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LEGAL NOTES

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FEDERAL INCOME TAX OWED BY INSURED—CLAIM AGAINST POLICY PROCEEDS—LIEN FILED AGAINST INSURED: *United States v. Bess* (United States Supreme Court, June 9, 1958) 357 U.S. 51. The Government brought this action to recover from the beneficiary, who had received the proceeds of several life insurance policies, the amount of federal income taxes owed by the insured at the time of his death. The insured had retained the right to change the beneficiary and had paid all premiums, but none in fraud of his creditors. Under New Jersey law the proceeds of the policies under the circumstances were not subject to creditors' claims.

The Government asserted its claim for unpaid income taxes prior to the insured's death and made a demand on him for payment. This demand created a lien on all of his property, including the life insurance policies. The insured had paid a portion of the taxes prior to his death.

The United States District Court held that the beneficiary was liable for the unpaid taxes, which were less than the policy proceeds but more than the cash value just prior to the insured's death. The Court of Appeals held that the Government's claim could not exceed such cash value but that the Government was entitled to recover from the beneficiary to this extent.

The United States Supreme Court affirmed on the basis that the lien filed prior to the insured's death attached to the proceeds in the hands of the beneficiary to the extent of the cash value immediately prior to the insured's death. The Court held that the state exemption statute did not serve to protect the beneficiary against the Government's claim. The Court also held that the cash surrender value did not expire with the insured's death so as to defeat the lien, stating (Brennan, J.):

> It is argued that the right to receive the cash surrender value expires with the death of the insured and that thus no property of his passes to the beneficiary. The contention is that the beneficiary receives the proceeds of the policies as performance by the insurance company of a separate promise to pay upon the death of the insured. It is said to follow 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." *United States v. Behrens*, 230 F. 2d 504, 506–507. This is to say that the cash surrender value is no part of the proceeds, but represents merely the right of the insured to cancel the policy and thereupon receive back from the insurer the amount accumulated from premiums paid in the past and held to cover the risk to be incurred in the future. Therefore it is said that the property represented

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by the cash surrender value disappears on the insured's death and no lien can survive in any part of the proceeds.

But the courts have long recognized that the surplus of the paid premiums accumulated to make up the cash surrender value should be treated for some purposes as though in fact a "fund" held by the insurer for the benefit of the insured. Judge Addison Brown stated in *In re McKinney*, 15 F. 535, 537:

"Though this excess of premiums paid is legally the sole property of the company, still in practical effect, though not in law, it is 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 view was approved in *Hiscock v. Mertens*, 205 U.S. 202, 211, and *Burlingham v. Crouse*, 228 U.S. 459, 469. See also *United States v. Behrens*, *supra*, at 507. Thus in economic reality the insurer pays the beneficiary the insured's "fund," plus another account sufficient to perform the insurer's promise to pay the proceeds on the insured's death. *Rowen v. Commissioner*, *supra*, at 647. Therefore we hold that, for purposes of § 3670, there was a transfer of property from the insured to Mrs. Bess, and that the lien attached to the property before his death followed the property into her hands.

Mr. Justice Harlan and Mr. Justice Burton dissented on the basis that the agreement of the insurer to pay a cash value was an independent promise which disappeared with the insured's death.

The distinguishing feature between this case and the *Stern* case, decided the same day, was that in this case but not in the *Stern* case the Government had placed a lien on the policies while the insured was living.

See *TSA* IX, 449–50.

FEDERAL INCOME TAX OWED BY INSURED—CLAIM AGAINST POLICY PROCEEDS: *Commissioner of Internal Revenue v. Stern* (United States Supreme Court, June 9, 1958) 357 U.S. 39. Six years after the death of Dr. Stern the Tax Court found that he owed the Government a substantial amount on account of back income taxes. This liability made his estate insolvent, although there was no claim that Dr. Stern was insolvent at any time prior to his death. Neither was there any claim that he paid any premiums in an attempt to defraud his creditors. The insured had reserved the right to change the beneficiary, which gave him full control over the policies while he lived.

The Government brought this suit against the beneficiary, claiming that she was a "transferee" of the proceeds of the policies within the meaning of a federal statute and liable to the Government for the unpaid taxes. The Tax Court agreed with the Government and held her liable for the amount of the deficiency, which was in excess of the cash value just prior to the insured's death. On appeal, the Court of Appeals held that the beneficiary was not liable, even to the extent of the cash value at the insured's death. The Government then sought this review by the United States Supreme Court.

The Supreme Court held that the transferee statute in question did not create

any liability but merely was a procedural statute, that the rights of the Government must be determined under state law and that under Kentucky law creditors had no claim to the policy proceeds under the circumstances.

The Supreme Court refused to adopt uniform federal case law even though the controversy involved federal taxes. The Court held that the beneficiary was not liable to the Government "because Kentucky law imposes no liability against respondent in favor of Dr. Stern's other creditors." The Court explained that its decision did not rest on the Kentucky exemption statute, which admittedly could not protect against a claim by the Government.

The Chief Justice, Mr. Justice Black and Mr. Justice Whittaker dissented on the basis that state law should not be looked to in order to determine liability for federal income taxes, but that there should be a uniform rule. The dissenting Justices would have held the beneficiary liable to the extent of the cash value just prior to the insured's death.

A digest of the opinion in the Court of Appeals is found in *TSA* IX, 450–1.

ACCIDENT AND HEALTH ADVERTISING—JURISDICTION OF FTC: *Federal Trade Commission v. National Casualty Company* (United States Supreme Court, June 30, 1958) 357 U.S. 560. The Federal Trade Commission ordered National Casualty to "cease and desist" from certain advertising practices found by the Commission to be false, misleading and deceptive and in violation of the Federal Trade Commission Act. The National Casualty claimed that its advertising was not false, misleading and deceptive; but it also claimed that the FTC lacked jurisdiction because of the passage of the McCarran-Ferguson Act, Public Law 15 of 1945, and because of the existence in most states of statutes prohibiting unfair and deceptive insurance practices.

National Casualty was licensed in all states, the District of Columbia and Hawaii. The advertising material in question was prepared at the home office and shipped in bulk to the agents in the various states. There was little direct mail advertising and no use of radio or television.

The National Casualty appealed from the FTC order to the Court of Appeals for the Sixth Circuit and that Court held that FTC was under the circumstances without jurisdiction. FTC then sought and received this review by the United States Supreme Court.

The United States Supreme Court found that National Casualty's advertising programs requiring distribution by local agents were subject to regulation by the several states and that, contrary to what FTC had claimed, there was no area in which state regulation could not be made effective. The United States Supreme Court also rejected FTC's argument that FTC jurisdiction should be upheld where state regulation had not in fact been effectively applied. The FTC claimed that under such circumstances "such business is not regulated by State law" within the meaning of the McCarran-Ferguson Act enacted in 1945, which left the regulation and taxation of insurance largely to the states. The United States Supreme Court refused to hold that there was a distinction be-

tween "legislation" and "regulation" as contended for by FTC, and hence the Court affirmed the judgment below holding that FTC lacked jurisdiction.

The United States Supreme Court heard at the same time an appeal from the Fifth Circuit in the *American Hospital and Life Insurance Company* case, where the Court had likewise set aside the order of the FTC. American Hospital was licensed in only 14 states but otherwise the facts were quite similar and the United States Supreme Court agreed that in this case also the FTC lacked jurisdiction.

A brief on behalf of most of the states was filed in the United States Supreme Court in support of the position that the FTC lacked jurisdiction.

The *American Hospital* case is digested at *TSA* IX, 104–5.

VARIABLE ANNUITY—JURISDICTION OF SEC: *Securities and Exchange Commission v. Variable Annuity Life Insurance Company* (C. A., D.C., May 22, 1958) 257 F.2d 201. The Securities and Exchange Commission brought suit in the United States District Court for the District of Columbia to enjoin Variable Annuity Life Insurance Company, a District of Columbia corporation, from selling certain unregistered contracts or policies. The National Association of Securities Dealers intervened in the case on the side of SEC, and Equity Annuity Life Insurance Company, a similar company likewise chartered under District of Columbia laws, intervened on the side of VALIC.

The companies claimed that the SEC lacked jurisdiction. Their claim was based on an exemption in the Securities Act of 1933 exempting from SEC control "any insurance or endowment policy or annuity contract, issued by a corporation subject to the supervision of the insurance commissioner, bank commissioner, or officer performing like functions, of any State or Territory of the United States or the District of Columbia." The companies claimed that the type of contract was an "annuity contract" within the meaning of this exemption provision. They also claimed that they were not subject to the Investment Company Act of 1940 because of exemption in this Act of an insurance company; and, further, that the McCarran-Ferguson Act, Public Law 15 of 1945, left the regulation of their business to the District of Columbia except as to certain specified federal statutes.

The contract issued by VALIC provided for the payment by the holder of a fixed sum of money per year which would be invested largely in common stocks. The holder of the contract would receive credit not in dollars but, rather, in "accumulation units." When the time came for the commencement of the annuity, the amount of the monthly payment initially would depend on the then value of the units and the amount of the payments thereafter would be determined by the success of the company with its investments.

The District Court dismissed the suit on the basis that the SEC lacked jurisdiction, and on appeal, the Court of Appeals for the District of Columbia affirmed, stating (Madden, J.):

The arrangement is, of course, novel. It has been invented in an attempt to obviate the lack of reality of the traditional life insurance and annuity policy in relation to the value of the dollar. Annuity policies bought to provide a living in his latter years for the policy-holder annuitant, and life insurance policies bought to provide for the families of deceased policy holders have proved inadequate because of the decline of the value of the dollar in terms of purchasing power. Persons who have paid for life insurance or annuities have wished that they had bought, instead, tangible things or equities which would have, or might have, kept pace with the inflation of prices. There was room and need for experimentation in an effort to meet this serious problem. The contracts or "policies" offered by VALIC are an experiment in that direction. The question in this litigation is whether these contracts are "insurance" contracts, within the meaning of the statutes quoted above.

The Superintendent of Insurance of the District of Columbia, after due inquiry, issued to VALIC a certificate of authority "to transact within the District of Columbia the business of Life Insurance and Variable Annuities." Insurance Commissioners of three other States have issued similar licenses. The opinion of these officials, charged with the task of careful supervision of the business of insurance to protect the public from imposition, that the business of VALIC is the business of insurance, is important.

Elements of similarity between the "variable annuity" here in question and the traditional annuity may be noted. Both provide that the policy holder may elect at what time between certain stated ages, such as 50 and 70, the annuity payments are to begin. Both provide that the policy holder may cash in the value of his annuity before annuity payments begin. Both provide a loan value for the annuity contract. Both provide for the payment to beneficiaries in case of the death of the annuitant before annuity payments begin. Both provide that if the policy holder ceases paying premiums, a reduced annuity is nevertheless acquired for the payments he has made. Both provide options whereby payments may continue to another beneficiary after the death of the principal annuitant, and other options. Both have provisions making the annuity payments exempt from the claims of creditors.

It is apparent that the VALIC contract bears many resemblances to a conventional annuity policy. The appellants say that these resemblances are superficial; that the identifying quality of insurance is risk-shifting, and that in the VALIC contracts the policy holder bears his own risk, the risk that the company's investments of his premiums will increase or decrease in value. But perhaps the most important risk that the purchaser desires to shift when he buys an annuity is the risk that he will live longer than his funds will last. If everyone died on the day set for him by the mortality tables, there would be no point in paying an insurance company for doling out one's funds. A savings account, or Government or municipal or good corporate bonds, or a simple trust would do as well. VALIC, by the fact of issuing an annuity policy, does assume the risk of when the annuitant will die. If it does not bear the risk itself, it provides the machinery whereby the risk is shifted from the individual to the group of policy holders.

The appellants urge that VALIC policy holders, like investors in investment companies, may lose their savings and ultimately fail to receive the protection which they hoped to buy when they paid their premiums. That fact seems to us to be inherent in the nature of this experiment in annuity contracts. Holders of traditional annuity policies in Germany lost all their protection in the inflation of the twenties, and in France nearly all their protection in the post-war inflation. We have already adverted to the situation in this country. Experience in England has been similar.

The statutes which we have quoted above show an unmistakable determination on

the part of Congress to leave the insurance business in the control of the States until Congress should in plain terms exert its power over some or all aspects of it. The appellants say that, by definition, the business of the appellees is not insurance. We find no such definition. The definitions in the Securities Act and the Investment Company Act indicate that if the insurance commissioner of a state subjects the business to his supervision, it is the business of insurance. The VALIC contracts have many qualities of the traditional business of insurance. They depart from the tradition only in their attempt to solve a problem badly in need of solution. Unless we confine insurance, by definition, to what has actually been done in the past under the name of insurance, and invent a new and distinctive name for this new business which so greatly resembles insurance, we should not contradict the insurance commissioners. The new business will need the expert and watchful supervision of these experts in insurance. We think the statutes lodge the responsibility with them.

This case will be reviewed by the United States Supreme Court, a petition for a writ of certiorari having been granted on October 13, 1958.

SETTLEMENT OPTION—RIGHT OF BENEFICIARY TO LUMP SUM SETTLEMENT: *Vant v. Mutual Benefit Life Insurance Company* (C. A. 3, April 30, 1958) 255 F.2d 263. The insured entered into an agreement with Mutual Benefit providing that on his death the widow should receive interest at 3 percent for her life and upon her death the son should receive interest at the same rate until January 1, 1943, and should then receive the proceeds (assuming the prior death of the widow). It was agreed that the right of withdrawal should be withheld from the wife during her lifetime and should also be withheld from the son until January 1, 1943. After the insured's death Mutual Benefit issued a certificate in accordance with its agreement. After January 1, 1943 the widow and son, both living, contracted to "merge their interests" and they demanded the proceeds immediately and outright. Mutual Benefit refused to pay except in accordance with its agreement, and the wife and son brought this suit, which the United States District Court dismissed.

On appeal, the Court of Appeals affirmed the judgment of the District Court, holding that, at least in the absence of changed circumstances, the Court would not interfere with the agreement which had been entered into between the insured and Mutual Benefit. The Court discussed but properly declined to express an opinion on the question whether if circumstances had changed since the agreement was entered into there would have been a different result, as might be the case with a trust, stating (Hastie, C.J.):

> We are aware that the view propounded by Professor Scott—that under the proper circumstances, the court will treat the insurance company in the same way as a trustee —has been influential to the extent that it has been introduced into the Restatement of Trusts. See § 12, comment gg (1948 Supp.) and comments thereto. Whether or not Pennsylvania would adopt this view in an appropriate case we do not attempt to say. For the present complaint and the motions upon which the case was submitted for final decision present for adjudication merely the question whether the two beneficiaries can at their pleasure so "merge their interests" as to receive immediately and in full that distribution of proceeds which under the insurance contract was to be deferred. This we hold they cannot do.

LIEN FOR INCOME TAXES—INSURED OUT OF COUNTRY: *United States v. Metropolitan Life Insurance Company* (C. A. 4, January 14, 1958) 256 F.2d 17. The insured was convicted of evading federal income taxes and before he could be sentenced he fled to Canada. The Metropolitan policy and another policy in Guardian Life were payable to his wife, if living, otherwise to his daughter. He reserved the right to change the beneficiary and the cash value was available to to him. Neither the wife nor the daughter was available for service of process except by publication.

The Government filed a tax lien against the policies and thereafter brought this action to foreclose the lien. Service in the suit was had on the insured and on the wife and daughter by publication. The Government claimed that the policies were property subject to seizure for the unpaid taxes.

The United States District Court dismissed the action on the basis that in the absence of an election by the insured to take the cash surrender value there was no property which could be attached. On appeal, the Court of Appeals for the Fourth Circuit reversed, holding that the Government could seize such interest as the insured had in the policies and that the form of action was proper. The Court in its opinion stated (Parker, C.J.):

> To sum up, we think that the insured unquestionably had a property interest in the policies in question; that the value of this property interest was the cash surrender value of the policies; that this property interest was subjected to the lien for taxes when the assessment list was placed in the hands of the Director of Internal Revenue; that the insurance companies were fixed with notice of the lien when notices were served upon them; that the proceeding instituted under 26 U.S.C. § 7403 was a proper proceeding to foreclose the lien; that the government as holder of the lien can elect in the proceeding to take the cash surrender value of the policies; and that a decree of the court directing that the cash surrender value of the policies be paid to the United States will protect the insurance companies from further liability under the policies. As said by Judge Harrison in United States v. Trout, supra, [46 F. Supp. 485] we "see no reason to uphold a taxpayer who admits he has an interest in property but flauntingly says it is beyond the reach of the Government." To which we may add that the court is not so impotent that it cannot apply to the satisfaction of tax liens property interests of a taxpayer held by corporations within its jurisdiction.

On rehearing, the Court on June 10, 1958 adhered to its decision.

TOTAL DISABILITY—NOMINAL EARNINGS DURING PERIOD OF TRAINING FOR NEW JOB: *Mason v. Loyal Protective Life Insurance Company* (Iowa Supreme Court, July 28, 1958) 91 N.W.2d 389. Dr. Mason, engaged in the general practice of medicine, was insured under a disability policy which provided benefits during "total disability," defined as "complete loss of business time due to inability of the Insured to engage in his regular occupation or any gainful occupation for which he is reasonably fitted." Dr. Mason was forced to give up his practice in June 1955 because of "nerve deafness." At that time his earnings were at a rate in excess of $25,000 per year. He then took up a three-year residence in radiology in a Veterans' Hospital. His pay during the first year was $2,712 and he was to receive $3,195 the second year and $3,550 the third year.

Loyal Protective claimed that Dr. Mason was not disabled as required and refused to pay him the $200 a month provided for under the policy. He brought suit and in the trial court it was held that he was totally disabled as required. Loyal Protective claimed that as a matter of law it was entitled to judgment and appealed. On this appeal, the Iowa Supreme Court affirmed this judgment, stating (Garfield, C.J.):

> Of course we do not say mere reduction in earning capacity resulting from disability amounts to total disability under such a clause as we have here. But we are not prepared to disagree with what seems to be the trend of authority that such words as "any gainful occupation" in this policy mean any occupation, reasonably approximating the same livelihood of the insured's regular occupation, as he might fairly be expected to follow, in view of his station, circumstances, and capabilities. We think, therefore, instructions 6, 7 and 8 are not incorrect in the respect suggested by defendant.