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LEGAL NOTES

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FEDERAL TAX LIEN—EFFECT ON INSURED'S DEATH: *United States v. Behrens* (C.A. 2, February 15, 1956) 230 F. 2d 504. Prior to the insured's death the Government assessed the insured for unpaid income taxes and served upon him notices of assessment and demands for payment of the taxes. At the time of his death he had assets valued at less than $9,000 plus surrender values of life insurance policies in excess of $22,000 with face values of $59,000. His liabilities were in excess of $34,000 including unpaid federal and state taxes. His life insurance policies were pledged with a New York bank to secure a $17,000 loan.

The insured reserved the right to change the beneficiary but had not exercised this right. Upon the insured's death the proceeds less the amount of the indebtedness to the bank were paid to the named beneficiary. The Government brought this action against the beneficiary, claiming that its lien applied to the extent of the cash value of the proceeds in the hands of the beneficiary. The United States District Court dismissed the Government's suit, but on appeal the Court of Appeals for the 2nd Circuit held that the Government's claim could be satisfied out of the proceeds to the extent of the surrender value. The Court also said that although the lien of the bank was entitled to priority the policy proceeds were sufficient to satisfy both the Government and the bank, and hence the Government's claim was not limited to the difference between the cash value immediately prior to death and the amount owed to the bank.

In its opinion the Court, Hand, C.J., stated:

> Considered strictly upon the basis of the legal rights created, the lien on the "surrender values" came to an end with Behrens's death. The obligation of an insurer in a policy of life insurance is made up of a number of promises, of which one is to pay to the beneficiary the amount of the insurance—the "proceeds"—and another is to pay the "surrender value" to the insured upon his demand. The performances of these promises are not only separate, but inconsistent with each other: the payment of the "surrender value" cancels the promise to pay the "proceeds" and the promise to pay the "proceeds" assumes that the insured has not demanded and received the "surrender value." The premiums when paid become the property of the insurer and the insured has no interest in them, although it is true that in New York, as in most states, a life insurance company's finances are regulated by statute in much detail in order to protect policyholders. Moreover, the privilege granted to a bankrupt by the second proviso of § 70, sub. a(5) of the Bankruptcy Act, 11 U.S.C.A. § 110, sub. a(5) is no ground for supposing that the "surrender value" is not extinguished by the insured's death. That privilege does not in any way affect the legal relations of the parties to the contract itself; all it does is to avoid the exercise by the trustee in behalf of the creditors of the bankrupt's

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right to the "surrender value," as an asset to which they ought properly to be entitled. This it does on consideration that the bankrupt shall pay the trustee the value of the "surrender value" to be administered as part of the estate. It follows from what we have said that there is no logical escape from holding that the "surrender value" comes to an end on the insured's death, if we dispose of the controversy in accordance with the ordinary rules governing contracts.

However, in *Rowen v. Commissioner of Internal Revenue*, supra, 215 F. 2d at page 647, we held that "it is not realistic to view his" the insured's "death as wiping out these values. Under the policies, his death was merely a condition upon which the surrender values no longer payable to the decedent became merged in the greater values which the insurers were obligated to pay the beneficiaries." There can be no doubt that the courts have spoken of the "surrender value" as though it were in fact a fund which the insurer held as a custodian for the insured. This way of looking at the situation was long ago stated by Judge Addison Brown with his customary clarity, and the Supreme Court has twice quoted what he said with approval. We shall not requote it in full; it is enough to excerpt the following passages. "Though this excess of premiums paid is legally the sole property of the company, still in practical effect, though not in law, it is the moneys of the assured deposited with the company in advance to make up the deficiency in later premiums * * *. So long as the policy remains in force the company has not practically any beneficial interest in it, except as its custodian, with the obligation to maintain it unimpaired and suitably invested for the benefit of the insured. This is the practical, though not the legal, relation of the company to this fund." This language obviously treats the surplus of the paid premiums that makes up the "surrender value," as a "fund" held for the insured, and, if it were such, the lien would follow it into the "proceeds." Regardless of what Judge Medina and I might have held, had the question come up as *res nova*, we think that this interpretation is imperative, and therefore we all agree that the "proceeds" were subject to the lien.

The defendant also claims that in any event she was entitled to deduct the amount of the loan that Behrens had obtained from the bank, secured by a pledge of the policies. After his death she paid the loan and now seeks to be subrogated to the pledge. The tax lien, not being filed, did not indeed have priority over the pledge; but the "proceeds" were large enough to pay both claims, and it is well settled law that, when one creditor has a claim against two funds as security and another creditor has a claim against only one of them, the loan of the first will be marshalled against that fund which is security for his loan only.

FEDERAL ESTATE TAX—PREMIUM-PAYMENT TEST—CONSTITUTIONALITY: *Kohl v. United States* (C.A. 7, October 13, 1955) 226 F. 2d 381. The insured took out three life policies in 1921 and 1922. He paid all premiums thereon through 1940, and on January 21, 1941, he assigned the policies absolutely to his three children, who thereafter paid the premiums.

After the insured's death in September 1943, the Commissioner of Internal Revenue claimed that part of the proceeds proportionate to the premiums paid by the insured should be included in his estate for tax purposes and a deficiency assessment of $66,009.62 was levied. Thereafter the executors paid and sued for the recovery of the amount assessed with interest. Their claim was that the policy proceeds could not be taxed as part of the insured's estate because the insured prior to his death had parted with all interest in the policies. The

Government's claim was based on T.D. 5032, promulgated January 10, 1941, or ten days prior to the assignments. This is the Treasury Decision which established the premium-payment test almost two years before it was written into the law specifically by the Congress.

The United States District Court found for the executors, and on this further appeal the Court of Appeals for the 7th Circuit affirmed the judgment. The Court of Appeals took the position that the Government was seeking to levy a direct tax on the proceeds of the policies without apportionment, contrary to the provisions of the United States Constitution. The Court also found that the 1939 statute on which T.D. 5032 was based was not broad enough to support this ruling.

In its opinion the Court, Lindley, C.J., stated:

> We are of the opinion that to construe and apply the two sections to the facts of this case as the government would have us, would necessarily result in their unconstitutionality. Such construction would require that the insurance, regardless of its ownership at the time of the decedent's death, must be included in his gross estate. Such is not a tax on a transfer but rather a direct tax on proceeds without apportionment, as required by Article I, § 2, Clause 3 and Article I, § 9, Clause 4 of the Constitution. A tax mposed on property or the income therefrom only by reason of its ownership is direct. *Pollock v. Farmers' Loan & Trust Co.*, 157 U.S. 429, 578, 580, 15 S. Ct. 673, 39 L. Ed. 759. Such taxes bear directly upon persons, upon their possession and enjoyment of rights, whereas indirect taxes are levied upon the happening of an event such as an exchange or transmission of property.
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> In the present case no transfer, no transmission of property rights in and to the policies in question, occurred upon the decedent's death. After the father, in his lifetime, made a completed gift of the insurance, reported it and paid the tax thereon, no interest remained in him. From that time, the assignees owned the policies and all rights in and to the same. "The assignees were in truth, not by any fiction, the absolute owners of the * * * policy." *Bohnen v. Harrison*, 7 Cir., 199 F. 2d 492, at page 494. They might have sold the policies and transferred to others any and all proceeds thereof. They might have surrendered them and received their cash value from the insurer. The assignor could exercise no control over, no rights in these pieces of property, which he had completely transferred. To tax as a part of his estate something which was no longer his, is to do violence to our constitutional provisions.
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> The government insists that Congress may properly impose at the death of the assignor a tax upon policies of insurance transferred during his life, measured by the value of the policies at the time of his death. But this argument loses sight of the basic premise that it is the transfer which is taxed and that alone and that that act was completed during the decedent's lifetime. No authority cited supports the government's theory. The cases upon which it relies, upon examination, are found to be, without exception, cases in which either some property interest, some right of reversion or some economic benefit in the property transferred, was retained by the transferror.
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> The government argues that the district court was not justified in holding that the pertinent sections of the statutes, when applied as the government seeks to have them

applied, bring about retroactive results, for the reason, that under the law, as it existed prior to the amendment provided by § 404, the policies were taxable. Though the statute did not provide for such taxation prior to the amendment, it is said that Regulation 5032 promulgated Jan. 10, 1941, eleven days prior to the assignments did so provide. But that regulation, if it meant to read into applicable law taxability of completely transferred insurance policies to third persons, transcended the then existing § 811(g). That section made it plain that Congress intended to tax insurance (a) receivable by the executors, and (b) receivable by other beneficiaries. It did not apply to completed transfers to third persons. T.D. 5032, however, attempted to include for taxation all policies transferred before the death of the decedent. It included such assignees. In this respect it went beyond the statutory provisions which covered only insurance receivable by the executors or beneficiaries.

This decision may be of great importance to life insurance. Certain governmental officials have suggested from time to time that the premium-payment test should be restored. If this decision is sustained, the premium-payment test cannot, of course, be reinstated without a Constitutional amendment; and it would be practically impossible to enact such an amendment.

The transfers were made prior to the enactment of the premium-payment test by the Revenue Act of 1942. However, on the constitutional question this would make no difference; but it would make a difference on the point of construction discussed above. This case would also seem to indicate that the Internal Revenue Code of 1954 could not be construed to impose a tax when the policy was disposed of absolutely and the only "possibility of reverter" retained by the insured was the possibility that the insured might get something back by way of inheritance.

For some reason the Government did not seek a review of this case by the United States Supreme Court. Perhaps it is awaiting a favorable and conflicting decision on the point from another circuit.

SOLDIERS' AND SAILORS' CIVIL RELIEF ACT OF 1940—OBLIGATION OF VETERAN TO REPAY: *Plesha v. United States* (C.A. 9, November 30, 1955) 227 F. 2d 624. Plesha entered the service and asked that his commercial life insurance premiums be paid by the Government under the terms of the Soldiers' and Sailors' Civil Relief Act of 1940. He lapsed this insurance after discharge and the Government sought to collect what it claimed to have paid in premiums on his account by deducting $221.05 from a special dividend due him under his National Service Life Insurance policy. The claim of the Government was that the Soldiers' and Sailors' Civil Relief Act of 1940 imposed personal liability on the veteran to repay. By a 1942 amendment this obligation clearly was imposed as to applications thereafter made, but the amendment was not by its terms retroactive.

Plesha sued for the portion of his dividend withheld. The United States District Court held against him on the basis that there was an implied obligation on his part to repay. On this appeal the Court of Appeals for the 9th Circuit reversed. The Court found that the legislative history on the matter of personal liability was uncertain, that the application of Plesha, made in accordance with the statute and on a form furnished him, contained no specific obligation to repay and that the United States Supreme Court had said that the Act should be "liberally construed to protect those who have been obligated to drop their own affairs to take up the burdens of the nation."

The Court also found that under the accounting procedure between the Government and the insurance companies it was difficult to determine the exact amount the United States actually expended on any individual veteran because under the law there was a pooling of debits and credits as to all insured in a particular company.

The Court recognized that a different result had been reached in the 10th Circuit in a similar case, which the Court in the Plesha case thought was erroneously decided. The Government is now seeking a review by the United States Supreme Court of the decision in the Plesha case, and it is quite likely that this review may be had in view of the fact that there is a conflict in the decisions of the two circuits on this point.

In the early days of World War II a considerable volume of insurance was sold by some life insurance companies just as the applicant was entering the service, with the idea of having the Government pay the premiums. The applicants relied on the published statements of the Veterans Administration to the effect that there was no personal liability for repayment of the premiums assumed by the Government. A reaction unfavorable to the life insurance companies was created later when the Veterans Administration asked the insureds to repay.

INTERPLEADER ACTION—LIABILITY OF INSURANCE COMPANY FOR STATUTORY PENALTY: *Equitable Life Assurance Society v. Nichols* (Florida Supreme Court, January 26, 1956) 84 S. 2d 500. There was a dispute as to whether the change of beneficiary was validly made or whether it was procured by undue influence on the part of the new beneficiary. In view of this dispute the Equitable Society paid the proceeds into court and asked that it be discharged from liability. The trial court found for the new beneficiary and ordered Equitable to pay an attorney's fee and one-half the cost of the litigation to the successful claimant. This award was under a Florida statute.

On appeal the Florida Supreme Court held that the proceeds were awarded to the proper claimant but that the Equitable should not have been charged with the costs and the attorney's fee. The Court held that the statute in question should be interpreted as authorizing the recovery of attorney's fees only where the proceeds were withheld wrongfully by the insurance company and this was not such a case.

CONDITION PRECEDENT—MISREPRESENTATION STATUTE: *Krause v. Equitable Life Insurance Company of Iowa* (Massachusetts Supreme Judicial Court, November 7, 1955) 129 N.E. 2d 617. Krause applied for a life policy March 30, 1948 and was examined April 2. Four days later he collapsed and remained unconscious for several minutes. He was treated by a doctor at the place where he collapsed and later went home with his family physician, who took an electrocardiogram, the results of which did not appear. The insured died the following December of a heart condition.

In his application for the policy the insured agreed that

> the Company shall incur no liability until said policy is delivered to me and the entire first premium therefor is actually paid while I am in good health, and then only if I have not consulted or been treated by any physician or practitioner since completion of the medical examination.

No binding premium had been paid. The policy was issued April 16 and the first premium was paid April 21.

After the insured's death the company denied liability on the basis of this condition precedent and the beneficiary brought this suit. The trial judge submitted to the jury the question whether the insured had consulted or been treated by a physician on April 6 or April 7 and the answer of the jury was in the affirmative. The trial court accordingly directed a verdict in favor of the company.

The beneficiary appealed, claiming that the application language quoted above was a "representation" or "warranty" within the meaning of a Massachusetts statute which provides:

> No oral or written misrepresentation or warranty made in the negotiation of a policy of insurance by the insured or in his behalf shall be deemed material or defeat or avoid the policy or prevent its attaching unless such misrepresentation or warranty is made with actual intent to deceive, or unless the matter misrepresented or made a warranty increased the risk of loss.

The beneficiary's contention was that the jury should have been permitted to pass on the question whether the "representation" or "warranty" was made with actual intent to deceive or increased the risk of loss.

The Massachusetts Supreme Judicial Court found that the clause in question contained conditions rather than representations or warranties and that no contractual duty under the policy ever arose because of the consultation or treatment by the physicians.

STATUTE OF FRAUDS—PAROL ASSIGNMENT: *Katzman v. Aetna Life Insurance Company* (New York Court of Appeals, July 8, 1955) 309 N.Y. 197, 128 N.E. 2d 307. The insured's wife supported him out of her earnings most of their married life. Nine years before he was killed accidentally in 1953 the insured took out a policy naming his wife as beneficiary. She claimed the agreement was that she was to pay the premiums, which she did, and that the policy would belong to her. Three years before the insured died he surreptitiously withdrew and took possession of the policy, changing the beneficiary to his sister. After his death the widow paid the funeral expenses in reliance on the belief that she was the beneficiary and the policy proceeds would cover the cost.

After the insured's death the widow learned of the change of beneficiary and thereafter brought suit, claiming that she was named beneficiary pursuant to an oral agreement and that she was the victim of fraud and deceit. The named beneficiary claimed that this oral agreement could not be shown because of a section in the New York Statute of Frauds which renders unenforceable any "contract to assign or an assignment * * * of a life * * * insurance policy, or a promise * * * to name a beneficiary of any such policy unless the agreement or some note or memorandum is in writing."

The trial court held that the above provision in the law, enacted in 1943, did not prevent proof of the oral agreement, but on further appeal the Appellate Division reversed, holding for the named beneficiary.

In the Court of Appeals the judgment of the Appellate Division was reversed and the case was sent back for trial. The decision in the Court of Appeals was by a court split four to three.

In reversing the Appellate Division, the Court, Dye, J., stated:

> It is undeniable that subdivision 9 of section 31 of the Personal Property Law, enacted by chapter 104 of the Laws of 1943, effective March 11, 1943, under the sponsorship of the *amicus curiae* with the approval of the Insurance Department, was designed as the insurance counterpart of section 347 of the Civil Practice Act to prevent frauds against a deceased person and to end litigation based upon unsupported oral agreements with decedents "to assign" or to "name beneficiaries." However pertinent such enactment may be to situations depending for proof solely upon oral promise, it is not authority for dismissing the within complaint for insufficiency. Here we are not dealing with a cause of action based on an oral promise to give property in the future as in *Matter of Ditson*, 177 Misc. 648, 31 N.Y.S. 2d 468; *Rosseau v. Rouss*, 180 N.Y. 116, 72 N.E. 916, or to name a beneficiary, *Ward v. New York Life Ins. Co.*, 225 N.Y. 314, 122 N.E. 207, but rather to prevent consummation of a scheme between the insured and his sister to undo surreptitiously that which he, in fact, had done openly just as he had agreed to do. In this instance the plaintiff's case does not depend solely on an executory oral promise "to assign" the policy for, concededly, the policy when originally issued was delivered to her under circumstances indicating an intent "to assign" same to her.
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> The widow should be allowed her day in court to show, if she can, that she is the victim of fraud and wrongdoing. As in any lawsuit, the burden of proof rests with the plaintiff widow to establish the allegations of her complaint. If the statute is to be used as a shield, it is only right that the court should know whether it is protecting a wrongdoer. On this record a triable issue of fact is presented which should not be summarily disposed of by motion but only after a plenary trial.

The three dissenting Justices were of the opinion that the section of the Statute of Frauds quoted above clearly applied.

ACCIDENTAL MEANS—DEATH FROM SUNSTROKE—VISIBLE CONTUSION OR WOUND: *McDaniel v. Imperial Life Insurance Company* (North Carolina Supreme Court, December 14, 1955) 90 S.E. 2d 546. The accident policy covered death resulting through external violent and accidental means and required that there be a visible contusion or wound on the exterior of the body. The insured died from sunstroke. The trial court and, on appeal, the North Carolina Supreme Court found that there was no visible contusion or wound and held that the insurance company was not liable to the named beneficiary. In its opinion the North Carolina Supreme Court recognized that there was a conflict among the courts of other jurisdictions as to whether death by sunstroke was death through external, violent and accidental means. It found that it was unnecessary to decide this point because of the fact that there was no visible contusion or wound as required.

INSURABLE INTEREST STATUTE—RETROACTIVE EFFECT: *McCain v. Yost* (Texas Supreme Court, December 14, 1955) 284 S.W. 2d 898. The insured and his wife, residents of Texas, were divorced in 1953 and prior to the enactment later that year of the insurable interest statute in Texas. Under the Texas law in effect when the divorce was granted, the divorce terminated the insurable interest of the wife-beneficiary and she could not retain the proceeds. Later that year the Texas Legislature amended the statute to declare that a designated beneficiary did have an insurable interest and a right to retain the proceeds. The insured died in 1954 without effecting a change in beneficiary.

The administrator of the insured's estate brought this action against the named beneficiary, claiming that the insurable interest statute did not apply under the circumstances and that the insured's estate was entitled to the proceeds. The beneficiary claimed that in view of the fact that the insured did not change the beneficiary after the enactment of the new insurable interest statute she was entitled to retain the proceeds. The trial court and the intermediate appellate court awarded the proceeds to the insured's estate, but on further appeal the Supreme Court of Texas reversed, stating:

> Since the Act became effective prior to the death of the insured, and since he did not exercise his right to change the beneficiary, and since Article 3.49-1 expressly requires that a liberal construction of the Act be given in order to effectuate the purposes of the statute, and since the Act provides that such construction of its provisions shall not be limited or restricted by previous declarations or holdings of the courts of Texas defining the term insurable interest, we hold that the insurable interest rule announced in Article 3.49–1 should apply, and so holding, it naturally follows that petitioner had an insurable interest and was entitled under the law to have the proceeds of the policy paid to her.