and a suggestion as to the manner of its application.

9. Knetsch v. United States, *supra* note 6.

10. Fuller, *Business Purpose, Sham Transactions and the Relation of Private Law to the Law of Taxation,* 37 Tul. L. Rev. 355 (1963); Guterman, *Substance v. Form in the Taxation of Personal and Business Transactions,* N.Y.U. 20th Inst. on Fed. Tax 951, 958-59 (1962).

11. 34 T.C. 1, (1960). See also Maysteel Products Co., 33 T.C. 1021, *rev'd,* 287 F.2d 429 (7th Cir. 1961) (deduction of amortization of bond premium and deduction at fair market value for charitable contribution of the bonds while they sold at a premium were both allowed).

12. The Commissioner conceded the genuineness of the transactions in *Stanton,* arguing that the transactions were devoid of commercial and economic substance. L. Lee Stanton, 34 T.C. 1, 9 (1960).

13. "Independent" was used by the court to indicate that the loan was negotiated in arm's length transaction.

what they appeared to be in form, had no substantive commercial reality, and must be disallowed. The dissent, however, found the loan, the purchase and pledge of collateral, and the sale of collateral in satisfaction of the loan to be genuine financial and commercial transactions upon which tax consequences could be based under *Gregory v. Helvering*,[14] which would disregard tax motive in an otherwise genuine transaction. The dissent would follow the holding of the Tax Court in *L. Lee Stanton*[15] that interest on genuine indebtedness is deductible; it saw no grounds for distinguishing *Stanton*.[16] Further, section 163(a), by its plain meaning, would allow a deduction; and the remedy for tax avoidance possibilities created thereby lies with Congress, not the courts.

The transactions in the instant case were not merely a matter of form. Taxpayer dealt at arm's length with independent lending institutions, and bona fide debtor-creditor relationships were created as a result of the dealings. Nor were the transactions without economic significance independent of tax consequences, for fluctuations in the market interest rate would affect the value of the notes taxpayer had purchased.[17] However, an objective appraisal of taxpayer's economic purpose for entering into the transactions clearly indicates that there could have been no economic purpose other than tax avoidance. Application of an objective business purpose standard to individual interest deductions allegedly entered into for the production of income presents little difficulty in a case such as *Knetsch* or the instant case, for in both the probability of economic gain, apart from tax savings, was minimal. Such a standard will be increasingly more difficult of application, however, as the probability of economic gain increases in any particular instance, even though the greatest economic consideration involved in the transaction is tax savings. Such a solution leaves a large gray area where taxpayers act at their own risk. Further, it might well be asked whether the Court in *Knetsch* was correct in its incorporation of the business purpose requirement into the individual interest deduction, for an individual is clearly allowed a deduction for interest expense incurred when he borrows to finance a purely personal item and no inquiry

14. *Supra* note 7.

15. 34 T.C. 1 (1960).

16. Kapel Goldstein, 44 T.C. 284, 302 (1965) (dissenting opinion). The majority distinguished *Stanton* from the fact situation in Max Barnett, 44 T.C. 261, 281 (1965), which distinction was incorporated into the opinion of the court in *Goldstein*.

17. Subsequent government borrowings were made at higher rates of interest. This made taxpayer's bonds less attractive, comparatively, to prospective investors and caused a decline in their value. Had the reverse been true, the taxpayer might have realized a net before-tax gain from the transaction, although such a result appeared highly unlikely to the taxpayer and her advisors.

will be made into the purpose for his borrowing. It is submitted that, if the courts are going to continue to legislate in the area of the individual interest deduction, they should restriet themselves to instances where the transaction is purely formal.

Taxation—Insurance Companies— The Interplay Between Tax-Exempt Income and the Reserve Deduction

The Life Insurance Company Income Tax Act of 1959, Section 804 of the Internal Revenue Code of 1954, as amended,[1] provides the formula for determining the taxable income of insurance companies. According to the "basic" formula, each item of investment income, including interest from tax-exempt securities, is divided proportionately into a company's share and a policyholders' share.[2] The company is then taxed on its share of the investment income, less a deduction for the tax-exempt income included in that share.[3] Sub-

1. 73 Stat. 115 (1959), 26 U.S.C. § 804 (1964), amending Int. Rev. Code of 1954, ch. 736, 68A Stat. 258.

2. Under the 1959 Act the "policyholders' share" of income is that amount of income which is assumed (on the basis of actuarial predictions) sufficient when added to reserves to meet the predicted policyholder and other contract obligations for the year in question. The amount allocated to the company is the balance of the income after these claims have been met. Each dollar of investment income is allocated between these two "shares" in the same proportion as each share bears to total investment income.

3. "(2) TAXABLE INVESTMENT INCOME DEFINED.—For purposes of this part, the taxable investment income for any taxable year shall be an amount (not less than zero) equal to the sum of the life insurance company's share of each and every item of investment yield (including tax-exempt interest, partially tax-exempt interest, and dividends received), reduced by . . . (a) the sum of . . . (1) the life insurance company's share of interest which under section 103 is excluded from gross income . . . ." 73 Stat. 115 (1959), 26 U.S.C. § 804(a)(2) (1964), amending Int. Rev. Code of 1954, ch. 736, 68A Stat. 258 (1954). The act provides a three-phase procedure for taxation of life insurance companies. Under phase one the tax base is the investment sources less investment expenses and deduction of the companies share of exempt interest, as described above. Under phase two the tax base represents 50% of the excess of total net income from all sources—"gains from operations"—over taxable investment income. The excess, if it exists, results from underwriting gains or savings resulting from fewer deaths than expected, and any reduced expenses in servicing policies. Phase three imposes a tax on certain underwriting gains made available to shareholders which are not taxed under phase two. See generally Life Ins. Co. Income Tax Act of 1959, 73 Stat. 115, 26 U.S.C. §§ 801-820 (1964), amending Int. Rev. Code of 1954, ch. 736, 68A Stat. 258. For purposes of this article, the discussion is limited to the tax base under phase one above. This enables the discussion to concentrate on the constitutional aspects of the tax treatment of tax-exempts and the arguments raised by counsel in the instant case. To the extent that phase two raises

section 804(a)(6), set forth under the heading "Exception," provides that if any application of the foregoing formula should result in the imposition of a tax on tax-exempt securities, "adjustment shall be made to the extent necessary to prevent such imposition."[4]

The Atlas Insurance Company, having been taxed according to the basic formula without any adjustment under 804(a)(6), sued for a refund claiming that under this section it was entitled to an "adjustment" allowing for the deduction of the total amount of tax-exempt income received. Atlas argued that Congress had intended subsection 804(a)(6) to apply to the typical case; they argued further that irrespective of congressional intent the application of the basic formula alone would result in the "imposition of a tax" on tax-exempt income, thereby requiring the application of sub-section 804(a)(6). The District Court rejected these claims, but the Tenth Circuit reversed. On appeal to the Supreme Court of the United States, *held*, reversed. Congress did not intend the "adjustment" provisions, section 804(a)(6), to apply to the typical case, and the application of the basic formula does not impose a tax on tax-exempt income. *United States v. Atlas Life Insurance Co.*, 381 U.S. 233 (1965).

Traditionally in the case of insurance companies the amount of income which will be taxed has been subject to two limitations: (1) the instrumentalities of one government body are immune from taxation by another government body,[5] and (2) the portion of an insurance company's "income," which must be reserved to meet the policyholders' claims against the company is not included in the com-

these same issues, they have been covered in the present discussion. Therefore, no attempt has been made to direct the discussion at phase two or to refer specifically to the "exception" clause of that phase which is exactly analogous to the "exception" clause of phase one discussed fully in this article.

4. "(6) EXCEPTION.—If it is established in any case that the application of the definition of taxable investment income contained in paragraph (2) results in the imposition of tax on . . . (A) any interest which under section 103 is excluded from gross income . . . adjustment shall be made to the extent necessary to prevent such imposition." 73 Stat. 115 (1959), 26 U.S.C. § 804(a)(6) (1964), amending Int. Rev. Code of 1954, ch. 736, 68A Stat. 258 (1954).

5. The original immunity for government securities was establisbed in McCulloch v. Maryland, 17 U.S. (4 Wheat) 316 (1819), and has had a history of affirmance ever since. Wurzel, *Tax-exempt Interest of Life Insurance Companies: A Study in "Discriminatory" Taxation*, 70 YALE L.J. 17 (1960). However, the petitioner in the instant case did suggest that such immunity might fall if it were contested before the courts today. Brief for Petitioner, p. 67, United States v. Atlas Life Ins. Co., 381 U.S. 233 (1965) [hereinafter cited as Brief for Petitioner]. There would, of course, be no objection to the federal government taxing its own bonds, but it has traditionally refrained from doing so. The present federal exemption for all government bonds is set forth in the INT. REV. CODE OF 1954, § 103(a): "(a) *General rule.* Gross income does not include interest on—(1) the obligations of a State, a Territory, or a possession of the United States, or of any political subdivision of any of the foregoing, or of the District of Columbia . . . ."

pany's taxable income.[6] The extent to which an insurance company may be entitled to both of these exemptions in their entirety has been the subject of much litigation and legislative re-evaluation. The Insurance Act of 1921 placed a tax on a company's investment income, defined as the gross income from interest, dividends, and rents, less deductions for (a) interest from tax-exempt securities, and (b) an amount of income presumed necessary to meet annual policy claims against the company. The deduction for annual policy claims, however, was to be reduced by the amount of tax-exempt interest received.[7] The general application of this formula was

6. The business of a life insurance company consists of incurring obligations, primarily to policyholders, and investing the funds obtained through such obligations. The premiums charged for insurance are calculated on the assumption that the premiums received will be invested and earn interest, which, when added to the accumulated premiums, will be sufficient to pay the obligations as they become due. State law normally guards the financial integrity of insurance companies by requiring that they maintain a "reserve fund" sufficient to meet the actuarially predicted annual policyholder claims against them. The mortality tables and the assumed rate of interest used in the computations are regulated by state law; and if the net assets of the company fall below the reserve so computed, the company is deemed insolvent and may no longer continue in business.

Since the reserve is computed by "discounting" the predicted policyholder claims to the present at the assumed rate of interest, it is obviously necessary, if the reserve is to continue to measure the company's ability to meet its policyholder obligations, that the reserve be increased each year by an amount equal to the interest which the assets represented by the reserve would presumably earn. Thus, out of the income actually earned each year from the investment of the premium receipts, a certain portion—that part representing the assumed rate of interest—must be "set aside" and added to the reserve to "fund" the anticipated policyholder obligations. Brief for Petitioner, p. 4. This annual addition to the "reserve fund," termed the "policyholder reserve" in the 1959 Act, is a requirement of state law intended to keep the reserve fund up to date.

Whether these "funds" so obligated to the policyholder claims against the company be considered expenses of the insurance business or whether they are considered "funds" held in trust for the creditors of the company, it is clear that they do not represent profit or "beneficial ownership" to the company, and it would be inequitable to tax them as such. Consequently, taxable income of insurance companies has traditionally not included income allocated to meet these policyholder claims. The annual allocation generally runs about 3½% of the company's total policy obligations. HUEBNER & BLACK, LIFE INSURANCE 192 (5th ed. 1958). It also constitutes typically about 85% of a company's annual investment income. Wurzel, *supra* note 5, at 21. It is further suggested that Congress permits the "reserve deduction" in an attempt to keep premium rates at a minimum and thereby encourage the health of the insurance industry. *Id.* at 19. Similar deductions for the company's reserve obligations may apply to state property taxes on net worth. In such cases, the total reserve fund rather than the annual increment thereto is the measure of the "reserve deduction."

7. "Sec. 244. (a) That in the case of a life insurance company the term 'gross income' means the gross amount of income received during the taxable year from interest, dividends, and rents . . . .

"Sec. 245. (a) That in the case of a life insurance company the term 'net income' means the gross income less

(1) [interest on tax-exempt securities] . . .

(2) An amount equal to the excess, if any, over the deduction specified in paragraph (1) of this subdivision of 4 per centum of the mean of the reserve funds re-

challenged in *National Life Insurance Co. v. United States.*[8] The taxpayer argued that a tax formula was invalid to the extent that *any* adverse tax consequences were made to follow from the ownership of tax-exempt securities:

> The Government can tax anything it pleases, except tax-exempts; but it must deduct tax-exempts from anything on which it imposes taxes. . . .
>
> . . .
>
> The state, in making any deduction or in granting any privilege, cannot make the ownership of tax-exempt securities result in the taxpayer getting a less *benefit* or *privilege* than he would have had if he had not owned them, because the minute you do that, you are putting a burden on the ownership of the tax-exempt securities.[9]

The Court found that the formula imposed a tax on tax-exempt income and held that it was invalid to the extent that it reduced the reserve deduction by the amount of tax-exempt income. The Court did not, however, go so far as to hold that any adverse tax consequences flowing from the receipt of tax-exempt income was the equivalent of a tax on such income. Instead, it based its decision on a more limited principle: "One may not be subjected to greater burdens upon his taxable property solely because he owns some that is free. No device or form of words can deprive . . . the taxpayer] of the exemption for which he has lawfully contracted."[10] This rationale, known as the "National Life doctrine," has been applied to analogous tax formulas with varying interpretations.[11]

In the *Gehner* case,[12] a Missouri insurance company brought suit to contest a state property tax on the taxable assets of insurance companies, less deductions for legally required reserves.[13] The Mis-

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quired by law, and held at the beginning and end of the taxable year. . . ." The Revenue Act of 1921, ch. 136, 42 Stat. 261.

8. National Life Ins. Co. v. United States, 277 U.S. 508 (1928).

9. *Id.* at 512 (Emphasis added).

10. *Id.* at 519.

11. At least part of the difficulty in interpreting the *National Life* case stems from an inconsistency between what the Court said and what the Court did. To prevent "greater burdens" on taxable income as a result of the receipt of nontaxable income, the Court need only require that the "pro rata share" of deductions per unit of taxable income remains the same. The Court, however, permitted the full reserve deduction notwithstanding increased proportionate ownership of tax-exempt income; thus taxable income was permitted more than its pro rata share of the reserve deduction. See note 17 *infra* and accompanying text. Permitting an effective deduction means that the deduction is being allowed against taxable income. To charge a deduction or any part of it against nontaxable income results in no deduction at all for the part so charged. There can be no effective tax deduction where there is no tax basis to reduce, and tax-exempts, by definition, do not form a portion of the tax basis.

12. Missouri *ex rel.* Missouri Ins. Co. v. Gehner, 281 U.S. 313 (1930).

13. "The property of all insurance companies organized under the laws of this state shall be subject to taxation . . . . Every such company or association shall make returns, subject to the provisions of said law: First, of all the real estate held or controlled by it; second, of the net value of all its other assets or values in excess of the legally required reserve necessary to reinsure its outstanding risks and of any

souri court had held that the deduction could be taken for only that proportion of the total legal reserves as taxable assets bore to total assets.[14] The taxpayer demanded the total reserve deduction. The United States Supreme Court held for the taxpayer purportedly under the National Life doctrine.[15] In interpreting this doctrine the court said:

> [W]here as in this case the ownership of United States bonds is made the basis of denying the full exemption which is accorded to those who own no such bonds this amounts to an infringement of the guaranteed freedom from taxation. It is clear that the value of appellant's government bonds was not disregarded in making up the estimate of taxable net values. That is in violation of the established rule [of the National Life case].[16]

As was pointed out by Justice Stone in his well reasoned dissent,[17] this holding was not in accord with the National Life doctrine and in effect was an adoption of the position previously advocated by the National Life Insurance Company, namely that "ownership of tax-exempt securities [cannot] result in the taxpayer getting a less benefit or privilege than he would have had if he had not owned them."[18]

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unpaid policy claims, which net values shall be assessed and taxed as the property of individuals . . . ." Mo. Rev. Stat. § 6386 (1919).

14. The Missouri Supreme Court ". . . found the company's liabilities were chargeable against all its assets—taxable and nontaxable alike—and declared that such reserve[s] . . . and claims should be apportioned between the two classes of assets according to their respective amounts of total assets. . . ." Missouri *ex rel.* Missouri Ins. Co. v. Gehner, *supra* note 12, at 319. An asset's "pro rata share" of a deduction is that portion of the deduction which bears the same ratio to the total deduction as the asset bears to total assets.

15. "It necessarily follows from the immunity created by federal authority that a State may not subject one to a greater burden upon his taxable property merely because he owns tax-exempt government securities . . . ." Missouri *ex rel.* Missouri Ins. Co. v. Gehner, *supra* note 12, at 321.

16. *Ibid.*

17. "[In *National Life*, the Court said,] 'one may not be subjected to greater burdens upon his taxable property solely because he owns some that is free.'

"But the present statute has no such effect. Calling the deduction of policy liabilities, required for the computation of the tax an 'exemption' and saying that ownership of tax exempt securities is made the basis of denying the 'full exemption,' may give this case a verbal resemblance to that, but it does no more. True, a change by appellant from taxable to tax free investments would result in a smaller deduction from its taxable assets, but it would also result in a proportionate reduction of its taxable assets with a corresponding decrease in taxable values, always in exact proportion to appellant's investment in tax exempt securities.

"Only if the taxpayer were the fortunate recipient of a gift of tax exempt securities . . . [would the deduction per unit of taxable values be decreased] and this not solely or at all because its newly acquired securities are 'free,' but because they, like its taxable assets, may be used to meet policy obligations, and thus proportionately relieve taxable assets from that burden." *Id.* at 329 (Stone, J., dissenting).

18. National Life Ins. Co. v. United States, *supra* note 8, at 512. The Atlas Insurance Company also contended that this was the effect of the *Gehner* holding. "Atlas urge[d] that the rule of *National Life*, when read in conjunction with Missouri Ins. Co. v. Gehner, *supra* note 12, means that a tax is imposed on tax-exempt interest whenever the liability of the taxpayer receiving such interest is greater than it would have been if the tax-exempt interest had not been received." 381 U.S. at 244. The

The "burden" which was imposed by this formula was a non-tax burden; taxable and non-taxable assets alike had been charged with meeting a share of the legal reserve requirements. As the proportionate ownership of tax-exempt assets increased, their pro rata share[19] of the reserve requirements increased, reducing proportionately the amount of the reserve requirement properly allowable as a deduction from taxable assets.[20] Since the tax "burden" imposed by that formula was not discriminatory and had not changed with the receipt of tax exempt assets, the formula was not in violation of the National Life doctrine. The formula in the *National Life* case reduced the reserve deduction by the full amount of tax-exempt interest, forcing tax-exempt income to absorb more than a pro rata share of the reserve deduction. As a result taxable income was denied its pro rata share of the reserve deduction and the taxpayer was, indeed, "subjected to greater burdens upon his taxable property solely because he owned some that . . . [was] free."[21]

Only a year after the *Gehner* case, the majority holding of that case was impliedly overruled by *Denman v. Slayton.*[22] In *Denman* the taxpayer contested the validity of Section 214(a)(2) of the Revenue Act of 1921, which permitted an income tax deduction for interest paid or accrued on all indebtedness except that incurred to purchase tax-exempt securities.[23] The taxpayer claimed that this exception was an infringement on the constitutionally guaranteed immunities of tax-exempt assets, and invoked both *National Life* and *Gehner.* In essence, the claim of the taxpayer was the same as that in the *Gehner* case, namely that the tax basis should be reduced for expenses or reserve obligations properly allocable, in accounting theory, to tax-exempts which are not a part of the tax basis.[24] Without mention-

circuit court in finding for the Atlas Insurance Company accepted this as the holding in *Gehner.* Comparing *Atlas* with *Gehner,* the circuit court said, "In both instances the liability of the taxpayer is increased, solely by reason of the receipt of tax-exempt interest, and no form or method for determining it can disguise its incidence. We conclude . . . the . . . [1959] Act does result in the imposition of a tax on exempt interest . . . ." Atlas Life Ins. Co. v. United States, 333 F.2d 389, 399 (10th Cir. 1964).

19. See note 14 *supra.*

20. The reserve deduction corresponds in amount to the legal reserve requirements, and the legal reserve requirements are intended to correspond to the obligations of the company. For this reason the terms "reserve deduction," "reserve requirement or reserve fund" and company "obligations" refer to a corresponding amount of dollars and are often interchangeable in use.

21. National Life Ins. Co. v. United States, *supra* note 8, at 519.

22. Denman v. Slayton, 282 U.S. 514 (1931).

23. "Sec. 214(a). That in computing net income there shall be allowed as deductions: . . . (2) All interest paid or accrued with the taxable year on indebtedness, except on indebtedness incurred or continued to purchase or carry obligations or securities . . . the interest upon which is wholly exempt from taxation . . . ." Revenue Act of 1921, ch. 136, 42 Stat. 239.

24. The *Denman* case denies a deduction for obligations incurred *directly* by the

ing the *Gehner* case, the Court necessarily repudiated it and established the principles which presently govern the treatment of tax-exempts:

> While guaranteed exemptions must be strictly observed, this obligation is not inconsistent with reasonable classification desigued to subject all to the payment of their just share of a burden fairly imposed. . . . The classification complained of is not arbitrary, makes no improper discrimination, does not result in defeating any guaranteed exemption, and was within the power of Congress.[25]

This position was reaffirmed in *Helvering v. Independent Life Insurance Co.*[26] in which the Court upheld the limitation of tax deductions for real estate expenses to those expenses related to real estate which produced taxable income.[27] The Court held that this did not discriminate against tax-exempt uses of the real estate and cited *Denman* for the position that limiting deductions to expenses attributable to or incurred in producing taxable income or taxable assets is a legitimate and separate concept from the "taxation of exempt securities condemned in *National Life Ins. Co. v. United States.*"[28]

To summarize, the present principles governing tax-exempt assets are first, that such assets are to be immune from direct taxation. Any indirect means aimed solely at defeating this immunity must fall, and

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acquisition of tax-exempt assets. There is no plan for apportionment of existing deductions to all assets as there was in *Gehner*, and therefore there can be no decrease of a previous deduction with the acquisition of tax-exempts. The taxpayer in *Atlas* attempted to distinguish *Denman* from *Gehner* on these grounds. "[In *Gehner*] expenses would have been incurred in any event and would have been fully deductible if no exempt income had been received.

"[T]o disallow a deduction for such an expense because of the receipt of a tax-exempt interest would be a radical departure from the policy of exemption . . . ." Brief for Respondent p. 46. United States v. Atlas Life Ins. Co., 381 U.S. 233 (1965). However this is a difference in appearance only. In both cases the obligations for which reserve deductions are demanded did, indeed, result in the acquisition of tax-exempt receipts, and the link between the obligations and the tax-exempts is of the same force in both cases. See notes 55 & 56 *infra*. In *Gehner* the taxpayer was allowed to apply the reserve deduction corresponding to these obligations to exclusively taxable income. In *Denman* the taxpayer was not permitted to apply a deduction corresponding to such obligations to taxable income, and *Denman* necessarily overrules *Gehner*. "[T]hus the Court not only refused to follow the implications of *Gehner* in the context of the federal income tax, but also sustained the propriety of disallowing the expense attributable to the production of nontaxable income. Such disallowance was not to impose an impermissible burden on the exempt receipts." 381 U.S. at 246.

25. Denman v. Slayton, *supra* note 22, at 519.

26. Helvering v. Independent Life Ins. Co., 292 U.S. 371 (1934).

27. "Sec. 245(b). No deduction shall be made . . . [for taxes, exhaustion, wear and tear of property, obsolescence] on account of any real estate owned and occupied in whole or in part by a life insurance company unless there is included in the return of gross income the rental value of the space so occupied. Such rental value shall not be less than . . . 4 per centum per annum of the book value . . . of the real estate so owned or occupied." Revenue Act of 1921, ch. 136, 42 Stat. 261.

28. Helvering v. Independent Life Ins. Co., *supra* note 26, at 381.

in this respect, the National Life doctrine is good law. Beyond this, tax-exempt assets are not immune from bearing the burdens which are naturally and rightfully incident to their ownership. Thus, they must pay their pro rata share of the reserve obligations, and a "reserve deduction" corresponding to this share of reserve obligations cannot be applied against taxable receipts.

Following the express overruling of the tax formula of the 1921 Act in the *National Life* case, life insurance companies were permitted full and separate deductions for both tax-exempt income and reserve obligations. Dissatisfied with this result, Congress introduced a new formula in the Revenue Act of 1941,[29] which in effect charged tax-exempt income with a pro rata share of reserve obligations. This charge was based upon an industry-wide calculation of total annual reserve obligations (determined by actuarial and interest tables) and annual net income. The percentage of the former to the latter was applied to the net income of a particular company to arrive at its reserve deduction. This formula was not contested by taxpayers, apparently for two reasons: (1) the industry-wide reserve deduction percentage was so great that the individual company's net taxable investment income was miniscule; (2) each company could minimize its tax burden by purchasing tax-exempt securities because the income therefrom was not included in the computation of the individual tax liability.[30]

This industry-wide calculation was unsatisfactory due to the fact that it resulted in an erratic variance in tax liabilities for successive years and it was not directly related to each company to which it was applied.[31] The 1959 Act continued to charge all income with a pro rata share of reserve obligations, but the pro rata share was determined on a company by company, rather than an industry wide basis. The basic formula dividing all investment income between a company's share and a policyholders' share indicates an intent not to permit complete and separate deductions for tax-exempt income and reserve obligations. This apparent intent, however, is clouded by the "exception" clause appended to the basic formula which provides that if application of the basic formula should result in a tax on tax-exempt income, "adjustment" shall be made to the extent necessary to prevent such taxation.[32]

29. Int. Rev. Code of 1939, § 202(b), as amended, ch. 619, 56 Stat. 870 (1942).
30. 333 F.2d at 395.
31. Wurzel, *supra* note 5, at 20.
32. A question of legislative interpretation is raised because the "exception" clause is inconsistent with the basic formula of the act. If the "exception" clause were intended to be of general application the apportionment formula would be ineffective. If on the other hand, it were not meant to be of general application, and were not so applied, the "exception" clause itself would be surplusage because it is not possible

In sustaining the application of the basic formula without the exception clause tax formula in the instant case, the Court dealt first with the issue of legislative interpretation and then with the constitutional issue. Since the adjustment clause 804(a)(6) was written as an "Exception," the Court held on the basis of the plain meaning rule that it was not intended to be applicable to the typical case.[33] "Otherwise the exception would become the rule and the general formula of little, if any, utility."[34] The Court found that interpretation supported by the legislative history of the act. The original House version of the bill, which contained essentially the same limitation on reserve deductions as the final act, had been proposed to prevent a double deduction[35] for exempt interest. After a thorough consideration of the argument that the limitation resulted in a tax on tax-exempts, the proponents of the bill concluded that in its general application the limitation would not result in a tax on tax-exempt interest.[36] The Court concluded that the "exception" clause was not intended to be of general application, and had been added simply as a safeguard to cover unusual situations which Congress feared might arise.[37]

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to conceive of any unusual circumstances which, as opposed to the general case, would result in the imposition of a tax on tax-exempt interest.

33. 381 U.S. at 239.

34. *Id.* at 240.

35. *Ibid.*

36. The Court relied on statements by the Senate Committee on Finance, and Senator Byrd, chairman of the Committee, both of whom without mentioning the "exception" clause, stated that the purposes and effect of the law was to not impose a tax on tax-exempt interest. *Id.* at 241. The taxpayer contended that these statements were made with the view that the "exception" clause was to be of general application. See note 44 *infra* and accompanying text. But there is no justification for such an assertion.

A statement by Representative Mills, Chairman of the House Ways and Means Committee, indicated that the "exception" clause was not considered necessary to avoid the imposition of an unconstitutional tax. "'It is my belief that the appropriate deduction was allowed by the House bill . . . [which included no "exception" clause] and that these provisions of the final bill, which closely follow the Senate amendment, make no change of substance.' 105 CONG. REC. 10412." 381 U.S. at 242.

37. "None of the materials called to our attention, however, explain why or for what purpose Sections 804(a)(6) . . . (was) added to the Act, save for mere recitations in the reports and the debates that an adjustment would be required in any case where tax-exempt interest was shown to be subjected to tax. It may be that Congress thought that peculiar facts and circumstances in particular cases would require different treatment than the general formula would provide." *Ibid.*

The district court in finding for the government, decided that the "exception" clause had been ". . . enacted by Congress to make doubly sure that tax-exempt interest would not in fact be taxed and that if by some misapplication of the formula or mathematical error it is taxed, then by application of these provisions an adjustment would be made." Atlas Life Ins. Co. v. United States, 216 F. Supp. 461 (N. D. Okla. 1963).

The government contended before the Supreme Court that the "exception" clause had a dual purpose. First, it deprived the Treasury Department of standing to attack

The Court then found that the application of the basic formula did not in fact result in the imposition of a tax on tax-exempt income and the "exception" clause was therefore not required in the instant case. The Court's argument followed generally the rationale of the *Denman* case. After distinguishing the *National Life* case[38] and disavowing the *Gehner* holding,[39] the Court said,

> We affirm the principle announced in Denman and Independent Life that the tax laws may require tax-exempt income to pay its way. In our view, Congress has done no more in the 1959 Act than to particularize this principle in connection with taxing the income of Life insurance companies.[40]

The Court noted the inherent logic of allowing deduction of receipts used to meet the reserve requirements of insurance companies, and of assessing those deductions against all receipts on a pro rata basis:

> We see no sound reasons, legal or economic for distinguishing between taxable and nontaxable dollars or for saying the reserve must be satisfied by resort to taxable income alone. Interest on municipal bonds may be exempt from tax, but this does not carry with it exemption from the company's obligation to add a large portion of investment income to policyholder reserves.[41]

The Court found "unrealistic" the argument that under this formula a company would be penalized for investing "idle" funds in tax-exempts or for obtaining tax-exempts when its taxable income and its reserve obligations remain the same. In fact the company would obtain a net benefit from investing "idle" funds in tax-exempts; and in all probability increased ownership of tax-exempts will correspond to increased obligations of the company which will in turn increase the reserve deduction. More importantly, the Court held that there was no constitutional requirement that the tax liabilities of a company be unchanged under these varying circumstances. The difference in tax liabilities "necessarily follows from the application of the prin-

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the basic doctrine of tax immunity of government securities should the present act be litigated. Senator Butler was quoted as saying, "The Treasury has been waiting for this opportunity for years. The arguments are prepared. All that is needed is the legal controversy . . . . Brief for Petitioner, p. 66. *Hearings on H.R. 4245 Before the Senate Finance Committee,* 86th Cong., 1st Sess. 702 (1959). Second, the "exception" clause was included to provide the proper remedy in the event that Congress ". . . had been mistaken in its judgment that the general taxing formula did not tax exempt interest." Brief for Petitioner, p. 69. The appellate court and the respondent before the Supreme Court of the United States both contended that the "exception" clause was meant to supersede the general formula. See note 45 *infra* and accompanying text.

38. 381 U.S. at 245.
39. *Ibid.*
40. *Id.* at 247.
41. *Id.* at 249.

ciples of charging exempt income with a fair share of the burdens properly allocable to it."[42]

> In the last analysis Atlas' insistence on both the full reserve and exempt-income exclusions is tantamount to saying that those who purchase exempt securities instead of taxable ones are constitutionally entitled to reduce their tax liability and to pay less tax per taxable dollar than those owning no such securities. The doctrine of intergovernmental immunity does not require such a benefit to be conferred on the ownership of municipal bonds.[43]

In the final analysis, the Court was correct in finding that Congress did not intend the "exception" clause to be of general application. Both parties agreed that the arguments relating to the tax treatment due tax-exempt income were fully debated throughout the legislative history of the act. The appellate court and the taxpayer erred, however, in assuming that the "exception" clause necessarily indicates that Congress accepted the argument that the basic formula imposed a tax on tax-exempt income and intended the "exception" clause to supersede the basic formula in its general application.[44] The legislative history relied on by the appellate court and the taxpayer showed an intent by Congress not to tax tax-exempts, but it is not clear or even plausible in some instances that they felt it was necessary for the "exception" clause to be applied in the normal case to effect this intent.[45] The taxpayer further failed sufficiently to explain

42. *Id.* at 251.
43. *Ibid.*
44. Atlas Life Ins. Co. v. United States, 333 F.2d 389, 397 (10th Cir. 1964).
45. The appellate court and the respondent before the Supreme Court relied on the following excerpts from the legislative history of the act: "When the Senate version came to the floor for consideration the Chairman of the Finance Committee, reporting on the bill, stated that it was 'the intention of the Committee not to impose any tax on tax-exempt interest' and that the 'Treasury has assured the Committee that this formula dces not impose any tax on tax-exempt interest. The bill adds a proviso to the effect that if the formula I have described does result in the imposition of a tax on this item, the formula is to be adjusted so that it does not do so' 105 Cong. Record, Part 6, p. 8401. A letter from the treasury . . . reviewed the statutory formula for determining an insurance company's taxable income and, referring to the exception sections, expressed the view that 'this additional language is not necessary, since we can not envision a situation in which the operation of the proposed tax formula would result in the substantive imposition of tax on municipal bond interest or on any other form of tax-exempt income.' 105 Cong. Record, Part 6, p. 8402." *Ibid.* See also Brief for Respondent, p. 24 n. 14. "Senator Curtis, who was asked to make the detailed explanation of the statute, made the following statement on the floor of the Senate before the amended version was adopted '. . . no tax-exempt income or credits of life insurance companies will be included in the tax base of such companies, under this bill. This should allay any fear that any constitutional provision is transgressed.' 105 Cong. Record, Part 6, p. 8429." *Id.* at 397 n. 13; Brief for Respondent, p. 25 n. 15. "Representative Mills, after the conference committee reached agreement on the final Act, reported to the House: 'It is my belief that the appropriate deduction was allowed by the House bill and that these provisions of the final bill, which closely follow the Senate amendments, make no change of sub-

the wording of the statute. He suggested that Congress expressed its controlling intentions in the form of an "exception" clause because it was unsure of the effect of the complicated apportionment formula.[46] However, in light of the extended legislative debates and the plain wording of the basic formula, it appears more logical that Congress did understand the normal effect of the basic formula, but was uncertain either of its application to abnormal circumstances, or of the judicial acceptability of the formula in light of *National Life* and *Gehner*.

It was these uncertainties rather than an intent to supersede the basic formula which compelled the addition of the "exception" clause.

The Court was also correct in sustaining the constitutionality of charging all income with a share of the reserve obligations, thereby reducing the corresponding reserve deductions allowable against taxable income. This follows logically from the nature of the deduction. The reserve deduction corresponds to the legally required reserve fund of the company. Income utilized to meet these requirements cannot be said to represent "beneficial ownership" by the company, and the reserve deduction simply recognizes that it would be inequitable to tax such income.[47] Income receipts of an insurance company are fungible, and it is reasonable to assume that all are proportionately responsible for meeting a pro rata share of the obligations of the company.[48] Consequently, all such income receipts

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stance.' 105 Cong. Record, Part 8, p. 10412. He further stated that the final Act '. . . clarified the language of the House bill to make it definite that we do not intend to tax the interest on tax-exempt securities.' *Id.* 10414." 333 F.2d at 398. Brief for Respondent, p. 25. *Contra*, note 25 *supra*.

46. Brief for Respondent, p. 30. Atlas Life Ins. Co. v. United States, 333 F.2d at 397.

47. See note 6 *supra*.

48. "It is . . . the nature of the life insurance business . . . that the companies' entire investment income, taxable and otherwise, plays a part in feeding the reserves for policyholders, in establishing the companies' solvency to the satisfaction of the State Insurance Commissioner, and in substantiating the recognition taxwise (through deduction, credit or exclusion) of their commitment to the policyholders." Wurzel, *supra* note 6, at 17. See text accompanying note 41 *supra*. "Net worth . . . into which of necessity enter all his [the taxpayer's] assets subject to liabilities and all such obligations of the tax-payer as the statute permits to be deducted . . . is the subject of the tax to which exemptions are to be applied. . . . To say that debts must be deducted from taxable assets alone, that no part of the net worth of the taxpayer who owns tax-free securities may be taxed if his debts equal his tax-free securities, is equivalent to saying . . . either that the taxable assets constitute no part of the net worth or that, even though they are a part, still that part is not taxable. But it is not to be supposed that a mathematician, an accountant or a business man would regard the taxable assets as contributing nothing to surplus, or . . . that there is any basis for saying that net worth could, on any theory be attributed more to one class of assets than the other." Missouri *ex rel.* Missouri Life Ins. Co. v. Gehner, *supra* note 12, at 324 (Stone, J., dissenting).

deserve a pro rata share of the reserve deduction. Applying a part of the deduction to tax-exempt income necessarily limits the effect of the deduction,[49] but such application is required by the nature of the deduction and does not result, as the Court suggested in *Gehner*, in a denial of the "full exemption."[50] Moreover, to hold that the reserve deduction is permissible in whole against taxable income, requires the holding that tax-exempt income is not chargeable with the reserve obligations of the company. In effect this amounts to "a debt exemption"[51] in addition to the tax exemption granted tax-exempt incomes. In demanding this, the taxpayer has taken the incongruous position that tax-exempt income, which by definition is not included in the tax base, should be granted an additional exemption which enables it to reduce the existing tax base. Certainly, there can be no claim of right to such legislative largesse.

The taxpayer conceded that where, as in the *Denman* case, obtaining tax-exempt securities directly and immediately created obligations, deductions corresponding to those obligations should not be applied against taxable income.[52] It was acknowledged that this would be a double deduction. The taxpayer, however, distinguishes this situation from the instant case on the grounds that here the obligations are unrelated to the receipt of tax-exempt income; therefore reducing reserve deductions as a result of such income is foundless and in effect taxes tax-exempt income.

> [T]he annual increase in reserves necessary to provide for 'policyholders' claims' is an expense of doing business as a life insurance company which would be incurred whether or not tax-exempt interest has been received.[53] Petitioner's failure to recognize . . . (the) difference between the allocation of expenses which may or may not be deductible depending on how they are identified, and the denial of deductions for expenses that are incurred in any event and are denied only because of the receipt of state and municipal bond interest . . . is the fundamental defect in its whole argument.[54]

49. See note 11 *supra*.

50. Missouri *ex rel.* Missouri Life Ins. Co. v. Gehner, *supra* note 12, at 321.

51. "[T]he only assumption on which the rule . . . [of the majority in *Gehner*] could proceed, . . . [is] that government honds, because they are tax-exempt, are also debt-exempt, or may not be used for the payment of debts, when in fact and in law tax-exempt securities constitute a part of the corporate reservoir of capital, all of which without distinction may be drawn on for the payment of obligation." *Id.* at 324 (Stone, J., dissenting).

52. The Respondent considered it a "logical extension of *National Life*" to disallow deductions which is the same, in effect, as setting-off deductions against tax-exempts for "expenses directly connected" with tax-exempt income. Brief for Respondent, p. 14.

53. *Id.* at 8.

54. *Id.* at 49. The petitioner rightly points out that this argument errs in supposing that the creation of expenses for which a reserve deduction is allowed thereby requires the final realization of that deduction. Rather, a subsequent acquisition of tax-exempt income may carry with it certain burdens which rightly affect that reserve

However, it does not follow that, because annual reserve obligations would arise regardless of the receipt of tax-exempt income, the two are unrelated. The fixed nature of the reserve obligation is, in fact, immaterial in determining an existing connection between company income and company obligations. The fact is that the company did receive tax-exempt income; this resulted from the ownership of tax-exempt securities. The acquisition of these securities may well have been based upon the receipts from policies giving rise to the obligations which are presently due and for which deductions are demanded. If this is the case, to permit deduction in whole against taxable income amounts to a double deduction for tax-exempt income. Again, a company's income producing assets are fungible and it is reasonable to assume that all such assets are equally traceable to a pro rata share of the company's policy obligations and all investment income is thereby chargeable with a pro rata share of annual reserve deductions.[55]

Moreover, the taxpayer's argument errs in assuming that the reserve deduction corresponding to due obligations is limited to that income which can be said to have created those obligations. The deduction, as was pointed out, is applicable to that income which is responsible for meeting those obligations, for it is that income which is not truly owned by the company. All income of insurance companies being treated as fungible is applied against company obligations. Therefore all income, taxable and tax-exempt, is chargeable with a pro rata share of the annual reserve deduction,[56] and tax-exempt income thereby rightfully becomes a factor limiting the effective reserve deductions.

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deduction. "In short, the fallacy in the formula proffered by respondent and accepted by the court below is that it assumes that the same allocations and subtractions must be made on account of the reserve fund regardless of whether the taxpayer company has, or has not, received income from state bonds. The 1959 Act prescribes different allocations and subtractions. The question, however, is not whether the tax is more, but whether the changed apportionment is reasonable." Brief for Petitioner, p. 29.

55. "If the company's investment income, earned at the 'cost' of the annual addition to the reserve, were entirely from taxable securities, there would be no problem, and the cost would be deductible in full. [I]t becomes appropriate . . . to allocate the cost between the two kinds of income produced by it . . . . Certainly some part of the cost of using the policyholders' funds is attributable to the production of the tax-exempt interest, and unless Congress is constitutionally required to allow the costs of producing tax-exempt income to be off-set against taxable income, so reasonable an allocation can hardly be subject to challenge." Brief for Petitioner, p. 34.

56. "There is nothing to the argument that since the reserve obligation remains the same whether there is exempt income or not, no part of the obligation is fairly chargeable to exempt income . . . . The fact is that the annual addition to reserve must be made up from investment income, whatever its source, and the company owed to its policyholders a share of the tax-exempt dollar fully as much and in the same sense that it owes a part of the taxable dollar." 381 U.S. at 249 n.18.

Viewing the aggregate effect of this act, the Senate Finance Committee estimated that some 40 million of the 500 million dollars expected to be derived annually from the bill would result from charging tax-exempt income with meeting a portion of the reserve obligations.[57] The Treasury similarly estimated that the revenue to be derived from this charge would be in the neighborhood of 35-40 million dollars on the basis of 1958 income.[58] The estimate by the life insurance company representative was 32½ million dollars.[59] A more significant effect, however, than the increase in federal revenue which this act will occasion, may be the influence which it will have on the purchase of state and local bonds. The respondent amici curi suggested that an intent to encourage the sale of state and local bonds was the fundamental concern of the 1959 act, and that the act was intended to be interpreted accordingly.

> The exemption protected by the Congress was not created for the benefit of life insurance companies or any other investors. They are mere conduits. State and local governments are the beneficiaries. Without the adjustment authorized by the Exceptions, the conduit is clogged and the intended state and local government benefit is dissipated.[60]

In 1964 life insurance companies held approximately 3.9 billion dollars worth of state and local bonds, which constituted 2.7 per cent of their total invested funds. This represented a decrease from 2.8 per cent in 1959 and from the all time high of 6.8 per cent in 1940. This 2.7 per cent of total insurance company investments represented approximately 4.5 per cent of all outstanding state and local bonds.[61]

The precise question of what quantitative effect the present interpretation of the 1959 Act will have on sales of tax-exempt securities has not yet been answered. Some less significant studies have attempted to correlate generally the change in desirability of tax-exempt bonds with a change in the net returns expected on such bonds. Senator Talmadge stated in the legislative debates before the Senate Finance Committee:

> One of my constituents goes so far as to make this assertion: Under present market conditions, taxable utility bonds are currently offered to yield about 4.6. Under the proposed new tax bill in order to be comparatively

57. The bill referred to in this estimate was the 1958 bill which was essentially the same as the 1959 bill actually adopted. This estimate was made on the basis of 1958 figures. S. Rep. No. 291, 86th Cong., 1st Sess. 12 (1959).

58. *Hearings Before the Senate Finance Committee on H.R. 4245,* 86th Cong., 1st Sess. 121 (1959).

59. *Id.* at 317.

60. Brief for State and Local Governments as Amici Curiae, p. 2, United States v. Atlas Life Ins. Co., 381 U.S. 239 (1965).

61. *Id.* at 13 n.3.

> attractive municipal bonds would have to yield approximately 4.10. This excludes the great bulk of municipal bonds currently being offered in the range of three, three and three-quarters. If full tax-free status is granted his company would be interested in this type of security on yields as low as a 3½ per cent.[62]

Senator Talmadge did not suggest exactly how many dollars worth of municipal bonds or what percentage of such bonds then being held or purchased by insurance companies would become impractical investments for insurance companies with the passage of the 1959 Act as presently interpreted.

The respondent as amici curiae presented a study attempting to relate the returns possible on tax-exempt bonds to purchases by insurance companies.[63] Municipal bond yields were said to range between 71 per cent and 68 per cent of the yield on corporate bonds. If the ratio held at 68 per cent the industry in 1963 could have saved some 44.9 million out of a total tax collected of 651.0 million if it had been able to shift 3 billion dollars of its assets to exempt securities. If the ratio of municipal bond interest to corporate bond interest had been 64 per cent, the industry could have saved 32 million in taxes by switching 2 billion dollars of its assets to exempt securities. If the ratio were 60 per cent the reduction possible by switching to exempt securities was nil. Unfortunately, the amount which the 1959 Act was expected to affect the return ratio on municipal securities was not given. Apparently it is too early to assess the effect of the present interpretation of the 1959 Act on insurance company purchases of state and municipal bonds. Whether the detriment to sales of such bonds will more than outweigh the benefit of the expected increased Treasury revenues remains to be seen. This much is certain, however, whatever detriment to sales actually occurs can be no more than a policy consideration for future legislators. Any claim that tax-exempt securities are constitutionally protected from all statutory impairment of their tax advantages, *whether or not that impairment is related to burdens rightfully incident to such bonds*, has been forever laid to rest by the instant case.

62. *Hearings Before the Senate Finance Committee on H.R. 4245*, 86th Cong., 1st Sess. 45 (1959).

63. Brief for State and Local Government as Amici Curiae, *supra* note 59, at 12-14.

Torts—Strict Liability Doctrine Not Applicable Absent Physical Harm to Person or Property?

Seely purchased a truck manufactured by White Motor Company from White's dealer, Southern Truck Sales, under a conditional sales contract. Pursuant to White's express warranty[1] contained in the purchase order, Southern, with guidance from White's representatives, made a number of repairs over an eleven month period in an effort to correct a defect which caused the truck to bounce violently. Thereafter, the truck overturned when the brakes failed to function properly; and when Seely served notice that he did not intend to make any more payments on the purchase price, Southern repossessed the truck. Upon Seely's failure to prove that the defect caused the accident, the trial court denied recovery for repairs. However, finding breach of express warranty, the court awarded return of the purchase price and profits lost from inability to make normal use[2] of the truck.[3] On appeal to the Supreme Court of California, *held*, affirmed. Upon the breach of a manufacturer's express warranty, the purchaser of a defective product may recover from the manufacturer, with whom he is not in privity, the purchase price and lost profits arising from the breach, but strict liability will not apply unless the defect causes physical harm to persons or property. *Seely v. White Motor Co.*, 45 Cal. Rptr. 17, 403 P.2d 145 (Sup. Ct. 1965).

The modern law of products liability began with the landmark decision of *MacPherson v. Buick Motor Co.*,[4] which established the rule that a manufacturer can be held liable for personal injury to an ultimate purchaser without privity, if, through negligence in his manufacturing process, he created a dangerous product. However, under the more recently developed theory of strict liability, a manufacturer may incur liability without privity for physical injuries caused by a defective product even though he has exercised all possible care.[5] All

1. "The White Motor Company hereby warrants each new motor vehicle sold by it to be free from defects in material and workmanship under normal use and service, its obligation under the warranty being limited to making good at its factory any part or parts thereof. . . ." Seely v. White Motor Co., 45 Cal. Rptr. 17, 20, 403 P.2d 145, 148 (Sup. Ct. 1965).

2. The court held that the fact repairs were made over an 11 month period established that Seely was not making an abnormal use of the truck. *Id.* at 22, 403 P.2d at 150.

3. Seely had paid $11,659.44 of the total purchase price of $22,041.76. The amount awarded for lost profits was $9,240.40. *Id.* at 19-20, 403 P.2d at 147-48.

4. 217 N.Y. 382, 111 N.E. 1050 (1916). For a complete discussion of how the *MacPherson* rule has been extended with respect to plaintiffs, defendants, and products, see PROSSER, TORTS § 96, at 661-64 (3d ed. 1964).

5. RESTATEMENT (SECOND), TORTS § 402A (1965). See generally Wade, *Strict Tort Liability of Manufacturers*, 19 Sw. L.J. 5 (1965).

of the early strict liability cases involved either foodstuffs or drink.[6] In the fifties, the courts extended the rule to cover products intended for intimate bodily use,[7] and now the *Restatement* applies strict liability to "any product in a defective condition [which is] unreasonably dangerous. . . ."[8] While many theories have been used to clear the hurdle of privity,[9] one of the most significant was that an implied warranty either ran with the goods[10] or was made directly to the customer. With *Greenman v. Yuba Power Products, Inc.*,[11] came full recognition that "the liability imposed is not one governed by the law of contract warranties but by the law of strict liability in tort."[12] There is another theory of strict liability resting on a so-called express warranty.[13] In cases espousing this theory, a manufacturer is held strictly liable to a purchaser who has relied on advertisements or representations as to the quality of the products and has suffered physical damage as a result.[14] While recognizing liability in this situation, the *Restatement*[15] speaks in misrepresentation and deceit terminology and thereby avoids confusion of this tort action with a true express warranty case. Originally, strict liability was limited to actions for personal injury, but more recently has been applied to cases involving physical damage

6. The first was Mazzetti v. Armour & Co., 75 Wash. 622, 135 Pac. 633 (1913) (unwholesome meat).

7. See, *e.g.*, Graham v. Bottenfield's, Inc., 176 Kan. 68, 269 P.2d 413 (1954) (hair dye); Markovich v. McKesson & Robbins, 106 Ohio App. 265, 149 N.E.2d 181 (1958) (wave solution).

8. RESTATEMENT (SECOND), TORTS § 402A (1965).

9. See, *e.g.*, Madouros v. Kansas City Coca-Cola Bottling Co., 230 Mo. App. 275, 90 S.W.2d 445 (1936) (assignment of warranty from retailer to consumer); Ward Baking Co. v. Trizzino, 27 Ohio App. 475, 161 N.E. 557 (1928) (consumer is third party beneficiary); Wisdom v. Morris Hardware Co., 151 Wash. 86 274 Pac. 1050 (1950) (1929) (retailer is consumer's agent).

10. This theory was introduced in Coca-Cola Bottling Works v. Lyons, 145 Miss. 876, 111 So. 305 (1927).

11. 27 Cal. Rptr. 697, 377 P.2d 897 (Sup. Ct. 1963).

12. *Id.* at 63, 377 P.2d at 901. The importance of this recognition is that it eliminates the troublesome warranty concepts of privity, notice, and the manufacturer's right to disclaim in cases involving physical damage.

13. The Supreme Court of Washington recognized this so-called express warranty to avoid the privity barrier in Baxter v. Ford Motor Co., 168 Wash. 456, 12 P.2d 409, *aff'd per curiam on rehearing*, 15 P.2d 1118 (1932), *aff'd on second appeal*, 179 Wash. 123, 35 P.2d 1090 (1934).

14. *E.g.*, Randy Knitware, Inc. v. American Cyanamid Co., 11 N.Y.2d 5, 181 N.E.2d 399, 226 N.Y.S.2d 363 (1962); Rogers v. Toni Home Permanent Co., 167 Ohio St. 244, 147 N.E.2d 612 (1958).

15. RESTATEMENT (SECOND), TORTS § 402B (1965): "One engaged in the business of selling chattels who, by advertising, labels or otherwise, makes to the public a representation of a material fact concerning the character or quality of a chattel sold by him is subject to liability for *physical harm* to a consumer of the chattel caused by justifiable reliance upon the misrepresentation, even though (a) it is not made fraudulently or negligently, and (b) the consumer has not bought the chattel from or entered into any contractual relation with the seller." (Emphasis added.)

to property.[16] The most controversial question in the field of products liability at present is whether strict liability should be extended to the situation in which the plaintiff suffers only an economic loss. A recent case, *Santor v. A & M Karagheusian, Inc.*,[17] has answered the question in the affirmative. Until *Santor*, it has been necessary for a purchaser seeking to recover from the manufacturer economic losses not arising from personal injury or property damage to proceed under the commercial law theory of express warranty, which requires notice of the defect to the manufacturer, and which allows the manufacturer to issue disclaimers.

Chief Justice Traynor's negative response to the question, whether a strict liability action for loss of bargain may be maintained against the manufacturer by a purchaser not in privity, is the real importance of the instant case. But the court did allow Seely to recover on the commercial theory of breach of express warranty. The court ruled that the promise in the purchase order together with White's promises over the eleven month period constituted an express warranty to the purchaser which was breached by the repeated failures to correct the bouncing, notwithstanding White's attempted limitation of its obligation of repair and replacement.[18] Having expressly warranted the product to the purchaser, privity was unnecessary.[19] Further, White clearly had notice of the defect. Having established the plaintiff's right to recovery, the court affirmed the award of the purchase price and lost profits as losses resulting naturally and directly from the breach of warranty.[20] While reaffirming his opinion in *Greenman*

16. "There is no sensible reason for distinguishing between the two kinds of damage; and the question would appear to be rather one of choosing the products to be covered by the strict liability." Prosser, *The Assault Upon the Citadel (Strict Liability to the Consumer)*, 69 YALE L.J. 1099, 1143 (1960). This view is supported by RESTATEMENT (SECOND), TORTS § 402A(1) (1965).

17. 44 N.J. 52, 207 A.2d 305 (1965). Santor purchased carpeting sold as Grade No. 1 which proved to be defective. No one was injured and plaintiff's damage was solely that of loss of bargain. As the retailer had moved to another state, Santor brought suit against the manufacturer seeking recovery of the purchase price. The trial court decided there was a breach of an implied warranty of merchantability from the manufacturer to the purchaser even though there was no privity. Judgment was entered for the full purchase price. The Supreme Court of New Jersey agreed with the trial court's reasoning, but went on to say that liability could be based on strict liability in tort. Damages were reduced to the difference between the purchase price and the actual market value of the carpet. It should be noted that there is no significant difference in what the trial court and the supreme court said; for if an implied warranty of merchantability is held to run without privity this accomplishes the same result as allowing a strict liability action for loss of bargain. It is possible that there could have been recovery on the ground of breach of express warranty since the carpet was sold as Grade No. 1, thus avoiding this extension of strict liability.

18. Seely v. White Motor Co., *supra* note 1.

19. Burr v. Sherwin Williams Co., 42 Cal. 2d 682, 696, 268 P.2d 1041, 1049 (1954).

20. Seely v. White Motor Co., *supra* note 1, at 20, 403 P.2d at 148, where the court is relying on CAL. COMMERCIAL CODE § 2714.

that warranty theory is not suited to the area of liability for personal injuries, Chief Justice Traynor argued that the rules of warranty are still applicable when the only injury the purchaser suffers is a loss of bargain. He explained that the distinction "between tort recovery for physical injuries and warranty recovery for economic loss . . . rests . . . on an understanding of the nature of the responsibility a manufacturer must undertake in distributing his products."[21] While it is just to demand of a manufacturer that his products not create unreasonable risks of harm to person and property, it is going too far to hold a manufacturer strictly liable when his product fails to meet a purchaser's economic expectations. Had White not warranted the truck to be free from defects under normal use, it would not be liable.[22] Chief Justice Traynor expressed the opinion that under strict liability a manufacturer could be held liable whenever his product failed to serve a purchaser's specific needs, and subsequently "would be liable for damages of . . . unlimited scope."[23]

Justice Peters' dissenting opinion contended that strict liability should apply because the nature of the damage sustained should be immaterial as long as it proximately flowed from the defect.[24] He argued that it is arbitrary to say that Seely could have recovered on the basis of strict liability if the defect had caused an accident, but that he cannot since he discovered the defect before an accident occurred. In both cases the defect has rendered the truck unusable. Justice Peters rebutted the majority's contention that if strict liability were applied in loss of bargain cases the manufacturer would be liable whenever the product failed to meet the purchaser's expectations by saying there would be liability only when the goods are unmerchantable.[25] Instead of drawing the line between warranty law and strict liability on the grounds of the nature of the damage, the dissent suggested that it be drawn at the time of the sale by using the "ordinary consumer"[26] test. If the purchaser falls in this category,

21. Seely v. White Motor Co., *supra* note 1, at 23, 403 P.2d at 151.

22. *Id.* at 22, 403 P.2d at 150. The court felt that recovery for loss of bargain should be allowed even though the manufacturer attempted to limit his liability to replacement of parts found defective because of the repeated failure to correct the bouncing.

23. *Id.* at 22-23, 403 P.2d at 150-51.

24. *Id.* at 25-26, 403 P.2d at 153-54.

25. *Id.* at 28, 403 P.2d at 156. The implied warranty to which Justice Peters is referring is found in CAL. COMMERCIAL CODE § 2314. The applicable provisions defining when goods would be unmerchantable are as follows: "(2) Goods to be merchantable must be at least such as (a) Pass without objection in the trade under the contract description; and . . . (c) Are fit for the ordinary purposes for which such goods are used . . . ."

26. Seely v. White Motor Co., *supra* note 1, at 30, 403 P.2d at 158. Justice Peters admits this test will need judicial definition, but he believes the "ordinary consumer" needs relief from the restrictive warranty provisions.

the warranty law requirements of privity and notice would be abolished and disclaimers would be restricted to "situations where it can be reasonably said that the consumer has freely assumed the risk. . . ."[27]

It should be observed that the majority does seem to equate the proposed strict liability with an implied warranty of fitness for a particular purpose,[28] while the dissent argues that it should apply only when the goods are unmerchantable. If the latter, the manufacturer's exposure to risks of unforeseen liabilities to ultimate purchasers is not nearly so great as the majority fears. However, if strict liability is extended to loss of bargain situations, especially in view of today's "long-arm" statutes,[29] manufacturers would probably be subjected to a limitless number of nuisance suits.[30] Against this distinct possibility should be balanced the relative number of times a consumer is without a remedy at present. Only if the retailer is insolvent, has left the state,[31] or for some other reason is not amenable to suit is the purchaser remediless. In the great majority of instances in which the consumer receives an unmerchantable product, a breach of warranty action will lie against the retailer. As for future developments in this area, the relative uncertainty of direction is indicated by two more recent decisions. The view of the majority appears to find support in *Inglis v. American Motors Corp.*,[32] decided subsequent to

27. *Ibid.*

28. This warranty is defined in CAL. COMMERCIAL CODE § 2315: "Where the seller at the time of contracting has reason to know any particular purpose for which the goods are required and that the buyer is relying on the seller's skill or judgment to select or furnish suitable goods, there is . . . an implied warranty that the goods shall be fit for such purpose."

29. See, *e.g.*, ILL. ANN. STAT. ch. 110, § 17 (Smith-Hurd 1956); N.Y. CIV. PRAC. LAW § 302.

30. A recent Tennessee case illustrates the handicap a foreign manufacturer faces when sued in the plaintiff's "backyard." In this action for breach of warranty, the jury absolved the local retailer of liability, this necessarily meaning that the article was not defective when delivered to the purchaser, while holding the manufacturer liable, meaning that the article was defective when the purchaser received it. The case was reversed at the appellate level. Kyker v. General Motors Corp., 214 Tenn. 521, 381 S.W.2d 884 (1964). If an implied warranty is held to run to a non-privity purchaser and an aetion is allowed against the manufacturer for loss of bargain as the dissent suggests, with the local retailer out of the picture there will be no way to detect the prejudiee recognized to exist against foreign manufacturers.

31. Santor v. A & M Karagheusian, Inc., *supra* note 17.

32. 3 Ohio St. 2d 132, 209 N.E.2d 583 (1965). This holding is more liberal than that in *Seely* for here the express warranty was simply the manufacturer's mass advertising; whereas in *Seely* there was the written promise in the purchase order and the repeated promises to the purchaser over the next 11 months. However, *Inglis* does not go as far as the dissent in *Seely* advocates. Justice Peters in *Seely* would say the manufacturer would be liable even if he had not expressly warranted the automobile through advertisements. The opinion in *Inglis* is not clear because the court in allowing recovery for breach of express warranty cites *Santor* and quotes passages from it in which the New Jersey court was affirming the purchaser's right to

the instant case. The court allowed the purchaser of a defective automobile, who had relied on the manufacturer's mass advertising to recover for loss of bargain on the basis of breach of express warranty, notwithstanding the absence of privity, while holding that a cause of action did not lie in tort. In an even more recent case, *Price v. Gatlin*,[33] the Supreme Court of Oregon expressly reserved opinion on the issue of whether a non-privity purchaser may maintain a strict liability loss of bargain action against the manufacturer, but indicated support for the negative answer of the *Seely* majority.[34] However, a strong three-judge dissent approved the *Santor* decision.

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recover for breach of an implied warranty of merchantability. *Id.* at 136, 209 N.E.2d at 587. It may well be that the Ohio Supreme Court will shortly adopt the position of the *Seely* disseut and the *Santor* decision when confronted with a case in which no express warranty can be found.

33. 405 P.2d 502 (Ore. 1965). The holding in this case was that a purchaser could not recover economic losses alone from a non-privity wholesaler who was not at fault.

34. "We believe, however, that the social and economic reasons which courts elsewhere have given for extending enterprise liability to the victims of physical injury are not equally persuasive in a case of a disappointed buyer of personal property." *Id.* at 503.