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LEGAL NOTES

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EXEMPTION STATUTE—ASSIGNMENT OF POLICY—GOVERNMENT TAX LIEN: *Meyer v. United States* (U.S. Supreme Court, December 16, 1963) 375 U.S. 233. The insured, Meyer, assigned four life insurance policies to a bank as collateral security for a loan. These policies were payable to his wife as beneficiary, and he reserved the right to change the beneficiary. The Government claimed that Meyer owed income taxes for past years and assessed deficiencies and filed a notice of tax lien with the insurance company.

Just prior to the insured's death the cash value of the policies was $27,-285.87, and the debt to the bank was slightly less than this amount. The bank was paid its debt of $26,844.66 out of the policy proceeds, and the named beneficiary, who had received the balance of the proceeds, tendered to the Government the difference between this amount and the cash value at death, or $441.21. Under a prior decision of the United States Supreme Court the Government's claim to the policy proceeds where it had merely filed a lien and done nothing more before the insured's death was limited to the cash value immediately prior to death. The beneficiary claimed that the bank had a first lien on the cash value and that the remainder of the proceeds in excess of the cash value was exempt from claims of creditors, including the United States Government, under New York law.

The Government's claim was that since the bank admittedly under the assignment could satisfy its claim out of any policy proceeds, including the excess beyond the cash value just prior to death, it should be required to do so, and the Government's recovery should not be limited to the $441.21 difference between the debt to the bank and the net cash value just prior to death. The Court of Appeals for the Second Circuit agreed with this contention (as it had in a prior case), but on appeal, the United States Supreme Court reversed. In its opinion by Justice Clark the Court respected what it deemed to be the policy of the Congress relative to state law exemption from creditors' claims, stating:

> We cannot overlook this long-established policy. In the absence of a definitive statutory rule to the contrary we therefore adopt the state rule and refuse to extend the equitable doctrine of marshaling assets to this situation. New York has a specific statute which exempts insurance benefits of a widow from the claim of creditors of her husband's estate and its courts have refused to marshal assets where to do so will diminish those rights. *Burns v. First Trust & Deposit Co., supra.* To apply marshaling in this case would overturn New York's beneficent policy and, in addition, would en-

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large the federal tax lien that the Congress has provided in § 3670. This we will not do. The judgment is therefore

Reversed.

Three of the Justices dissented, holding that the equitable doctrine of "marshaling assets" should be applied in this case, permitting the Government to satisfy its claim out of the policy proceeds to the extent of the cash value. In the dissenting opinion Justice White stated:

Nor is there any superior equity in the beneficiary to prevent the application of the well-established rule of marshaling, a rule long recognized by this Court. It is not unreasonable to suppose that the beneficiary enjoyed the benefits of the bank loan which is here used to insulate the cash surrender value from the government lien. What is more, the insured and his family used and spent the income which should have been used to pay federal taxes which had been due and payable for many years. Paying both the bank and the tax lien from the proceeds is wholly consistent with the arrangements made by the insured and with this Court's holding in *Bess.*

Finally, the federal revenue deserves more protection than it receives today. The Court may now protect a widow, but the rule announced will protect all beneficiaries, varied as they may be. Congress has declared that the United States shall have a lien on the assets of those persons who do not discharge their federal tax obligations. This Court now creates an exception to that policy by holding that the tax lien may not be paid from the cash surrender value of the insurance policy, solely because prior to the attachment of the tax lien Mr. Meyer had assigned the entire proceeds as collateral for a bank loan. I would not invite or validate the utilization of continuing and growing bank loans for the sole purpose of insulating insurance proceeds from the federal tax lien which otherwise would be satisfied from the policy proceeds.

There are in this case two secured creditors and two funds. The total assets are sufficient to satisfy the claims of both creditors, but the junior claimant has a lien on only one of the funds. It is entirely appropriate here to require the payment of both liens.

For the foregoing reasons, I respectfully dissent.

A decision such as this from the United States Supreme Court is encouraging.

EMPLOYMENT CONTRACT—SUICIDE OF INSURED: *Prudential Insurance Company v. Gray Manufacturing Company* (C.A. 2, January 29, 1964) 328 F.2d 438. Gray Manufacturing Company in 1957 entered into an agreement with Ditmars, its former president, to serve "as a consultant and in an advisory capacity." In addition to salary, the agreement provided that Ditmars' wife was to become the beneficiary of $200,000 life insurance for the years 1957 and 1958, $150,000 for 1959, and $100,000 for 1960, 1961, and 1962. On the last day of 1962, and several hours before the wife's interest in the policy expired by the terms of the agreement, Ditmars killed himself. The policy proceeds were claimed by the widow and named beneficiary, and also by Gray Manufacturing Company, and Prudential accordingly commenced an interpleader action.

In this action the District Court held that the widow was entitled to the proceeds under the terms of the agreement in spite of the suicide. On appeal, the three Circuit Judges who heard this case likewise all agreed, for reasons each elected to state separately, that the beneficiary was entitled to the proceeds.

The Court rejected Gray's contention that Ditmars owed a duty of fair dealing to his employer and that he should not have wrongfully destroyed himself in order to benefit his widow. The Court refused to attempt to probe the mind of Ditmars when he committed suicide, stating in effect that the conditions of the employment contract had been satisfied and that the widow was entitled to the proceeds of the policy in the event Ditmars died prior to January 1, 1963, as he did.

GOVERNMENT TAX LIEN—AMOUNT DUE FROM COMPANY: *United States of America v. Sullivan* (C.A. 3, April 10, 1964) F.2d. The United States brought this action to foreclose a tax lien on unmatured life insurance policies issued by Aetna Life Insurance Company and Manufacturers Life Insurance Company. Other companies were also involved in related litigation. The question presented was whether the life insurance companies were liable for the net cash value as of the date the policies were actually surrendered, or the larger net cash value available at some earlier date.

The insured, Mary E. Sullivan, and her husband, Cornelius W. Sullivan, owed the Government a large amount on account of federal income taxes. Thereafter, Mary Sullivan took out a policy on her life in each one of the two companies, naming her husband as beneficiary. The Government thereafter filed a tax lien in a number of jurisdictions but did not at that time serve either Aetna or Manufacturers with notice of the lien, and they had no actual notice from other sources. Manufacturers thereafter made a policy loan to the insured, which was used to pay premiums. The Government later served a demand on Aetna and on Manufacturers for the cash value available, and Manufacturers paid over to the Government the small amount of accumulated dividends. After this demand was served, both Aetna and Manufacturers took care of premiums thereafter due by means of the automatic premium loan provisions which were incorporated in the policies and which had been elected. The Manufacturers' policy had no cash value at the time of its actual surrender, and the Aetna policy had a cash value in a substantially reduced amount.

The District Court held that the Government was entitled only to the cash value on the date of the surrender of the policies, which came a considerable time after the suit was filed. The Government claimed that it was entitled to an amount equal to the policy loan made after the lien was filed and that the two companies were not entitled to apply the automatic policy loan provisions in order to take care of the premiums thereafter due.

The Court of Appeals for the Third Circuit held that the right to the cash values of the policies was not "property" or "rights to property" within the meaning of the tax lien statute, and the companies would not have been justified in refusing to carry out their obligation under the automatic premium loan provisions to take up the premiums until the policies had been surrendered. Hence, as the District Court had held, the companies were liable only for the cash values on the date of the surrender.

One of the judges dissented in part on the basis that after the insurance com-

panies had been served in the suit to foreclose the tax lien, they were not justified in thereafter taking up premiums under the automatic premium loan provisions. This judge agreed, however, that the policy loan made before actual notice of the lien was a valid transaction and should be given effect to.

There are now many cases pending which involve these same issues, and unless the Government is prepared to concede that it is wrong, presumably a review by the United States Supreme Court will be sought.

INCONTESTABLE CLAUSE—BENEFITS TO COMPANY: *Newton v. New York Life Insurance Company* (C.A. 9, December 10, 1963) 325 F.2d 498. The insured sued New York Life and two other life insurance companies based on alleged fraud, concealment, and misrepresentation in connection with the procurement of life insurance policies. The companies joined as parties defendant the agents who were alleged to have been guilty of the fraud, concealment, and misrepresentation. The companies then made the claim that the incontestable clauses in the policies were for their benefit as well as for the benefit of the insured and annuitant and hence the suits could not be maintained after the contracts became incontestable.

The District Judge agreed with this contention on the part of the companies and entered judgment for the companies. The insured appealed, claiming that the incontestable clause was for the benefit of the insured or annuitant and his beneficiary and hence could not be availed of by the companies in the manner here attempted.

The Court of Appeals for the Ninth Circuit reversed the judgment in favor of the companies and held that the suit could be maintained in spite of the presence in the contracts of the incontestable clauses.

The Court in its opinion (Madden, J.) stated:

> The plaintiffs say that the fact that no insurance company, except in the one instance just cited, has ever, in reported litigation, asserted the clause as a defense shows that the companies themselves, who invented the clause and write it into their policies, have not interpreted it as being for their benefit. The plaintiffs cite several reported cases in which it seems apparent that the incontestable clause, if applicable, would have won the company's case for it, yet it was not asserted as a defense. We think there is much force in the plaintiff's argument. It would be remarkable that the clause, in use for a century, would not have given rise to litigation and decision if the companies had thought they were entitled to rely on it.
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> The defendants Manufacturers and Dominion and third-party defendant Lloyd Steadman say that, in annuity cases, if the clause is not for the benefit of the insurer it is for the benefit of no one at all, it is wasted words, and to so hold is to violate the rule of construction of writings that every word in them is deemed to serve some purpose. This contention is based upon the fact that in the usual annuity contract the insured makes no representation about his state of health, or about anything except his identity and age, which subjects are expressly excepted from the incontestable clause. The plaintiffs explain the presence of the clause in annuity contracts as "boiler plate," verbiage which, because used in life insurance policies, has found its way into annuity policies issued by the same industry in much the same way as useless or obsolete

language can be found in the writings of any profession or occupation. The plaintiffs also suggest that, just as some companies write life insurance at higher than normal premiums upon the lives of persons having bad prospects for normal longevity, they might write annuity policies on such persons with premiums lower than normal. In that situation, of course, the company would have a vital interest in the truth of the annuitant's representation that he was in bad health, and the annuitant would want the assurance of the incontestable clause that his policy would not be subject, indefinitely, to be cancelled on the basis of a claim by the company that he had exaggerated his ills when applying for the policy.

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We are, then, dealing with language which was unquestionably originated by insurance companies solely to reassure prospective policyholders and thus make it easier to sell them insurance; which language in 100 years has only once been, in any reported case, claimed by an insurance company to be for the benefit of the insurer, which claim was rejected by the court in which it was made; which language was treated by the only text writer to whom it seems to have occurred that it might be for the benefit of the insurer as being so only by implication. Upon this background we could not possibly hold that the language "clearly and unambiguously" creates this right in the defendant insurance companies. To the contrary, we hold that, against its historical background in view of the interpretation which the incontestable clause receives and has received in the insurance industry, the constantly reiterated statement that the clause is for the benefit of the insured correctly states its legal meaning.

LIFE INSURANCE FEDERAL INCOME TAX—TAX-EXEMPT INTEREST: *Atlas Life Insurance Company v. United States of America* (C.A. 10, May 25, 1964) F.2d. Atlas brought this action in the District Court of Oklahoma to recover taxes which it claimed were imposed on the receipt of tax-exempt interest. The claim of Atlas was that the basic formula of the Life Insurance Company Income Tax Act of 1959 did in fact tax interest from state and municipal bonds owned by it and that the so-called exception provisions of Phases I and II should be applied so as to avoid this result. The United States District Court ruled against Atlas and in favor of the Government, holding that even though Atlas was required to pay a larger tax on account of the receipt of tax-exempt income than would be payable if this interest had not been received, the "tax-exempt interest received by Atlas is not in fact taxed. . . ." See digest of this case, *TSA*, XV, 593–95.

On this appeal, the United States Court of Appeals for the Tenth Circuit reversed, all three judges holding that Atlas was entitled to recover the increased tax imposed on it by reason of the receipt of the tax-exempt interest. In the principal opinion, the Court reviewed at length the legislative history of life insurance taxation and particularly that relating to the passage of the 1959 Act. The Court concluded that the Congress did not intend to tax interest from state and municipal bonds but that Congress did intend to preserve the exemption from tax in line with two prior United States Supreme Court cases involving life insurance taxation.

The Court in its opinion stated:

Whatever may be said of the extent of the Congressional power to indirectly burden exempt interest in the exercise of its power to classify all income for purposes of taxation; and whatever may be said of the government's conception of the Congressional intent and purpose to observe those precepts in the enactment of this legislation, it seems manifestly plain to us that Congress did not intend to invade the integrity of the intergovernmental tax immunity doctrine as exemplified in the decisional law when the legislation was under consideration. The prenatal history of this Act convinces us that Congress legislated with an ear to the problem of the marketability of state and municipal securities, and with an eye to the constitutional limitations of National Life on the Congressional power to increase the tax burden of a life insurance company, solely by reason of the receipt of interest from state or municipal securities.

The question then is whether this is a National Life-Gehner case. The trial court did not think so, and, basing its decision on Slayton, concluded that there was in fact no imposition of a prohibited tax. We conclude that our case is within the ambit of the National Life case, which is "radically different" from Slayton. In National Life, the Court invalidated Section 245(a) of the 1921 Act because it in effect increased the taxpayer's tax liability, solely by reason of the receipt of tax-exempt interest. In Slayton, the same Court upheld Section 214(a) of the same Act as a valid measure to prevent the avoidance of tax on taxable income by the simple expedient of borrowing to purchase tax-exempt securities. As the Court observed in Slayton, the taxpayer "was not in effect required to pay more upon his taxable receipts than was demanded of others who enjoyed like incomes solely because he was the recipient of interest from tax-free securities—a result which we found would have followed enforcement of the literal provisions of Section 245(a)." Denman v. Slayton, supra, 519. And see Helvering v. Independent Life Insurance Co., 292 U.S. 371, 381.

While the extent of the burden on the exempt interest and the form and method of imposing it in our case may differ from National Life, the taxable effect differs only in degree. 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 that the application of the definitions in the Act does result in the imposition of a tax on exempt interest, and the taxpayer is therefore entitled to an adjustment to the extent necessary to prevent such imposition.

It is incumbent upon the taxpayer to prove the amount of the adjustment. It says that it is $11,252.19, and arrives at this amount by simply eliminating exempt interest wherever it is operative in the computation under the statutory formula. While the Government does not quarrel with the taxpayer's arithmetic, it strenuously denies support or sanction of the formula by which it is computed. In that respect it says that the treatment of the tax-exempt interest is the same as if the money used to purchase tax-exempt securities had remained idle.

Be that as it may, the Congress has expressly provided for an adjustment to the extent necessary to prevent the imposition of tax on the exempt interest. And, since we hold that the application of the statutory definitions does in fact result in a prohibited imposition; and since the taxpayer's computations are based upon the elimination of that interest, we must conclude that the adjustment does no more than prevent the prohibited imposition.

Insofar as the judgment of the trial court denies refund of $11,252.19, it is reversed with directions to enter judgment accordingly.

The concurring Judge wrote a short opinion stating in part that:

> I grant the power of Congress to classify income, within constitutional limits, for income tax purposes; and I recognize that the reserve deduction which comes from the division of income into the noted shares is a matter of congressional grace or bounty. The issue is the exercise of a power rather than the existence of a power. The statute under consideration discloses a clear intent not to tax income from state and municipal securities. No uncertainty in this regard exists to require recourse to legislative history for the ascertainment of congressional intent.
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> We are bound by the National Life and Missouri v. Gehner decisions. With full knowledge of those decisions, Congress provided that if the application of the statutory method causes a tax on tax-exempt income an adjustment shall be made to prevent such a result. By refusing to make the necessary adjustment the government, in effect, has written §§ 804(a)(6) and 809(b)(4) out of the statute. Atlas is entitled to recover the overpayment.

Without doubt the Government will ask the United States Supreme Court to review this or a similar case. It should be noted that the Atlas case involved only tax-exempt interest and not corporate dividends. The exception language of the 1959 Act, however, applies the proration principle (with the resulting tax) to corporate dividends as well as to tax-exempt interest. No constitutional claim of immunity can be raised with respect to the taxation through proration of corporate dividends. If this decision is not reversed by the United States Supreme Court, the Congress may see fit to change the law so that the Phase I and II exception provisions relate only to tax-exempt securities and not to corporate dividends. The revenue involved seems to be about equally divided between corporate dividends and tax-exempt interest.

BLUE CROSS—REFUSAL TO CONTRACT WITH HOSPITAL: *Baltimore County Hospital v. Maryland Hospital Service* (Maryland Court of Appeals, April 27, 1964) 200 A.2d 39. The hospital brought this suit against Maryland Hospital Service (Blue Cross), seeking an injunction and monetary damages, claiming Blue Cross was in restraint of trade. The hospital performed services chiefly relating to convalescence, rehabilitation, and postoperative care. Blue Cross had entered into contracts with some such hospitals but refused to deal with Baltimore County Hospital. If subscribers entered that hospital, they were not reimbursed.

The trial court dismissed the suit and on appeal the judgment was affirmed. The Maryland Court of Appeals took the position that Blue Cross, as a private corporation, had the right to do business with some and not with others and that Blue Cross, though covering about one-third the entire population of Maryland, was not a monopoly.

In its opinion the Court (Evans, J.) stated:

> Blue Cross is not a monopoly. The Court takes judicial notice of the fact that there are many private corporations selling hospitalization insurance in Maryland. The enabling statute for non-profit health service plans authorizes any non-stock corporation to be organized for this purpose. There is no suggestion that Blue Cross is conspiring with any person, company or hospital insurance plan to unlawfully injure the Hospital. Blue Cross is the largest company and dominates the hospital insurance field; however,

mere bigness is not a vice. In the case of Levin v. Sinai Hospital, supra, the amended bill alleged that the adoption of the rules and regulations of the medical board constituted a combination or conspiracy in restraint of trade, in violation of the Sherman Anti-Trust Act, 15 U.S.C.A. §§ 1–3.

. . . .

Blue Cross has not combined with or conspired with anyone to interfere with, restrain or prevent the Hospital from carrying on its business, although it is true that the Hospital has suffered economically by not being accepted as a member hospital. However, Blue Cross, being a private corporation, has the right to contract with whom it pleases. Its action cannot be construed as a restraint of trade, and this is assuming that hospitals are engaged in a trade.