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Recent Cases

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Recent Cases

EQUITY—RECEIVER OF RENTS

City of St. Louis v. Golden Gate Corp.1

The city of St. Louis, pursuant to a municipal minimum housing standards ordinance,2 filed a petition in circuit court alleging that the defendant, the owner of certain property, had, with notice of numerous violations, willfully permitted the violations to continue. These violations resulted in the property being “imminently dangerous and unsafe” and endangering the safety, health, and welfare of persons on and near the premises. The city alleged that it had no adequate remedy at law and sought in the alternative, a prohibitory injunction, or a mandatory injunction, or the appointment of a receiver with the authority to borrow money for repairs and to place a lien on the property for the cost of the repairs. Defendant’s motions to dismiss, alleging the invalidity and unconstitutionality of the ordinance,3 were sustained by the trial court, and plaintiff’s petition was dismissed with prejudice. The plaintiff appealed. The Missouri Supreme Court affirmed the judgment dismissing plaintiff’s petition. The supreme court held that “the relief of appointment of a receiver to collect rents, borrow money, use such funds for repairs and give priority for such obligations over rights of owners and mortgagees is beyond the general power of a court of equity,”4 and that such relief must have statutory authorization offering proper constitutional safeguards.

Generally, the appointment of receivers is used in cases concerning property which is involved in litigation, and where it is necessary for the preservation and

1. 421 S.W.2d 4 (Mo. 1967).
2. ST. Louis, Mo., Revised Code § 393.110 (1960), provides that the Building Commissioner, after making a determination that the safety, health, or welfare of persons on or near the property is endangered, may file a petition in the circuit court alleging continued violations of the Housing Code and praying for: a prohibitory injunction against further Code violations; or a mandatory injunction ordering compliance with Code provisions, or ordering the premises to be razed if there is a failure to timely comply; or the appointment of a receiver to collect all rents and profits, make the necessary repairs, and encumber the property as security for the cost of such repairs.
3. Defendant contended that the ordinance was: a denial of due process, in that it authorized the taking of property without just compensation; an unreasonable exercise of the police power; an invalid use of the city’s constitutional charter powers in that it authorized appointment of a receiver as the sole remedy for enforcement of an ordinance; an unconstitutional delegation of legislative authority to the judiciary; and an impairment of defendant’s obligation of contract with the holder of note and deed of trust by depriving defendant of rents.
4. City of St. Louis v. Golden Gate Corp., 421 S.W.2d 4, 7 (Mo. 1967);

(115)
maintenance of that property. The power of a court of equity to appoint a receiver in such a case is considered to be inherent in the court's general equity jurisdiction. This power is also legislatively recognized in Missouri's general receivership statute, which has been consistently construed to vest in the circuit judge a broad discretion concerning the appointment of a receiver. However, where the receivership sought does not fall within categories traditionally recognized as appropriate, the Missouri Supreme Court has not permitted such broad discretion, and has refused to appoint a receiver. This approach was followed in the noted case, where the statute was construed as neither enlarging nor restricting Pomeroy's four general classes of cases. The holding that appointment of a receiver is inappropriate in the aid of enforcement of a municipal housing standards ordinance confirms the fears of some commentators that without statutory authority of some kind, the general equity powers of a court would be insufficient to support the appointment of a receiver in a slum housing case.12

Plaintiff alternatively sought injunctive relief pursuant to another section of the municipal ordinance discussed above. However, because the supreme court felt that plaintiff failed to brief this issue on appeal, the court dealt only briefly with the availability of such injunctive relief. The supreme court seemed to feel, as it did in the case of the section of the ordinance dealing with receivership, that the injunctive relief section simply granted authority to the plaintiff to request such relief, but did not confer authority on the circuit court to grant it. In the

5. Stipp v. Bailey, 62 S.W.2d 482 (Spr. Mo. App. 1933); H. McClintock, Equity § 211 (2d ed. 1948).
6. Bushman v. Bushman, 311 Mo. 551, 560, 279 S.W. 122, 125 (1925); 1 R. Clark, Receivers § 46(a) (3rd ed. 1959).
7. Section 515.240, RSMo 1959 provides: "The court, or any judge thereof in vacation, shall have power to appoint a receiver whenever such appointment shall be deemed necessary, whose duty it shall be to keep and preserve any money or other thing deposited in court, or that may be subject of a tender, and to keep and preserve all property and protect any business or business interest entrusted to him pending any legal or equitable proceeding concerning the same, subject to the order of the court."
9. 4 J. Pomeroy, Equity Jurisprudence §§ 1332-35 (5th ed. 1941) states that a receiver may be appointed where: there is no competent person to hold and manage the property during a judicial proceeding, all the parties are equally entitled to possession of the property involved in litigation, a trustee is violating his fiduciary duties, or after judgment for the purpose of carrying the decree into effect.
10. See Kansas City v. Markham, 339 Mo. 753, 99 S.W.2d 28 (1936) (in suit to enjoin loan company from lending at illegal interest, receiver sought on grounds that the business was a nuisance); Sedberry v. Gwynn, 282 Mo. 632, 222 S.W. 783 (1920) (receiver sought for a solvent manufacturing business due to breach of a supply contract and threats by defendant); Price v. Bankers' Trust Co. of St. Louis, 178 S.W. 745 (Mo. 1915) (receiver sought as the sole remedy by creditors of a solvent country club).
11. City of St. Louis v. Golden Gate Corp., 421 S.W.2d 4, 7 (Mo. 1967).
absence of such authority, the supreme court apparently concluded that other
traditional limitations on equity jurisdiction prohibited the granting of injunctive
relief.

One of the limitations on such jurisdiction is the doctrine which prohibits
equity from enjoining commission of a crime.\textsuperscript{14} It is questionable whether viola-
tion of a housing standards ordinance should be conceptualized as a crime. The
Missouri Supreme Court has construed prosecutions by municipalities for violation
of housing code ordinances to be civil actions to recover a debt or penalty due
the city because of the violation.\textsuperscript{15} Moreover, the Missouri cases allow equity to
act where the acts sought to be enjoined are prejudicial to the public health and
welfare, \textit{i.e.} public nuisances,\textsuperscript{16} even though the party creating the public nuisance
may also be liable for prosecution under state or municipal laws.\textsuperscript{17} This is in accord
with traditional views of equity powers.\textsuperscript{18} However, the supreme court concluded
that a public nuisance theory was inapplicable in the noted case because the city
did not proceed on such a theory, and also because many of the violations were
minor in character.\textsuperscript{19}

The supreme court felt that equitable relief of any kind was unavailable
because the plaintiff had failed to show that the remedies at law were inadequate.
The briefs of plaintiff and amicus curiae argued the inadequacy of available legal
remedies—quasi-criminal prosecution, condemnation, and special tax liens for re-
pairs done by the city.\textsuperscript{20} The effectiveness of the use of criminal proceedings and
penalties in housing code violation cases has decreased in recent years, primarily
because it is cheaper for slum landlords to pay the fine rather than repair the
property.\textsuperscript{21} Condemnation is an unsatisfactory remedy since this would only aggra-
vate the housing shortage.\textsuperscript{22} The use of special tax liens requires the city to have
the funds initially, in order to make repairs, and limited resources mean fewer
repairs.\textsuperscript{23} The supreme court, however, simply dismissed the preceding arguments
with little discussion.

Six states have legislation authorizing receivership and either a prior lien on

\textsuperscript{14} State \textit{ex rel.} Allai v. Thatch, 361 Mo. 190, 198, 234 S.W.2d 1, 7 (En Banc

\textsuperscript{15} City of St. Louis v. Flynn, 386 S.W.2d 44, 48 (Mo. 1965).

\textsuperscript{16} State \textit{ex rel.} Allai v. Thatch, 361 Mo. 190, 198, 234 S.W.2d 1, 7 (En Banc

\textsuperscript{17} City of Washington v. Mueller, 218 S.W.2d 801, 803 (St. L. Mo. App.

\textsuperscript{18} J. POMEROY, \textit{Equity Jurisprudence} § 1349 (5th ed. 1941).

\textsuperscript{19} City of St. Louis v. Golden Gate Corp., 421 S.W.2d 4, 8 (Mo. 1967).

\textsuperscript{20} Brief for Appellant, pp. 21-28, Brief for the NAACP as amicus curiae,

\textsuperscript{21} Moerdler, \textit{A Program for Housing Maintenance and Emergency Repair},

\textsuperscript{22} Brief for Appellant, p. 26, Brief for the NAACP as amicus curiae, p. 10,

\textsuperscript{23} Brief for the NAACP as amicus curiae, p. 7, City of St. Louis v. Golden

Gate Corp., 421 S.W.2d 4 (Mo. 1967).
the entire property or a lien on rents until the cost of repairs is repaid. The only judicial test of such a state receivership statute has been in New York. In *In re Dep't of Bldgs. of City of New York*, the New York Court of Appeals upheld the constitutionality of the 1962 Receivership Law, even though it impaired the mortgagee's rights under his prior mortgage contract by postponing his right to the rents until the lien for the cost of repairs was repaid. The statute authorized the Department of Buildings, upon the certification of a "nuisance," to issue an order to the owner to remove the nuisance within a specified time. If this was not done, the department was authorized to apply to the supreme court for appointment of a receiver to remove or remedy the condition, with a lien for the costs incurred. The statute allowed the owner or mortgagee to apply to the court for permission to perform the work in lieu of appointing a receiver. The statutory lien was to be subject to the rights of holders of previously recorded mortgages or liens, except that any mortgagee or lienor duly served with the notice required by statute was not entitled to the rents or profits and could not foreclose his mortgage or lien until the receiver's lien was fully paid and satisfied. One of the mortgagee's contentions was that the statute was an unconstitutional impairment of his rights under his prior mortgage contract. The court held that this legislation was a reasonable exercise of the state's police power to promote the public interest in maintaining an adequate supply of safe and sanitary housing. Citing the landmark case of *Home Bldg. & Loan Ass'n v. Blaisdell*, the New York court recognized that the state is not prevented from exercising such powers merely because contracts between individuals may be affected. The court distinguished their 1938 decision in *Central Sav. Bank v. City of New York*, which held a 1937 amendment authorizing a lien having "priority over all other liens and encumbrances, including [previously recorded] mortgages" as an unconstitutional taking of property without due process of law, and as an unconstitutional impairment of the mortgagee's contract with the mortgagor.


27. Id., § 309(1)(a).

28. Id., § 309(1)(e).

29. Id., § 309(5)(c)(1).

30. Id., § 309(5)(c)(3).

31. Id., § 309(5)(e).


34. 250 U.S. 398, 437 (1933).

35. 279 N.Y. 266, 18 N.E.2d 151 (1938).

36. N.Y. SESS. LAWS 1937, ch. 353(g).

ral Savings the court held the statute procedurally defective, in that the mortgagee was given no notice or opportunity to be heard, whereas under the 1962 amendment involved in In re Dept. of Bldgs., the mortgagee must be given notice and an opportunity to participate in the proceedings. As to the impairment of contract rights argument, the court said the Central Savings decision can not be relied on to invalidate the 1962 amendment:

We assess the propriety and reasonableness and, by that token, the validity of an exercise of the police power in light of the conditions confronting the Legislature when it acts, and it can hardly be questioned that the situation, in terms of the shortage of safe and adequate dwelling units, which prompted the 1962 amendment (L. 1962, ch. 492, §1) presented a far more serious emergency than that existing in 1937.38

The “balancing” approach used by the New York court in In re Dept’ of Bldgs. to determine the validity of exercises of the police power lends support to the belief that under the ever increasing dilemma of slum housing, priority liens on the entire property may pass constitutional muster.39

Yet the New York statute upheld in In re Dept’ of Bldgs. provided only for a lien on rents until the cost of repairs was repaid, whereas the ordinance involved in the noted case granted authority to the city to seek a prior lien on the fee. The supreme court in Golden Gate apparently viewed the “permissive” St. Louis ordinance as being similar to the 1937 New York statute invalidated in Central Savings. It distinguished the 1962 New York statute involved in In re Dept’ of Bldgs. and the St. Louis ordinance by saying that the 1962 New York statute “afforded some protection of the rights of mortgagees by only postponing the right to collect rents until the cost of removing dangerous conditions have been repaid, instead of making such cost a prior lien to the mortgage.”40 A 1965 amendment to the New York statute,41 now providing for a prior lien on the fee, has not yet been judicially tested. Such a statute would seem to be constitutionally questionable in Missouri, in light of the above quoted dictum from the noted case, which emphasizes the idea of “limited priority.”

Recent commentaries speculate that a prior lien on the fee will withstand constitutional due process and impairment of obligation of contract objections,42 characterizing Central Savings as reflecting the “last gasp of the now discredited doctrine of substantive due process, long used to protect property interests against police power regulations.”43 A Columbia University legislative drafting research

40. City of St. Louis v. Golden Gate Corp., 421 S.W.2d 4, 8 (Mo. 1967).
43. Gribetz & Grad, op. cit. supra note 42, at 1265.
paper points out that commentary of the 1930's, immediately following the *Central Savings* decision, viewed it as an "anachronistic construction" of the state's power in the field of substandard housing, and concludes that there is good reason to rely on the validity of the 1965 prior lien provisions. On a practical level, the argument has been made that the mortgagee who shares in the economic benefits of slum housing should also share in the social costs.

An incongruity in the court's reasoning in *Central Savings* in relation to the impairment of contract contention has been noted by one commentator. The court admitted that the city, in the exercise of its police power, could close up, restrict the use of, or demolish a building. Demolition would completely destroy the mortgagee's security. Yet the court was unwilling to permit the use of a prior lien, which would much less harshly affect the mortgagee's security. Moreover, without the use of prior liens, the value of the lien to the cities would be insignificant, since the heavily mortgaged slum property would be improved at the city's expense and then prior mortgages would be foreclosed, leaving the property improved, and leaving the city with a lien of no value.

Dictum in the noted case indicates that the proposed expansion of the circuit court's equity jurisdiction is a matter of "state interest," and thus not authorized by the constitutional grant of charter powers for local government. There is similar dictum in previous Missouri cases. The rationale for such dictum in the noted case is that the circuit court is a state court and that any proposed expansion of its power or jurisdiction must be considered a matter of "state interest." However, earlier Missouri decisions held that validly enacted ordinances of a home rule city have the force and effect of laws within the meaning of the constitutional provision conferring such jurisdiction on the circuit courts "as is or may be provided by law."

Without the enactment of a statute with "proper constitutional safeguards," authorizing appointment of receivers of rents, the *Golden Gate* decision leaves

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44. **Legislative Drafting Research Fund of Columbia University, Legal Remedies in Housing Code Enforcement in New York City** 126 (1965).


49. *City of St. Louis v. Golden Gate Corp.*, 421 S.W.2d 4, 8 (Mo. 1967).


52. In the regular session of the 74th General Assembly, a proposed receivership of rents act, House Bill No. 576, providing for a prior lien on the rents, was defeated.
Missouri with the traditional legal remedies of criminal prosecutions, condemnation, and special tax liens for repairs done by the city. The Missouri Supreme Court's dictum in *Golden Gate* seems to indicate that "proper constitutional safeguards" means a lien on rents alone and not a prior lien on the entire property is permissible. Such an approach would restrict the effectiveness of equity as a receiver of rents to aid in the rehabilitation of slum housing in Missouri.

**CLIFFORD H. AHRENS**

### ATTORNEYS' LIENS—LIABILITY OF DEFENDANT'S MOTOR VEHICLE INSURER FOR LIEN OF PLAINTIFF'S ATTORNEY

*Downs v. Hodge*¹

Hodge had a cause of action against Fender as the result of personal injuries incurred in an automobile accident. State Farm Mutual Insurance Company was Fender's liability insurer. Hodge contracted with the legal firm of Downs & Pierce of St. Joseph, Missouri, plaintiff in the noted case, to represent him in his claim against Fender. Downs & Pierce were to receive a contingent attorney's fee of thirty three and one third per cent of any recovery obtained. State Farm had notice of this contract. Downs & Pierce proceeded to litigate the case, incurred expenses in relation thereto, and represented Hodge in the trial of the lawsuit at Chillicothe, Missouri. The verdict was adverse to Hodge. Pending appeal, another attorney, acting on behalf of Hodge and having had access to materials prepared by Downs & Pierce, settled with State Farm for three thousand dollars. Plaintiff never received legal fees in compensation for the services rendered Hodge.

Downs & Pierce commenced an action against their former client, Hodge, and also against the insurer of Fender, State Farm Mutual Insurance Company. After dismissing the suit against Hodge, the plaintiff obtained a verdict against the insurer, whose appeal is the subject of this note. The Kansas City Court of Appeals held that where a liability insurer is bound to defend the insured by reason of its contract, it takes on the liabilities of the insured. And, by reason thereof, when it settles with an adverse party in disregard of an outstanding attorneys' lien, the insurer becomes liable for said lien.²

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¹. 413 S.W.2d 519 (K.C. Mo. App. 1967).
². The Missouri statutory provisions on attorney's liens are §§ 484.130, .140, RSMo 1959. Section 484.130, RSMo 1959 states:
From the commencement of an action or the service of an answer containing a counterclaim, the attorney who appears for a party has a lien upon his client's cause of action or counterclaim, which attaches to a verdict, report, decision or judgment in his client's favor, and the proceeds thereof in whosoever hands they may come, and cannot be affected by any settlement between the parties before or after judgment.
Section 484.140, RSMo 1959 notes the legality of contingent fee contracts, and provides that, upon proper notice, the attorney:
has a lien upon the claim or cause of action, and upon the proceeds of any settlement thereof for such attorney's portion or percentage thereof,
At common law, attorneys had no lien for their services in Missouri. The first such lien was created by statute in 1901. The present version of the Missouri Attorneys' Lien statute, sections 484.130 and 484.140, RSMo 1959, is identical to that enacted in 1901. The courts of Missouri have found that these sections, and their predecessors, are not unconstitutional and have admonished that they are to be liberally construed. Once the lien has attached in favor of a plaintiff's attorney (or in favor of the attorney of a defendant who has filed a counterclaim), both parties to the lawsuit become liable on the lien in the event a judgment is paid, or a settlement made and satisfied in disregard of that lien. The filing of a suit or the service of an answer containing a counter-claim dispenses with the necessity of giving the adverse party notice of the contingent fee contract which creates the lien. As in the noted case, a settlement made without regard to the lien of an attorney of record gives rise to a cause of action against the defendant for the contracted percentage of the amount paid in satisfaction. The attorney's rem-

which the client may have against the defendant or defendants, or proposed defendant or defendants, and cannot be affected by any settlement between the parties either before suit or action is brought, or before or after judgment therein, and any defendant or defendants, or proposed defendant or defendants, who shall, after notice served as herein provided, in any manner, settle any claim, suit, cause of action, or action at law with such attorney's client, before or after litigation instituted thereon, without first procuring the written consent of such attorney, shall be liable to such attorney for such attorney's lien as aforesaid upon the proceeds of such settlement, as per the contract existing as herein provided between such attorney and his client.

edy where there has been a settlement in disregard of his lien is an independent action against his client or against the adverse party corresponding to the common law action of trespass on the case. In such actions, contrary to the general rule, Missouri follows a minority position in that the attorney is not required to prove that his client's cause of action was meritorious in order to enforce his lien against the defendant who has settled with that client.

_Downs v. Hodge_ extends these principles to cover the factual situation involving the defendant's liability insurer. In holding the insurer liable for the attorney's lien, the Kansas City Court of Appeals relied on two general lines of reasoning: (1) The court noted that the insurance company was bound to defend the suit and to pay all sums which might arise out of Fender's operation of his automobile by reason of the insurance contract. The company controlled the litigation, and its lawyers defended the original suit. The language of the court is helpful: "For all purposes connected with this case of _Hodge v. Fender_, defendant was the alter-ego of Fender. Defendant was Fender. It, therefore, became and was liable to do, what Fender was liable to do." According to Missouri precedent, if Fender settled with Hodge in disregard of the lien of Hodge's attorney, he became liable, along with Hodge, to satisfy that lien. (2) Recognizing that the decision to be rendered would enlarge the scope of enforcement of attorneys' liens in Missouri, the court of appeals explained why such an extension was desirable in an historical sense. Noting that this case arose sixty-seven years after the statute was first adopted, the court reasoned that the law ought to grow along with the development of the automobile industry and the corresponding growth of motor liability insurance. The law, said the court, should take notice that motor vehicle liability insurance is carried by almost every automobile operator and is necessary for the automobile owner's financial protection. The nature of such insurance, which puts the insurer in the position of defendant for purposes of litigation and trial, should be considered by the courts in allocating the legal consequences of trial.

The issue presented in _Downs v. Hodge_ has not often been considered by American courts. In _Berkemeier v. Dormuralt Motor Sales_, an Illinois case, Phillip Becker was injured as the result of the negligent operation of a motor vehicle by Dormuralt Motor Sales. Dormuralt had an automobile liability insurance policy with Eastern Automobile Insurance Underwriters. Berkemeier was retained by Becker as his attorney. A settlement was entered into between the insurer and Becker, who executed a release in favor of Dormuralt. The attorney

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9. Noell v. Missouri Pac. R. Co., 335 Mo. 687, 74 S.W.2d 7 (1934). This problem does not arise where the attorney's lien has attached to a final judgment because a payment by the judgment debtor to the judgment creditor in disregard of an attorney's lien is void. _Restatement (Second) of Agency_ § 464 (1958).


13. _Cases cited note 6 supra_.


15. 263 Ill. App. 211 (1931).
brought action against both Dormuralt and the insurance company claiming the former to be insolvent. In reversing a decree against both defendants, the Illinois court held that the Attorneys' Lien Act of that state creates liability only against the opposing party and not against his insurer. Since Becker's cause of action was against Dormuralt and not Eastern Underwriters, the court, in adopting a literal interpretation of the statute, denied recovery against the insurer.

A later New York case, *Koenig v. Aetna Casualty & Surety Company*, allowed a plaintiff's attorney to recover in an independent action against the defendant's insurance carrier. In that case the attorney had given notice of his lien to the defendant prior to a settlement made between the plaintiff and the defendant's insurer. The insurance carrier was held liable to the attorney for his lien. Although the New York statute makes no provision as to the insurer, Aetna failed to make an objection on that ground.

A third case, which established a lien in favor of an attorney against the insurer of an adverse party, did not deal with automobile liability insurance, but with workmen's compensation. *Camp v. United States Fidelity & Guaranty Company*, a Georgia case, arose out of the failure of the defendant or his insurer to pay compensation awarded by the Industrial Commission of Georgia. At a later stage in the litigation, the employee settled directly with the employer and his insurer on the workmen's compensation claim. The employee's attorney proceeded against both the employer and insurer. The insurer's demurrer was granted in the lower court, but reversed in the Court of Appeals of Georgia. The court held that the defendants were "not at liberty to satisfy the award until the lien or claim of the attorney for his fee is fully satisfied."

Although *Downs* concerned motor vehicle liability insurance, the rule it establishes might also be applied to the area of workmen's compensation by the Missouri courts. Indeed, in *Clark v. Midwest Bakeries & Macaroni Manufacturing Company*, where the facts were very similar to *Camp*, Missouri courts dealt with the attempt of an employee's attorney to recover against an employed and his insurer who failed to satisfy an attorney's lien after notice had been given them. The issue was avoided, however, by pointing out that the appropriate section of the Missouri Workmen's Compensation Act purports to preserve awards of the Industrial Commission against "the claims of all persons except as to attorneys' fees and even then only to the extent the Commission may allow." In this case the Commissioner did not allow the lien against the client (employee), and there-

19. N.Y. JUDICIARY LAW § 474 (McKinney 1948).
21. Id. at 654, 157 S.E. at 210.
23. § 287.260, RSMo 1959.
fore the lien could not be enforced against the employer or the insurer.\textsuperscript{25} If the lien had been allowed against the client, the court would have had to determine whether the insurer could be held liable. Had such a determination been necessary, it is possible that the \textit{Downs} rule could be applied to workmen’s compensation insurers. The language in section 287.260, RSMo 1959 allows attorneys’ liens against compensation awards at the discretion of the Commissioner. Section 287.300, RSMo 1959, provides that, if an employer is insured, “his liability shall be secondary and indirect, and his insurer shall be primarily and directly liable hereunder to the injured employee, his dependents or \textit{other persons entitled to rights hereunder}” (emphasis added). In view of these statutory provisions, companies engaged in insuring employers under the Workmen’s Compensation Act should be aware of possible liability to an employee’s attorney if they satisfy awards in disregard of the lien of that attorney.\textsuperscript{26}

Since the Kansas City Court of Appeals has shown a willingness to enlarge the scope of recovery available to an attorney for the enforcement of his lien in the \textit{Downs} case, it is useful to speculate as to what further extensions might be made to the scope of the Missouri Attorney’s Lien Act. Such speculation can lead to another rapidly expanding area of the law—uninsured motorist coverage insurance. An analogy can be drawn between the position of a defendant’s liability insurer and the corresponding position of an uninsured motorist insurer whose liability exists when the defendant has no liability insurance.\textsuperscript{27} This insurer does not stand in the shoes of the uninsured motorist for purposes of litigation against the insured, but it does replace the defendant’s liability with its own to the extent of the policy limits. If the insurer settles a claim of its insured under uninsured motorist coverage without regard to the fees due the insured’s attorney, is the insurer liable to the attorney under the Attorneys’ Lien Act? A settlement between a plaintiff-insured and his uninsured motorist insurer does not release the defendant from responsibility for his original tort. To the contrary, section 379.203, Laws 1967, p. ––––, H.B. No. 262, § A gives the insurer the right of subrogation against any “person or organization legally responsible for the bodily injury for which such payment is made. . . .” Therefore, at least in theory, the attorney still has a lien on the cause of action against the defendant. But, for practical purposes, even if the attorney retains a lien against the surviving cause of action, such a remedy is usually of no value because the uninsured defendant is usually judgment-proof.

There is an additional barrier to the enforcement of an attorney’s lien in an uninsured motorist case. The uninsured motorist policy normally will contain a

\begin{itemize}
  \item \textsuperscript{25} There can be no lien in favor of an attorney unless there is a contract debt due him from his client. Mills \textit{v.} Metropolitan St. Ry. Co., 282 Mo. 118, 221 S.W. 1 (1920).
  \item \textsuperscript{26} Other liability insurers should also be aware of \textit{Downs}, since the rationale of the decision likely extends to all types of liability insurers.
  \item \textsuperscript{27} Missouri enacted a statute dealing with uninsured motorist coverage in January, 1967. § 379.203, Laws 1967, p. ––––, H.B. No. 262, § A.
\end{itemize}
clause giving the insurer the right of subrogation against the uninsured motorist. 28 If the policy has fully compensated the insured for all injuries incurred, thus barring him from a second recovery against the uninsured tortfeasor, the result is the same as if the claim of the insured had been assigned to his insurer. 29 Either result would act to forestall recovery by the attorney of his reasonable attorney fees. In the first instance, a possible lien on the cause of action against the uninsured tortfeasor will most likely be uncollectible because of the probable insolvency of said tortfeasor. In the second instance, recovery by his client might extinguish the attorney's lien altogether because the cause of action is now in the hands of the insurer. In this situation, for either of these reasons, a court may well decide to allow the attorney to enforce his lien against the uninsured motorist insurer.

Since the Missouri Attorney's Lien statute was enacted in 1901, a defendant has been responsible for the attorney's lien attached to a cause of action against him if he settles in disregard of that lien. The Downs decision puts the defendant's liability insurer in the same position of not being able to settle in disregard of a lien. To guard against liability, the insurer should obtain a written consent to the settlement from the attorney or attorneys of the adverse party. 30 An alternative safeguard would be for the insurer to make the claimant's attorney joint payee on the settlement draft. The insurer must avoid the mistake in Downs where the settlement was made through one attorney but in disregard of the rights of another attorney who had been in the case at an earlier stage; in other words, the insurer must be careful that it has the consent of all attorneys who might have a lien on the proceeds of any settlement made with plaintiff.

The decision in Downs v. Hodge is an extension of the Missouri Attorneys' Lien Act designed to assure that lawyers will be compensated for their services. As such, attorneys, as well as liability insurance companies, should be aware of its existence and significance.

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28. To understand the full significance of such a clause, see Williams, Uninsured Motorist Insurance—Subrogation—Settlement with Tortfeasor, 32 Mo. L. Rev. 159 (1967).


30. According to one early case, the burden of proof is on the attorney to prove he did not consent in writing to the settlement. Wolf v. United Rys. Co. of St. Louis, 155 Mo. App. 125, 133 S.W. 1172 (St. L. Ct. App. 1911). Note also the language in § 484.140, RSMo 1959.
NEW TRIAL—VERDICT AGAINST THE WEIGHT OF THE EVIDENCE

Lupkey v. Weldon (concurring opinion)\(^1\)

In a libel action, after the jury returned a verdict in favor of the plaintiff, the trial court granted the defendant's motion for a new trial on the ground that the verdict was against the weight of the evidence. The defendant had denied the allegations of the petition, but had adduced no substantial evidence in his behalf at trial. On appeal, the Missouri Supreme Court, in an opinion limited to libel actions, affirmed the lower court order.\(^2\) The majority opinion states the usual rule that an order for a new trial on the ground that the verdict is against the weight of the evidence will be overturned on appeal only where a verdict contrary to the one brought in by the jury could never be permitted to stand; or, where the trial court should have directed a verdict against the party at whose instance the new trial was granted.\(^3\) However, the majority opinion then goes on to find this rule to be inapplicable in libel cases. Article I, Section 8 of the Missouri Constitution provides that in libel suits the jury shall determine the law and the facts; and this section has been interpreted to mean that a verdict may never be directed for a plaintiff in a libel suit.\(^4\) Therefore, an order granting the defendant in a libel suit a new trial because the verdict is against the weight of the evidence will never be overturned.\(^5\)

The concurring opinion, on the other hand, indicated that the decision should not be limited to libel cases. The concurring opinion maintained that the lower court should be affirmed, regardless of the fact that it was a libel case, because when a defendant is granted a new trial on the ground that the verdict is against the weight of the evidence, there need not be any substantial evidence in the record to have supported a verdict for the defendant originally. The concurring opinion is noted for the purpose of determining if a distinction exists between the

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1. 419 S.W.2d 91, 94 (Mo. En Banc 1967).
2. Id. at 93.
3. Clark v. Quality Dairy Co., 400 S.W.2d 78 (Mo. 1966); State Highway Commission v. Vaught, 400 S.W.2d 153 (Mo. 1966); Madsen v. Lawrence, 366 S.W.2d 413 (Mo. 1963); Frager v. Glick, 347 S.W.2d 385 (Mo. 1961); Dawson v. Scherff, 281 S.W.2d 825 (Mo. 1955); Castorina v. Herrmann, 340 Mo. 1026, 104 S.W.2d 297 (1937); Walsh v. Southwestern Bell Telephone Co., 331 Mo. 118, 52 S.W.2d 839 (1932); Fitzjohn v. St. Louis Transit Co., 183 Mo. 74, 81 S.W. 907 (1904); Haven v. Missouri R. Co., 155 Mo. 216, 55 S.W. 1035 (1900); Chitwood v. Davis Const. Co., 113 S.W.2d 1043 (St. L. Mo. App. 1938); Joy v. Bixby, 10 S.W.2d 342 (St. L. Mo. App. 1928).
5. Lupkey v. Weldon, 419 S.W.2d 91, 93 (Mo. En Banc 1967), quotes Ukman v. Daily Record Co., 189 Mo. 378, 390, 88 S.W. 60, 64 (1905), concerning libel cases under our Constitution:

| If the defendant can get either the court or the jury to be in his favor, he succeeds, while the prosecutor or plaintiff cannot succeed unless he gets both the court and the jury to decide for him. From this condition of things it further follows that the court may direct a non-suit, but cannot coerce a verdict for plaintiff. . . .

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granting of a new trial to the plaintiff on the ground that the verdict is against the weight of the evidence and the granting of a new trial to the defendant on the same ground. If such a distinction is found to exist, consideration must be given to its possible conflict with an often-stated concept that to grant a new trial on the ground that the finding is against the evidence would be arbitrary if there were no evidence to weigh. And, finally, if the distinction is valid, its application to the noted case must be examined.

The determination of a motion for a new trial on the ground that the verdict is against the weight of the evidence is within the sound discretion of the trial court, and will not be disturbed on appeal absent an abuse of that discretion by the trial court. The theory behind this policy is that the trial court has access to matters not of record (such as the demeanor of the witnesses), and is in a superior position to decide whether or not the verdict is against the weight of the evidence. Appellate courts are not afforded an opportunity to weigh the evidence or consider its credibility; their review is limited to determining whether there has been an abuse of discretion. Thus, a trial court's order granting a new trial motion will be upheld where there is substantial evidence to support the order; that is, where there is evidence to support a contrary verdict. It will be reversed where no verdict for the moving party could ever be permitted to stand, or where the non-moving party was entitled to a directed verdict. A motion for a new trial on the ground that the verdict is against the weight of the evidence should be distinguished from a motion for a directed verdict or a judgment n.o.v. A motion for a new trial is sometimes used to test the sufficiency of the evidence.

6. Within this article, "plaintiff" is used to indicate the party with the burden of the risk of non-persuasion of the jury. "Defendant" is used to indicate the party who does not have that burden.

7. See, e.g., Castorina v. Herrmann, 340 Mo. 1026, 1032, 104 S.W.2d 297, 300 (1937).

8. Section 510.330, RSMo 1959 provides:
A new trial may be granted for any of the reasons for which new trials have heretofore been granted. . . . Only one new trial shall be allowed on the ground that the verdict is against the weight of the evidence. . . .

Supreme Court Rule 78.01 has adopted the language of that statute.

9. Andres v. Brown, 300 S.W.2d 800, 801 (Mo. 1957); Dawson v. Scherff, 281 S.W.2d 825, 831 (Mo. 1955); Weathers v. Falstaff Brewing Corp., 403 S.W.2d 663, 667 (St. L. Mo. App. 1966).

10. State Highway Commission v. Vaught, 400 S.W.2d 153, 155 (Mo. 1966); Madsen v. Lawrence, 366 S.W.2d 413, 416 (Mo. 1963); Haven v. Missouri R. Co., 155 Mo. 216, 232, 55 S.W. 1035, 1040 (1900); Joy v. Bixby, 10 S.W.2d 342, 343 (St. L. Mo. App. 1928).


14. Schmidt v. Allen, 303 S.W.2d 652, 655 (Mo. 1957); Castorina v. Herrmann, 340 Mo. 1026, 1029, 104 S.W.2d 297, 299 (1937); Walsh v. Southwestern Bell Telephone Co., 331 Mo. 118, 131, 52 S.W.2d 839, 845 (1932).

15. Fitzjohn v. St. Louis Transit Co., 183 Mo. 74, 76, 81 S.W. 907, 908 (1904).

16. See Frager v. Glick, 347 S.W.2d 385, 388 (Mo. 1961).
of the evidence, but the weight of the evidence is not the same as the sufficiency of the evidence. A motion for a new trial does not have the same function as a motion for a directed verdict or judgment n.o.v. In considering the latter motions, the trial court must give every benefit of inference to the non-movant. The trial court does not actually consider credibility because that issue is resolved in favor of the non-movant. On the other hand, in considering a motion for a new trial on the ground that the verdict is against the weight of the evidence, the trial court views all the evidence in the light most favorable to the moving party. Thus, in a case where the evidence was not such as to direct a verdict for a party, the trial court could nevertheless grant a new trial for that party on the ground that the verdict is against the weight of the evidence. And this is true also where the verdict is supported by sufficient evidence. For example, it is conceivable that a

17. See, e.g., Dawson v. Scherff, 281 S.W.2d 825, 830 (Mo. 1955); Smith v. J. J. Newberry Co., 395 S.W.2d 472 (St. L. Mo. App. 1965); Wood v. Walgreen Drug Stores, Inc., 125 S.W.2d 594 (St. L. Mo. App. 1939).

18. The concept of sufficiency is directly invoked by a motion for directed verdict or for judgment n.o.v. Sufficiency of evidence is a proposition addressed to the court and not to the jury. The evidence is sufficient when it proves each proposition essential to a proponent's claim to such a degree that a jury is justified in finding in the proponent's favor on the basis of that evidence. Only after a determination of sufficiency is the jury warranted in finding for the proponent. To that purpose the concept of credibility or weight of the evidence is but slightly related. The court must consider credibility in ruling on motions for directed verdict or judgment n.o.v. to the limited extent of determining whether the evidence can be believed by reasonable men at all. But questions of sufficiency do not speak to the sound discretion of the court.

In contrast to the sufficiency of the evidence, the weight of the evidence is a matter for the jury to decide. Weight of the evidence is admittedly a vague concept, but it is obviously something more than credibility (believability). Weight is perhaps the net persuasive effect of the evidence. It is the function of the jury to determine the weight of the sufficient evidence and to thereby arrive at a verdict.

In considering a motion for new trial on the ground that the verdict is against the weight of the evidence, the trial court must consider the weight of the evidence. However, it is actually a determination of credibility, and not a determination of total persuasive effect. The trial court has greater power to determine credibility on a new trial motion than on a directed verdict motion because, in ruling on a new trial motion on the ground that the verdict is against the weight of the evidence, the court is not limited to a mere determination that the evidence is not incredible as a matter of law. But the court's power to determine weight is not as broad as the power of the jury. The court cannot substitute its judgment as to choice of inferences for that of the jury. There is little doubt that the power of the court to grant new trials on the ground that the verdict is against the weight of the evidence is an inroad into the sphere of the jury. The power and duty of the court to determine sufficiency is not.

For a thorough discussion on the interrelationships between sufficiency and weight of the evidence see F. James, Jr., Civil Procedure, §§ 7.11, 7.13, 7.16, 7.20, 7.22 (2d ed. 1965).


22. Dawson v. Scherff, 281 S.W.2d 825, 830 (Mo. 1955); Ritzheimer v. Marshall, 168 S.W.2d 159, 165 (St. L. Mo. App. 1943).
plaintiff may offer sufficient evidence on each element of his case so that the defendant is not entitled to a directed verdict. The jury's verdict for the plaintiff would be supported by the evidence viewed in a way favorable to plaintiff, yet that verdict could be against the weight of the evidence viewed in a way favorable to defendant. In such a case, the trial court may grant defendant a new trial on the ground that the verdict is against the weight of the evidence.

Missouri cases do not expressly distinguish plaintiffs' motions from defendants' motions for new trial on the ground that the verdict is against the weight of the evidence. However, the concurring opinion in the *Lupkey* case notes that such a distinction exists.\(^{23}\)

When a plaintiff files a claim which is denied by the defendant, and the plaintiff presents evidence at trial but defendant does not, the defendant is entitled to a verdict when the jury does not believe the plaintiff's evidence.\(^{24}\) Because the plaintiff has the risk of the non-persuasion of the jury, the defendant is entitled to a verdict if the plaintiff fails to persuade the jury. The jury's verdict for defendant can be sustained although there is no substantial evidence in his favor. This type of situation was presented in the *Lupkey* case except that the jury's verdict was for plaintiff. When defendant moved for a new trial, the burden of persuasion principle would seem to be applicable. Therefore, defendant was entitled to a new trial although there was no substantial evidence in his favor if the trial court in its discretion found the weight of the plaintiff's evidence to be against the plaintiff.

While no evidence in favor of defendant was produced at trial, the plaintiff was not necessarily entitled to a directed verdict. And, significantly, a verdict contrary to the one returned would have been permitted to stand.\(^{25}\) To grant defendant's motion for a new trial on the ground that the verdict was against the weight of the evidence is not to say that the defendant was entitled to a directed verdict, as a matter of law, upon all the evidence viewed in a light most favorable to plaintiff. In contrast, to grant defendant's motion for a new trial is to say merely that a verdict for the defendant would have been permitted to stand upon all he evidence viewed in a light most favorable to defendant.

A distinction does exist between granting a plaintiff a new trial and granting a defendant a new trial on the ground that the verdict was against the weight of the evidence. The distinction follows from the principle that the burden of persuasion is borne by the plaintiff. In considering weight or credibility of the evidence, defendant prevails unless the plaintiff presents *persuading* evidence. It is not necessary for the defendant to present any evidence.

In the *Lupkey* case, to grant defendant a new trial on the ground that the verdict was against the weight of the evidence was not arbitrary because of the fact that the defendant produced no substantial evidence in his behalf at trial to

\(^{23}\) *Lupkey* v. Weldon, 419 S.W.2d 91, 94 (Mo. En Banc 1967).

\(^{24}\) Cluck v. Abe, 328 Mo. 81, 40 S.W.2d 558 (1931).

\(^{25}\) Ibid.
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“weigh” against the evidence produced by the plaintiff. In Lupkey, the truth of the plaintiff’s allegations was disputed and the issue of the credibility of the plaintiff’s evidence was present. The trial court had a right to disbelieve the plaintiff’s witnesses.26 In Security Bank of Elvins v. National Surety Co.,27 the court said that the fact that plaintiff’s witnesses’ testimony was not contradicted by any other witnesses did not deprive the trial court of its well-recognized right to consider weight and credibility when passing on a motion for a new trial.28 It is surely helpful in weighing evidence to have conflicting evidence, but the weight of the evidence is not determined solely by measuring it against the contradicting evidence. The weight and credibility of the evidence is determined notwithstanding the fact that there is no contrary evidence, because the plaintiff has the burden of persuasion.

Granting a new trial on the ground that the verdict is against the weight of the evidence allows both parties another chance to present evidence. The purpose of the new trial order is to do substantial justice between the parties. A plaintiff seeking a new trial is, in effect, asking not only that his evidence be believed, but also that the defendant’s evidence, if any, be disbelieved. A defendant, on the other hand, need only seek to have his evidence believed, or the plaintiff’s evidence disbelieved. The concurring opinion in the Lupkey case correctly points out that it is the application of the principle of the plaintiff’s burden of persuasion which makes proper the granting motions for new trial on the ground that the verdict is against the weight of the evidence to defendants who have presented no evidence.

In Lupkey, the plaintiff asserted that the editorial complained of was libelous per se, that truth was the only defense, and that no substantial evidence was produced to support the defense. Thus, the plaintiff could contend that, under the analysis of the concurring opinion, the defendant is not entitled to the new trial because the defendant has the burden of persuasion on the only defense to the claim. While it may be true that the defendant has the burden of persuasion on any affirmative defense, it is similarly true that such a defense does not relieve the plaintiff of his overall burden of persuasion. If the Lupkey defendant were to admit the allegations of the plaintiff, assert his affirmative defense, produce no substantial evidence to support his defense, and then move for a new trial after an unfavorable verdict, he would have the only or overall burden of persuasion and would not be entitled to the new trial. Within the context of a motion for new trial on the ground that the verdict is against the weight of the evidence, the defendant need only convince the court that the verdict for plaintiff is against the weight of the plaintiff’s evidence. The issue of the weight of the evidence on the affirmative defense only arises if the verdict for plaintiff is not against the weight of the evidence. In Lupkey the verdict for plaintiff was against the weight of the evidence produced to support the plaintiff’s claim. Therefore, the affirmative defense was of no concern.

27. 333 Mo. 340, 62 S.W.2d 708 (1933).
28. Id. at 341.
The concurring opinion in *Lupkey v. Weldon*\(^2\) correctly stated that the defendant was entitled to a new trial order on the basis of general procedure principles. Therefore, it was not necessary for the majority opinion to rely on the libel provisions in the Constitution to reach their decision.

BARBARA JILL BREDEMAN

LANDLORD AND TENANT—LIABILITY FOR RENT AFTER DESTRUCTION OF BUILDING—LEASE OF PART OF BUILDING

*Crow Lumber and Building Materials Co. v. Washington County Library Board*\(^1\)

Defendant, tenant, leased from plaintiff, landlord, "the street level floor only" of a certain building. The building contained a basement which was used by the landlord for storage. The lease contained neither covenants by the landlord to rebuild nor provisions excusing the tenant from paying rent if the building was destroyed or made untenantable. Nine months before the expiration of the term the building was made untenantable by an accidental fire. The tenant did not pay the rent for the remaining nine months and landlord brought suit to recover the back rent. The trial court entered judgment for the tenant and was affirmed by the St. Louis Court of Appeals.

The court of appeals recognized that Missouri courts have consistently enforced the general common law rule that in the absence of a provision excusing the lessee, he must continue to pay rent even if the demised premises are destroyed or made untenantable by accidental causes.\(^2\) The court noted, however, that this general rule had only been applied in Missouri where the leasehold was for more than a portion of a building.\(^3\) Considering the principal case one of first impression,\(^4\) the court adopted an exception to the general rule: when the leasehold is for only a portion of the building and the building is accidentally destroyed or made untenantable the tenancy ceases and the lessee is no longer liable for the rent.\(^5\)

The general rule that the lessee must pay rent even though the premises become untenantable has a long history. It was recognized over three centuries ago in the English case of *Paradine v. Jane*,\(^6\) and almost two hundred years ago

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29. 419 S.W.2d 91, 94 (Mo. En Banc 1967).
1. 428 S.W.2d 758 (St. L. Mo. App. 1968).
2. *Id.* at 760-61.
3. *Id.* at 760.
4. *Id.* at 764.
in the American case of Pollard v. Shaaffer. Both cases reasoned that since the lessee had made the covenant to pay rent, and could have protected himself in the lease, the court could not excuse him from performance because of "any accident by inevitable necessity." Paradine and Pollard also said that since the lessee could enjoy the advantage of casual or accidental profits he should bear the risk of casual losses.

Missouri courts recognized the general rule as early as 1852 in Davis' Administrator v. Smith & Bradley. The court in Davis followed the reasoning of Paradine and Pollard and added that a lease should be viewed as a purchase of the demised premises for the term of the lease. Therefore, the lessee should bear the loss occasioned by the destruction as any owner would. This reasoning was followed in subsequent Missouri cases, but later the rule was reapplied without mention of its underlying reasons. Although the Missouri courts have continued to uphold the rule, they have criticized it strongly as being unduly harsh.

Perhaps to alleviate this harshness some American courts developed an exception which excuses payment of rent if the lease involved only a portion of a building. In 1832, the Supreme Court of Ohio said in Winton v. Cornish that a lessee's interest in one room and the cellar of a house was terminated when the entire house was destroyed by fire. The court reasoned that since the only interest which the lessee had was in a part of the building and not in the land the destruction of the building left nothing on which the lease could operate. This reasoning has been accepted by many courts.

In the principal case the court of appeals adopted the reasoning of Winton and said "the lease of the 'street level floor only' of the building did not grant any

7. 1 Dallas 210, 1 Am. Dec. 239 (Pa. 1787). Both Paradine and Pollard involved demised premises which the lessee was unable to use during the term of the lease because they were occupied by enemy troops.
9. Id. at 897; Pollard v. Shaaffer, 1 Dallas 210, 1 Am. Dec. 239, 245 (Pa. 1787).
10. Davis' Adm'tr v. Smith & Bradley, 15 Mo. 467 (1852).
11. Id. at 469-70. It should be noted that the property aspect of a modern lease is often overlooked since the contract aspect looms so large. In a lease, the landlord transfers to the tenant a possessory interest for the term, and if there is a casualty destruction two property interests are destroyed, the tenant's term for years and the landlord's reversion in fee.
15. 5 Ohio 477 (1832).
16. Id. at 478-80.
17. See, e.g., Buerger v. Boyd, 25 Ark. 441 (1869); Signal v. Wise, 114 Conn. 297, 158 A. 891 (1932); Harrington v. Watson, 11 Or. 143, 3 P. 173 (1883); Porter v. Tull, 6 Wash. 408, 33 P. 965 (1893); Waite v. O'Neil, 76 F. 408 (6th Cir. 1896). The soundness of this distinction between the building and the land can be questioned. For most purposes buildings are treated as part of the land.
interest in the land." As a result, the lease was terminated by the destruction and the tenant's liability for the rent ended. While this reasoning covers apartment and many office and storeroom leases and may reach a more just result than that reached by the old general rule, the case uses an indirect approach where a more direct approach is needed. The better reason for the exception would seem to be to alleviate the harshness of the old general rule. And if this is the object, the old rule should be dealt with in a more direct manner. For example, several states have passed statutes which either partially or entirely excuse the lessee from paying rent when the premises are destroyed. Others have accomplished similar results by court decisions. Missouri courts, using a somewhat indirect approach, weakened the common law rule by excusing payment of rent where the lessor did not honor a covenant to rebuild or failed to provide insurance for the premises as he had covenanted.

The use of the exception to ease the harshness of the general rule may lead to difficulties. For instance, the lease may purport to be only of the whole building and not of the land. A District of Columbia case has said that if the building was destroyed under this type of lease the tenant would be excused from paying his rent. Missouri, on the other hand, in *McDaniel v. Willer* has said that a lease which purports on its face to lease only the building and makes no reference to the land will be deemed to include the land on which the building stands and any land necessary to the building's proper use. This recognition of some interest in the land would mean that the above exception could not apply. There would also be a problem if the lease was for a building built in the air space above another

19. Ibid.
20. Few courts have offered functional reasons for this exception, although some could be advanced. For example, in the *Winton* case the court refused to allow the tenant to rebuild on the foundation of the destroyed house in which he had rented one room and the cellar. This would indicate that where the tenant rents the whole of a lot and the improvements thereon, he should have to pay in the event of destruction because he may rebuild or make some other use of the lot. On the other hand, a tenant who rents only a portion of a building should not have to pay because he is not entitled to rebuild or make other use of the premises after their destruction.

21. See, e.g., CAL. CIV. CODE § 1933 (West 1956); N.Y. REAL PROP. LAW § 277. However, Georgia has codified the old common law rule in GA. CODE § 63-113 (1933).
22. Wattles v. Omaha Ice & Coal Co., 50 Neb. 251, 69 N.W. 785 (1897); Whitaker v. Hawley, 25 Kan. 674 (1881), using strong language against the common law rule but deciding the case on the ground that the lease substantially involved personal property; Coogan v. Parker, 2 S.C. 255 (1870), modifying the common law rule so as to excuse payment of rent if lessee rescinds the lease and surrenders the premises after their destruction.
23. Lincoln Trust Co. v. Nathan, 175 Mo. 32, 74 S.W. 1007 (1903).
26. 216 S.W.2d 144 (St. L. Mo. App. 1948).
27. Id. at 146.
building or other improvements in a large city and the upper building was destroyed. Would the doctrine of Schmidt or of McDaniel apply? Or what if the entire demised premises including land were washed away by a river? One court in such a case has said that since the subject of the lease was destroyed and there was no longer anything for the lease to operate on, the lease was terminated, excusing the lessee from paying further rents.

It appears that the best solution to the problem would be to abolish completely the old common law rule and excuse the lessee from payment of rent whenever the demised premises are destroyed or made untenantable. Short of this, however, the attorney can avoid the problem completely by using a well drafted lease which clearly defines the rights and liabilities of both parties in the event the demised premises are destroyed or made untenantable during the term of the lease.

ROBERT HICKEL

THE QUASHING OF SUBPOENAS OF DOCUMENTS LOCATED ABROAD—WHAT GOVERNS?

United States v. First National City Bank

Defendant First National City Bank of New York (hereinafter called Citibank) was served with a subpoena duces tecum requiring production of documents, among which were records kept at Citibank's Frankfort, Germany branch. Defendant refused to produce the German records, contending that should it comply with the subpoena, it would be faced with possible civil liability and economic loss in Germany. For failing to produce the documents, the district court adjudged Citibank

28. An example is the new Madison Square Gardens in New York over the site of the old Pennsylvania station.

29. Waite v. O'Neil, 76 F. 408 (6th Cir. 1896).

30. A rejection of the old rule would need to provide for the situation where the majority of the value of the demised premises is not destroyed by the destruction of a building thereon. For example, the tenant should not be excused from payment of rent upon a farm on which only a single building is destroyed.

31. See, e.g., E. Belsheim, Modern Legal Forms § 5071 et seq. (1962); 5 C. Nichols, Cyclopedia of Legal Forms § 5.1866 et seq. (1956); 7 P. Peterson & W. Eckhardt, Missouri Practice Legal Forms § 891 et seq. (1960); and any other good form book on leases.

1. 396 F.2d 897 (2d Cir. 1968).

2. Expert testimony established the nature of the "bank secrecy law" of Germany. The opinion stated:

...a bank—including a foreign bank (such as Citibank) licensed to do business in Germany—cannot divulge information relating to the affairs of its customers even in response to the process of a court of the United States. To do so...would amount to a breach of the bank's 'self evident' contractual obligation which flows from the business relationship between...
to be in civil contempt. The bank was fined $2,000 per day and the bank's vice-president was sentenced to sixty days' imprisonment. The United States Court of Appeals, Second Circuit, affirmed, holding that the mere possibility of civil liability was insufficient grounds for refusing to comply with the subpoena. The court found that Citibank did not make a good faith attempt to comply with the subpoena, and the proof of prospective civil liability was wholly speculative. The opinion concluded:

If indeed Citibank might suffer civil liability under German law in such circumstances, it must confront the choice . . . [of needing] . . . to "surrender to one sovereign or the other the privileges received therefrom," or alternatively, a willingness to accept the consequences.

This case is indicative of the dilemma often faced by banks, corporations, and individuals who do business on an international scale.

As a general rule, a court may direct a party or witness over whom it has in personam jurisdiction to produce documents under that person's control, even though those documents are located abroad. The cases, however, agree that it is

United States v. First National City Bank, 396 F.2d 897, 899 (2d Cir. 1968).

In addition, the bank was threatened with economic reprisals:

The customer "... informed Citibank that it would have to 'suffer the consequences' if it obeyed the subpoena. It was suggested that Bochringer (customer) would sue the bank for breach of contract and would also use its influence within German industrial circles to cause Citibank to suffer business losses." Id. at 899.

3. FED. R. CIV. P. 45(f), "Contempt—Failure by any person without excuse to obey a subpoena served on him may be deemed a contempt of the court from which the subpoena was issued." FED. R. CRIM. P. 17(g) is substantially the same. See also Taylor v. U.S., 221 F.2d 809 (6th Cir. 1955), holding that disobedience of a grand jury subpoena ducès tecum is punishable as a contempt of court.

4. The sentence is not as harsh as it appears. The punishment could not extend beyond the expiration date of the grand jury, which was apparently substantially less than sixty days. See Loubriel v. U.S., 9 F.2d 807 (2d Cir. 1926); U.S. v. Collins, 146 F. 553 (D. Ore. 1906). Query: would the court have affirmed the sentence of the vice-president had he faced, in reality, a 60-day sentence?

5. United States v. First National City Bank, 396 F.2d 897 (2d Cir. 1968), note 8 at 900.

6. Id. at 900.

7. Id. at 905.

improper for a United States court to order such disclosure if the disclosure would be in violation of the law of the foreign country; and a party to whom a subpoena duces tecum is issued may move to quash the subpoena on those grounds. The duty of the court in this instance is to determine if and when the motion should be granted, and how relief can be structured so as to minimize the hardship on the parties concerned. The Citibank case is the latest in a series of decisions defining the factors a court should weigh in disposing of such a motion.

The early cases in this area dealt with the problem in terms of absolutes. In a 1914 decision, Munroe v. United States, the court vacated the subpoena because the cost of production of records located in Paris was prohibitive, and it would be placing upon defendant an unconscionable burden to require him to superintend the documents during a perilous Atlantic crossing. In the post-war Prize Cases, the Prize Courts of Great Britain held that dismissal of a cause of action was proper when an order to produce records physically located in Sweden was refused on the grounds that to do so would place plaintiffs in violation of Swedish penal law. In The Consul Cortifzon in 1917, the opinion states, "... a court of Prize cannot properly be deterred from making what it conceives to be the appropriate order because a neutral claimant would, if he obeyed the order, be guilty of a breach of his own municipal law." The disposition of these cases curiously reflects the tenor of the international economic and political scene during the wane of the age of imperialism.

In more recent times advances in the areas of transportation and communication have caused international business relationships to flourish as never before. With this increase in economic—and necessarily political—contact, the need for a more sophisticated approach to problems of international legal conflicts is obvious. Many countries have laws and policies which forbid the disclosure or removal of business records from the country. In Switzerland, the law is very strict, since bank secrecy is the foundation of Swiss economic importance. On the other hand, the securities control and antitrust laws express the strong public policy of the United States, and enforcement of these laws cannot be thwarted by the law of another

10. See FED. R. Civ. P. 45(b).
11. 216 F. 107 (1st Cir. 1914).
14. "The position [of the Swedish plaintiffs] is anomalous, but the anomaly is certainly not due to the practice of the Prize Court.” From the Baron Stjernblad [1918] A.C. 173, 179.
country. Thus, the courts have had the job of balancing the interests of the United States, the foreign sovereign, and the party to whom the order was issued.

The procedural requirements for a party or witness seeking to avail himself of non-compliance with a court order on these grounds are twofold. First, he must show that a good faith attempt has been made on his part to comply with the order. This may entail ordering production by foreign employees or officers, requesting waiver by the foreign sovereign of penalties under the foreign law, or by requesting permission of foreign authorities to remove or copy the documents. In addition, there must be proof of foreign law. A party must show what law will be violated should the terms of the subpoena be carried out. Experts may be called and statutory text may be presented; in short, the court must be fully apprised of the effects of the foreign law.

The courts have generally tended to respect the foreign relations power of the executive branch of our government, and have tried to avoid any conflict with a foreign sovereign. If the sovereign has expressed an active interest in preventing the removal of documents in a specific case, a court is not likely to require a helpless petitioner to comply. Perhaps the most famous decision in this regard is the Interhandle case where the records sought were seized by an official of the Swiss gov-


16. RESTATEMENT (SECOND) OF FOREIGN RELATIONS LAW OF THE UNITED STATES § 40; U.S. v. First National City Bank, 396 F.2d 897 (2d Cir. 1967). In U.S. v. Standard Oil Co., 23 F.R.D. 1, 3 (S.D.N.Y. 1958), the court said, "... the burden upon the defendants in producing the documents or answering the interrogatories must be weighed against the necessity of the documents and information to the government." In the Citibank case, Citibank made no effort even to inquire of its German branch about the records.


21. SEC v. Minas de Artimisa, S.A., 150 F.2d 215 (9th Cir. 1945); U.S. v. Ross, 302 F.2d 831 (2d Cir. 1962).


23. SEC v. Minas de Artimisa, S.A., 150 F.2d 215 (9th Cir. 1945); U.S. v. First National City Bank, 396 F.2d 897 (2d Cir. 1968); Application of Chase Manhattan Bank, 297 F.2d 611 (2d Cir. 1959).


ernment in order to preclude production pursuant to a discovery order of a United States court. Compliance was a practical impossibility, and the United States Supreme Court vacated the order on these grounds. In Application of the Chase Manhattan Bank, the interest of the foreign sovereign was expressed in a different, but no less direct, manner. Subsequent to the court’s production order, the Panamanian government passed legislation which prohibited removal of business records. This positive expression moved the United States Court of Appeals for the Second Circuit to relieve the bank of the burden of production. In Canada, statutes have been passed prohibiting removal of business records for examination in foreign tribunals, and American courts, in response thereto, have not required production of documents located in Canada.

In the Citibank case, the court noted, and apparently deemed important, the fact that no opposition to the production of the records was presented by the German government. The court presumed that since there was no intervention by the State Department (the government was plaintiff), the requirement of production would not constitute judicial encroachment upon executive powers.

26. The seizure was made under Article 273, Swiss Penal Code (economic espionage), and Article 47, Swiss Banking Law (bank secrecy).

27. The court stated that the dismissal power in Rule 37 should not be used “...when it has been established that failure to comply has been due to inability, and not to willfulness, bad faith, or any fault of petitioner.” Societe Internationale v. Rogers, 357 U.S. 197, 212 (1958).

28. 297 F.2d 611 (2d Cir. 1962).

29. The litigation in regard to materials located in Canada has been vigorous, and the United States courts have largely refrained from stretching the bounds of international comity. In an early case, In re Grand Jury Subpoena Duces Tecum Addressed To Canadian International Paper Co., 72 F. Supp. 1013 (S.D.N.Y. 1947), the board of directors of a Canadian corporation passed a resolution which declared the records private and said that they could not be removed from Canada. This was asserted as a legally sufficient reason for quashing a subpoena duces tecum issued from a federal Grand Jury. The court stated on page 1020 of the opinion: “The corporation may not evade complying with the subpoena by a resolution of this character . . .” The motion to quash was denied.

Largely in response to this decision, the Canadian Business Records Protection Act, 1 Ontario Rev. Stat. (1960), ch. 44, pp. 421-422, was adopted. The main portions are:

1. No person shall, pursuant to or under or in a manner that would be consistent with compliance with any requirement, order, direction, or subpoena of any legislative, administrative, or judicial authority in any jurisdiction outside Ontario, take or cause to be taken, send or cause to be sent, or remove or cause to be removed from a point in Ontario to a point outside Ontario, any account, balance sheet, profit and loss statement, or inventory or any resume or digest thereof or any record, statement, report or material in any way relating to any business carried on in Ontario...

2. (2) Every person who, having received notice of an application under this section, contravenes this Act shall be deemed to be in contempt of court and liable to one year’s imprisonment.

In the subsequent case of Hirshhorn v. Hirshhorn, 278 App. Div. 1006, 105 N.Y.S.2d 628 (App. Div. 1951), the court denied inspection and discovery of documents and records in Canada because of the Canadian Business Records Protection Act, and stated that such discovery should be sought in Ontario.
The availability of alternative forms of relief has influenced the disposition of a motion to vacate. When the courts have been able to structure relief somewhere between the extremes of a total quashing on one hand and a contempt citation on the other, they have done so. Production orders have been modified in several ways to accommodate the interests of both parties to the suit. In SEC v. Minas de Artimisa, S.A., the Ninth Circuit directed movant to apply to the appropriate Mexican authorities for permission to copy records located there, the removal of which would constitute a violation of Mexican law. The order provided that if such permission was not forthcoming, the SEC would have to examine the books at the SEC’s expense in Mexico. A similar shifting of the burden of production is found in the order of the court in Chase Manhattan. Upon proof of foreign law, compliance was no longer required, and “the next move is up to the government,” presumably meaning that the government had to petition the Panamanian courts for permission to remove the documents if it was to see them at all. In modifying an order to produce records in Canada, the court in Ings v. Ferguson suggested recourse in Canadian courts was the only way documents located in Canada could be procured when their removal was prohibited by Canadian law.

Probably the most important consideration examined by the courts is the nature of the foreign law which movant claims he will violate should he comply with the subpoena. Clearly, the threat of criminal sanctions abroad constitutes a legally sufficient basis for a motion to quash. Whether the sanction involves fines or penal consequences is immaterial, and presumably the severity of the criminal sanction is irrelevant. Chase Manhattan held that an offense which was similar to the common law concept of misdemeanor was sufficient.

Prior to the Citibank case, there was no indication whether prospective civil liability abroad is also sufficient reason to quash a production order. The question was raised in Chase Manhattan, but was left unanswered. The facts of Citibank offered the Second Circuit the opportunity to answer it. This was done in an indirect manner, for the significance of Citibank lies not in the holding of the case, but rather in the dictum. The Citibank decision holds merely that on the facts, Citibank did not meet the good faith and proof of law requirements—that they did not “show cause why

30. 150 F.2d 215 (9th Cir. 1945).
31. 297 F.2d 611, 613 (2d Cir. 1962).
33. 282 F.2d 149 (2d Cir. 1960).
34. Societe Internationale v. Rogers, 357 U.S. 197 (1958); Application of Chase Manhattan Bank, 297 F.2d 149 (2d Cir. 1959); SEC v. Minas de Artimisa, S.A., 150 F.2d 215 (9th Cir. 1945).
35. Application of Chase Manhattan Bank, 297 F.2d 611, 613 (2d Cir. 1962). “The Government also argues that First National City Bank stands for the proposition that the foreign law prohibiting production must provide criminal sanctions to justify the court in modifying the subpoena. But we need not now decide whether the sanctions must always be criminal.”
36. The dictum is significant because most of these cases dealing with international business transactions are litigated in the Second Circuit, and because the language of the court gives a strong indication of how future cases may be decided.
they should not produce the documents. The dictum indicates, however, that the court finds a civil-criminal distinction in this area a cumbersome tool, and that in the future, civil liability may, in some cases, be grounds for refusal to comply with a subpoena duces tecum. The court does not go so far as to promulgate a formula to be followed, but it makes clear the deficiency in the case presented by Citibank. The liability must be reasonably certain. The court felt that this was not established, finding that Citibank had several defenses available to it. It is therefore a fair conclusion that if a party can show that compliance with an order to produce foreign records gives rise to a cause of action under foreign law, to which compulsion by an American court is no defense, the party will be excused from compliance, whether the foreign liability is categorized as civil or criminal.

The Citibank decision restricts, in one sense, the power of its process. However, it has provided a solid foothold upon which to base further developments in the area of foreign civil liability as a basis for a motion to quash orders for the production of documents located abroad.

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38. United States v. First National City Bank, 396 F.2d 897 (2d Cir. 1968) at 902. We would be reluctant to hold, however, that the mere absence of criminal sanctions abroad necessarily mandates obedience to a subpoena. Such a rule would show scant respect for international comity; . . . . It would be a gross fiction to contend that if the Bundesbank were to revoke the license of Citibank for a violation of bank secrecy the impact would be less catastrophic than having to pay an insignificant fine because the revocation is theoretically not “equivalent to a misdemeanor” or criminal sanction. We are not required to decide whether penalties must be under the “criminal law” to provide a legally sufficient reason for noncompliance with a subpoena; but, it would seem unreal to let all hang on whether the label “criminal” were attached to the sanction and to disregard all other factors. In any event, even were we to assume arguendo that in appropriate circumstances civil penalties or liabilities would suffice, we hold that Citibank has failed to provide an adequate justification for its disobedience of the subpoena.
INTERNAL REVENUE—ALLOCATION OF PURCHASE PRICE TO UNIQUE INVENTORY

Jack Daniel Distillery v. United States¹

The taxpayer, a newly-formed Tennessee corporation, acquired for cash and negotiable promissory notes all the stock of a predecessor Tennessee corporation and subsequently liquidated the old corporation thereby acquiring all its assets and assuming its liabilities. The new corporation carried on the whiskey distillery business previously operated by the old corporation.

The purchase and liquidation were executed in accordance with the provisions of section 334(b)(2) of the Internal Revenue Code of 1954.² This section provides that the basis to the acquiring corporation of the property received on liquidation shall be the adjusted basis of the stock with respect to which the distribution was made. The adjusted basis of the stock is allocated among the tangible and intangible assets acquired in proportion to their net fair market value³ when received.⁴

This was a suit in the United States Court of Claims for refund of corporation income tax paid and interest thereon for the fiscal periods ended April 30, 1958 through 1962. The Commissioner asserted that the cost basis allocated to whiskey inventory and depreciable property was overstated, and thus, income was under-

1. 379 F.2d 569 (Ct. Cl. 1967).
2. Upon liquidation of a subsidiary under § 332(b), the assets received by the parent generally carry over the basis they had in the hands of the subsidiary. INT. REV. CODE of 1954, § 334(b)(1). This means that the inherited basis might be more or less than the price paid for the stock. Prior to 1954, cases developed the principle that a purchase by one corporation of all or substantially all of the stock of another corporation, followed by a liquidation of the acquired corporation, produced a basis equal to the cost of stock rather than a carry over of basis. This was called the “single transaction” doctrine. Kimbell-Diamond Milling Co. v. Commissioner, 14 T.C. 74 (1950), aff’d, 187 F.2d 718 (5th Cir. 1951). In 1954, the doctrine was embodied in 334(b)(2) as an exception, providing that the parent corporation’s basis for property acquired in the liquidation of a controlled subsidiary is the cost of the stock rather than the subsidiary’s basis, if: (1) at least 80% of the stock is acquired, (2) by “purchase” (as defined), (3) during a period of not more than 12 months, (4) and if distribution is pursuant to a plan of complete liquidation under § 332 adopted not more than two years after the purchase. Because in theory the transaction is a purchase, the parent does not inherit the liquidated corporation’s earnings and profits as it would in a normal liquidation. These formal steps are controlling regardless of the acquiring corporation’s purpose or intent. B. BITTKER AND J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS, 375-76 (2d ed. 1966).
3. Treas. Reg. § 1.334-1 (c)(4)(viii) (1955). None of the assets was subject to a mortgage or pledge so fair market value and net fair market value were the same in this case.
4. This required allocation is similar to the rule set down in Williams v. McGowan, 152 F.2d 570 (2d Cir. 1945). There several assets constituting a going concern were sold by an individual proprietor. The court held that the proceeds must be allocated among the various assets to determine the nature of any gains or losses. The buyer is also required to allocate his cost among the assets received. Note, 13 TAX. L. REV. 369 (1958).
stated. Upon trial the government reduced its dispute over the allocation of cost to the amounts allocated to the unbottled whiskey inventory and goodwill. The valuations given the two principal assets in dispute by the parties were as follows:

<table>
<thead>
<tr>
<th></th>
<th>Cost to old</th>
<th>Commissioner</th>
<th>Taxpayer</th>
</tr>
</thead>
<tbody>
<tr>
<td>Unbottled whiskey</td>
<td>$3.2 million</td>
<td>$3.8 million</td>
<td>$11.6 million</td>
</tr>
<tr>
<td>Goodwill</td>
<td>-0-</td>
<td>$6.7 million</td>
<td>$2.5 million</td>
</tr>
</tbody>
</table>

The Commissioner assigned deficiencies totaling $3.5 million for the taxable years 1958 through 1962. The deficiencies resulted from the use of the old Jack Daniel cost basis for the assets in computing cost of goods sold and allowances for depreciation of the assets acquired from the old corporation. The taxpayer used insurance values in determining its basis in inventory and consequent income tax liability for the same taxable periods. The Court of Claims held that the taxpayer's valuation of the whiskey inventory constituted the fair market value of such inventory and was the proper basis for cost of goods sold. Thus, the claim for refund was allowed.

5. Another issue involved in the case was whether or not the residual method of valuing goodwill was acceptable. This is the method whereby the tangible assets are first valued and then goodwill is given the value of the excess of purchase price over the allocation to the tangibles. An alternative method would be to analyze the earnings of the business and value goodwill by capitalizing earnings considered to be in excess of a fair return on the tangible assets. See Crawford, Allocation of Goodwill in a Section 334(b)(2) Liquidation: Which Method May Be Used?, 26 J. of Tax. 204 (1967). The court in Jack Daniel determined that where the tangible assets are capable of definite valuation the residual method of valuing goodwill is acceptable. Jack Daniel Distillery v. United States, 379 F.2d 569, 579 (Ct. Cl. 1967). The residual method was used in: Cohen v. Kelm, 119 F. Supp. 376 (D. Minn. 1953); Motel Co. v. Commissioner, 22 CCH Tax Ct. Mem. 825 (1963), aff'd, 340 F.2d 445 (2d Cir. 1965); Copperhead Coal Co. v. Commissioner, 272 F.2d 45 (6th Cir. 1959).

6. There are clear motives behind these positions. If the government could have successfully argued that $6.7 million should be allocated to goodwill then taxable income could have been increased. Plaintiff, on the other hand, can benefit by allocating relatively large amounts to the inventory. This makes the cost of goods sold figure higher and stated income lower. In cases other than § 332(b) situations there is also a conflict over allocation between buyer and seller. In those cases seller would like to allocate large amounts to intangibles which are considered capital assets when sold. Note, 13 Tax. L. Rev. 369, 370 (1958).

7. Upon trial, the government had added a "future worth factor" of $.6 million, computed at 6.5% per year on the cost of inventory on the books of old Jack Daniel. This made the government's total valuation $3.8 million. The "future worth factor" was intended to take into account interest on the original investment and the storage and other charges incurred on the whiskey as it matured. The court rejected this as completely arbitrary in that it ignored the market concept. Equating cost with fair market value of the whiskey was viewed as "grossly inconsistent" with the seller's market for Jack Daniel. Jack Daniel Distillery v. United States, 379 F.2d 569, 578 (Ct. Cl. 1967).

In South Lake Farms, Inc. v. Commissioner, 36 T.C. 1027 (1961), aff'd, 324 F.2d 837 (9th Cir. 1963), there was a sale of stock to a new corporation which liquidated the old corporation and obtained a stepped-up basis in assets. The old
Prior to 1956, the distilling industry had entered into an agreement with insurance underwriters to use a method of valuing "irreplaceable whiskey" for insurance purposes that was different from that used for whiskey sold on the bulk whiskey market. This was done because it was believed that the market price of bulk whiskey did not adequately reflect the value of an irreplaceable whiskey. The method used by underwriters was to take the case price of the whiskey in glass bottles and subtract the excise taxes, bottling costs, and other unincurred charges. This valuation was made prior to any negotiations pertaining to the sale of the old Jack Daniel stock between seller and purchaser.

The taxpayer presented the following factors in support of its valuation. First, old Jack Daniel proposed the insurance value as being the fair market value of the unbottled inventory and this value was accepted by the purchaser. Second, regular independent auditors had determined that a purchase of the whiskey inventory at the insurance values would yield a substantial before-tax profit, and that the valuation was therefore a reasonable one. Third, three officers of other distillery and whiskey wholesale companies testified that in their opinion, the insurance valuation was the fair market value of the unbottled inventory. Two of the expert witnesses testified that in 1956, they would willingly have purchased,

corporation took deductions for the cost of planting crops while the new corporation took the cost of harvesting the same crops as a deduction. Both corporations reported net losses in the year. The Commissioner attempted to charge the old corporation with proceeds from the sale of crops by purchaser. The Tax Court rejected this view saying that the cost of planting was included in the value of assets sold to the purchaser, and thus, the proceeds of the sale were not includable in income to the seller. In the Jack Daniel case the government apparently wanted to prevent any stepped-up basis since the proceeds of a later sale could not be charged to the liquidated corporation. The language of § 334(b)(2) however, clearly provides for the stepped-up basis.

8. The Court considered the following facts as relevant to its decision. Jack Daniel whiskey was what is known in the distilling industry as an "irreplaceable whiskey," unique in its reputation for a distinctive taste. It had never been sold on the bulk whiskey markets. At the time of the acquisition it was considered the most distinctive of the famous bourbons because the method by which it was processed gave it a taste unlike any other whiskey on the market. Jack Daniels Distillery v. United States, 379 F.2d 569, 572 (Ct. Cl. 1967).

9. See footnote 8 supra.

10. In McGuire v. Commissioner, 44 T.C. 801 (1965), testimony of an insurance broker as to the insurance valuation of property was used in determining fair market value. In Pickering v. Commissioner, 5 B.T.A. 670, 672 (1926), a case in which the value of tangible property of a newspaper was in issue, an appraisal was made for insurance and accounting purposes prior to litigation. It was held that this appraisal alone supported petitioner's burden of proof as to establishing a different figure than that asserted by the Commissioner.

11. Treas. Reg. § 1.471-2 (1958) provides:
   (a) Section 471 provides two tests to which each inventory must conform:
      (1) It must conform as nearly as may be to the best accounting practice in the trade or business, and
      (2) It must clearly reflect the income.
   (b) It follows, therefore, that inventory rules cannot be uniform but must give effect to trade customs which come within the scope of the best accounting practice in the particular trade or business.
or participated in a joint enterprise to purchase, the Jack Daniel inventory at the insurance value, assuming that they would have had the right to sell the same under Jack Daniel labels. The Court of Claims concluded that the testimony was convincing that the inventory could have been sold to a third party at the insurance valuation if the purchasers were given the right to use the Jack Daniel labels.

The first important issue raised concerns the use of net realizable value (insurance value) as an acceptable measure of fair market value. It has been stated that fair market value is the price at which property would change hands in a transaction between a willing buyer and a willing seller, neither being under compulsion to buy or sell, and both being reasonably informed as to the facts. This means, that fair market value must be based on the best possible use of the subject matter. Under circumstances where it was clear that a loss on sale of inventory was to be incurred, the United States Tax Court in Space Controls, Inc. approved an inventory revaluation below cost at net realizable value. Inventory valuation at current selling values less direct costs of disposition has been approved in connection with livestock and farm products. In special situations such valuations are also accepted as good accounting practice. In holding for the taxpayer in the Jack Daniel inventory case, the Court of Claims concluded that the testimony was convincing that the inventory could have been sold to a third party at the insurance valuation if the purchasers were given the right to use the Jack Daniel labels.


13. In Gordon, What Is Fair Market Value?, 8 TAX. L. REV. 35, 36 (1952), it is stated that: "Fair market value in essence means sound value; it is the price for which the owner would hold out if he could." 10 J. MERTENS, FEDERAL INCOME TAXATION § 59.01 (1964) provides: "An important element in the value of property is the use to which it may be put."

14. 21 T.C.M. 295 (1962), rev'd in part, Space Controls, Inc. v. Commissioner, 322 F.2d 144 (5th Cir. 1963). The issue on appeal was whether goods in process could be revalued below cost in addition to completed inventory once it was certain that a loss on each item was to be incurred. The Commissioner contended that market, as used the lower-of-cost-or-market formula, was not what the products were to be sold for, but what the costs of production were including raw materials, labor and burden. The Tax Court held for the Commissioner on this issue but was reversed, the court of appeals finding that Treas. Reg. § 1.471-4(b) (1958), permitted the taxpayer to reduce the inventory in process to its net realizable value.

15. The concept of net realizable value was also approved as the proper method for determining fair market value of inventory in Berg v. United States, 167 F. Supp. 756 (W.D. Wisc. 1958). Inventory value was set at the price for which it could be sold less necessary costs of disposal and dealer's discounts.

16. Treas. Reg. § 1.471-6(d) (1958), provides that farmers may elect to value their products according to the "farm-price method" which follows the net selling price principle.

17. In W. PATON, ADVANCED ACCOUNTING, 160 (8th ed. 1954), it is stated: Net selling price ... has some standing in practice as a basis for the valuation of special kinds of inventories. By 'net price' in this connection is generally meant current selling value less estimated costs still to be met in preparing goods for sale and in effecting sale and delivery.

In H. FINNEY AND H. MILLER, PRINCIPLES OF ACCOUNTING, 220 (6th ed. 1965), it is stated that:

valuation of the inventory at selling prices less a provision for disposal costs is often regarded as acceptable practice if production costs are difficult to determine and the product has a ready marketability.
Daniel case the Court of Claims made it clear that the government’s method of valuation, being based on cost to the seller, completely ignored the market concept involved in the term fair market value.\(^\text{18}\)

The second important issue was whether the right to use the Jack Daniel label to market the whiskey was an incident of ownership which could be included in the fair market value of the unbottled whiskey. Because the cost of acquiring a trademark is considered a capital expenditure for an intangible asset,\(^\text{19}\) it is unclear whether any of the value attributable to the trademark can be included in the valuation of a tangible asset. Upon this question the case seems to be one of first impression.

The government argued that the value of the name had not yet attached to the unbottled whiskey because it was still work in process. The taxpayer claimed that the whiskey was unlike normal work in process in that with or without the Jack Daniel name, the whiskey had substantial value because of its inherent uniqueness. It was the distillation and leeching processes rather than the aging and bottling that gave the whiskey its distinctive flavor.\(^\text{20}\) The court concluded that the whiskey had reached a stage where its unique and distinctive qualities had given its name a value inseparable from the item itself.

The best possible interpretation of the court’s decision here is that there are two valuable incidents of ownership which correspond with the two functions of a trademark or trade name.\(^\text{21}\) The first of these incidents emerges from that function of a trademark that protects the goodwill of a trade or business.\(^\text{22}\) Its value is an intangible one, involving the protection or insurance of future profits. The other incident of value comes from the right to control the use of the trademark in con-
nection with a manufactured article. This element looks to the present and actually enhances the value of the manufactured item by reducing its vulnerability to competition. It is this latter value that attaches to the tangible asset and becomes a part of its fair market value. Thus, the value attributable to the use of the Jack Daniel trade name and label was included in the fair market valuation of the unbottled inventory. Since the parties made an arms-length allocation of $2.5 million to goodwill the court must have reasoned that the intangible value of the trade name and labels, which is the value derived from protection of future profits, was included in this allocation to goodwill. Moreover, it is an accepted accounting principle that in an acquisition of a business, the excess cost of assets

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23. In Seattle Brewing and Malting Co. v. Commissioner, 6 T.C. 856, 868 (1946), aff'd 165 F.2d 216 (9th Cir. 1948), it was stated:

The right to use a trade name is a monopoly as is a copyright or a patent. It carries with it the right to control its use in connection with a manufactured article and to prevent any competition that might destroy its value. It is a property right and the trade name is property, no less so because it is intangible.

24. The court stated that in terms of commercial reality, no businessman would have sold the unbottled whiskey unbranded on the bulk market because this would not have brought the best possible price. Jack Daniel Distillery v. United States, 379 F.2d 569, 576 (Ct. Cl. 1967).

25. The court placed great emphasis on the good faith nature of the transaction carried on between the buyer and seller. Defendant had attacked the negotiations as a sham for tax purposes. But the trial commissioner concluded that the parties to the sale acted in good faith when they agreed on the insurance value as the fair market value of the whiskey. In Philadelphia Steel and Iron Corp. v. Commissioner, 23 CCH Tax Ct. Mem. 558, 566 (1964), aff'd per curiam, 344 F.2d 964 (3rd Cir. 1965) the court stated:

Ordinarily, if the court, on the basis of its consideration of all the facts in a particular case concludes that the vendor and vendee, by their agreement in an arm's-length transaction, have made a fair allocation of depreciable and nondepreciable assets, including good will, their agreement will not be disturbed.

However, where the valuations in the agreement are not in accord with reality, the courts are not bound by the allocation. See Copperhead Coal Co., Inc. v. Commissioner, 272 F.2d 45 (6th Cir. 1959). In Seaton Publishing Co. v. Commissioner, 13 CCH Tax Ct. Mem. 303 (1954), the conflict was over valuation of depreciable assets. The court upheld the agreement of the parties even though no value was allocated to goodwill when it was obviously present. See the Motel Co. v. Commissioner, 22 T.C.M. 825 (1963), aff'd, 340 F.2d 445 (1965).

26. In Grace Bros., Inc. v. Commissioner, 173 F.2d 170, 176 (9th Cir. 1949), it was stated that:

... good will may attach to (1) the business as an entity, (2) the physical plant in which it is conducted, (3) the trade-name under which it is carried on and the right to conduct it at the particular place or within a particular area, under a trade-name or trademark; (4) the special knowledge or the 'know-how' of its staff; (5) the number and quality of its customers.

Generally, goodwill is thought of as including several other items, all of which are intangible.
acquired over the book values they carry may be allocated to the tangible asset that created the value itself rather than goodwill.  

The decision in Jack Daniel accepts the concept of net realizable value as a measure of fair market value of unique inventory. Thus, the principle will be applicable to lump sum purchases of businesses in which the purchase price is allocated to unique inventories in proportion to their fair market values. In this respect the decision adds to previous decisions. The decision also recognizes that in allocating a value to an asset, there may be incidents of ownership which are intangible in nature, but which are so closely linked to a tangible asset that their value can be considered as part of the value of the tangible assets. While this aspect of the Jack Daniel case seems to be one of first impression, it is in harmony with commercial reality and should be followed in situations involving valuation of unique inventories.

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27. A. WYATT, A CRITICAL STUDY OF ACCOUNTING FOR BUSINESS COMBINATIONS, AN ACCOUNTING RESEARCH STUDY OF THE AICPA, 63 (1963), where it stated:

The generally accepted accounting practice of accounting for assets at cost involves the use of fair market value of that which is given in exchange for the fair market value of that which is acquired, whichever is more readily determinable, as the appropriate measure of cost. Nothing in this concept requires that the excess of cost (as so measured) of properties acquired over the book value thereof be labeled or described as goodwill. In all cases, this excess should be allocated according to the factor or factors which created it. Accordingly, the excess may be allocated among a variety of accounts, e.g., inventories, fixed properties, intangibles other than goodwill, and goodwill (in the pure sense).

This statement was based on a survey of purchase combinations during the 1958-60 period. The study found that the excess of cost over book value of assets required was allocated to tangible assets as frequently as it was allocated to goodwill. See Rev. Rul. 59-60, 1959-1 Cum. Bull. 237 and Rev. Rul. 65-193, 1965-2 Cum. Bull. 370. See note 10 supra.

28. See note 4 supra.

A and B maintained a joint and survivorship bank account. The deposit agreement provided rights of survivorship and that either A or B could withdraw any or all the funds from the account. C, the former wife of B, secured a judgment against B for alimony and child support. C summoned First National Bank of Joplin as garnishee in order to collect the judgment from the joint bank account. A intervened, and moved that the garnishment be dissolved. In support of this motion, A presented evidence that the entire fund in the account represented her own personal savings and deposits. C argued that the introduction of this evidence varied the terms of the deposit agreement and thus violated the parol evidence rule. The trial court rejected the argument of C, and released the First National Bank from the garnishment. The Kansas City Court of Appeals affirmed, holding that where the debtor depositor has no actual financial investment in the account, the creditor may not invade the account to collect the judgment. The joint and survivorship bank account has become a popular arrangement by which the depositor can retain the use of the account fund during his lifetime and, at his death, pass the money to the survivor without complying with the formal requirements of a will. Joint bank accounts are also used often to achieve the convenience of use and access by all the parties to the account. The courts, noting the combination of joint ownership and rights of survivorship, have tended to label this banking relationship as a joint tenancy. However, this classification is not technically correct because of the right of either depositor, against the bank, to withdraw all of the money. Thus, it is understandable that the courts have

4. The right of a creditor to garnish this type of joint account for the individual debt of one depositor is not considered in this note. Since the bank may provide the same form for both a survivorship and “convenience” account, there may be an evidentiary problem in distinguishing between the accounts. See text supported by notes 34-38, infra.
5. Statutes in numerous states refer to the parties to the account as joint tenants, e.g., § 362.470, RSMo 1959, as amended 1967.
6. Note, 71 HARV. L. REV. 557 (1958); Park Enterprises v. Trach, 233 Minn. 467, 47 N.W.2d 194 (1951). In Ambruster v. Ambruster, 326 Mo. 51, 72, 31 S.W.2d 28, 37 (1930), the court stated that it is an economic fact that the typical depositor withdraws without giving a thought to the possibility that he has the right to withdraw only one-half of the fund. The author of Comment, Survivorship in Joint Bank Accounts, 16 WASH. L. REV. 105, 109 (1941), points out that there seem to be two meanings of joint tenancy, one a common law estate, the other an interest and right of survivorship in a joint bank account.
not reached uniform determinations of the per cent of the joint account fund that may be garnished when the debtor depositor has made no actual contribution to the joint bank account.\(^7\)

The Kansas City Court of Appeals, as a result of the decision in *Nieman v. First National Bank of Joplin*,\(^6\) has adopted the majority view\(^9\) that the garnishment of a joint bank account can reach only that proportion of the joint fund owned by the debtor; and evidence is admissible to show the actual contribution of each depositor. Courts recognize that the agreement between the joint depositors as to their banking relationship may not be reflected in the appearance of joint ownership manifested by the joint bank account.\(^10\) Thus, the courts can distinguish situations in which the depositor intended to make a gift of a present interest in the account from those situations where the joint bank account was only utilized to make a testamentary gift.\(^11\) In either situation, each depositor has a right of withdrawal against the bank. But, in those cases where only a testamentary gift was intended, there often exists a private understanding between the parties to the account that the co-depositor’s right of withdrawal will not be exercised until the death of the depositor.\(^12\) By permitting evidence of actual ownership in a garnishment case, the courts avoid transforming what was understood by the depositors as a testamentary transaction into an inter vivos gift.\(^13\)

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7. Hayden v. Gardner, 238 Ark. 351, 381 S.W.2d 752 (1964); Park Enterprises v. Trach, *supra* note 6; Dover Trust Co. v. Brooks, 111 N.J. Eq. 40, 160 A. 890 (1932). A few cases hold that a joint bank account is not subject to garnishment by the creditor of one of the depositors. For example, in jurisdictions that recognize tenancies by the entirety in personal property, the creditor of one spouse could not invade an account held by entirety. *See*, e.g., Cullum v. Rice, 236 Mo. App. 1113, 162 S.W.2d 342 (K.C. Ct. App. 1942).

8. 420 S.W.2d (K.C. Mo. App. 1967). An earlier case, Schnellmann v. Southern Commercial and Savings Bank, 123 Mo. App. 188, 100 S.W. 575 (St. L. Ct. App. 1907), seemingly approved the admission of evidence to show respective ownership of the depositors in a joint bank account. However, the holding may have been influenced by the fact that the joint account stood in the name of husband and wife. *See* text at note 7 *supra*.


10. *See* Note, *Disposition of Bank Accounts: The Poor Man’s Will*, 53 Colum. L. Rev. 103 (1953), where the author concludes that the same joint bank account form can be used to allow an agent to transact business, to facilitate the handling of family income, to evade bank regulation, to make an inter vivos gift, and to effectuate a testamentary disposition.

11. Intervenor testified: “I put the children’s name on the account so if anything happened to me, in case of death, it could be their money and they wouldn’t have to go through court.” *Nieman v. First National Bank of Joplin*, 420 S.W.2d 20, 21 (K.C. Mo. App. 1967).

12. The account in the *Nieman* case bore the names of a mother and her three children. Since many joint bank accounts are between family members, such an agreement is understandable; Kepner, *The Joint and Survivorship Bank Account—A Concept Without a Name*, 41 Calif. L. Rev. 596 (1953).


http://scholarship.law.missouri.edu/mlr/vol34/iss1/13
Two other positions, neither of which is concerned with the actual ownership of the depositors in the joint bank account, have been taken by the courts. One view is that the joint bank account is a strict joint tenancy. The effect of the garnishment is to sever the joint tenant relationship thus making the parties to the account tenants in common. The creditor, consequently, can garnish the share of his debtor. The second position, on the other hand, is the Minnesota rule which subjects the entire joint account to garnishment. The Minnesota Supreme Court reasoned that since the debtor co-depositor had a right to withdraw all the money in the account, the creditor, subrogated to this right, should have no less. The reasoning of Park Enterprises v. Trach seems persuasive, but the focus upon the right of withdrawal is inconsistent with the two prior views, and no other American jurisdiction has adopted this result.

The creditor in Nieman relied upon the rule of Commerce Trust Co. v. Watts to avoid the proposition that the joint bank account form did not control in a suit by an individual creditor. Watts involved a claim by the executor of a depositor's estate that the ownership of the funds in a joint account did not pass to the survivor. Because the form of the joint bank account does not reveal the reason for creating the account, the courts have used a variety of theories to

17. Ibid.
18. 233 Minn. 467, 47 N.W.2d 194 (1951).
19. The author of Note, 36 MINN. L. REV. 93 (1951), concludes that the Park case, supra note 18, recognized that a depositor really has no property interest in the joint bank account but only a chose in action against the bank for the money owed to him. It is certainly true that a bank account embodies a creditor-debtor relationship; e.g., Aetna National Bank v. Fourth National Bank, 46 N.Y. 82 (1871). Annot., 11 A.L.R.3d 1465, 1468 (1967), explains that characterization of the joint bank account under property concepts "[has furnished a convenient vehicle for the application of equitable principles apparently necessary where a creditor seeks to garnish a chose in action in which someone other than the debtor has an interest."
20. For a Canadian case in accord, see Empire Fertilizer v. Cioci, 4 D.L.R. 804 (Ont. App. 1934); See also Walt, Creditor Action In Reaching The Multiple Owner Account, 21 BUS. LAW. 225 (1965), advocates the approach of Park Enterprises v. Trach, 233 Minn. 467, 47 N.W.2d 194 (1951). However, in Leaf v. McGowan, 13 Ill. App.2d 58, 141 N.E.2d 67 (1957), the court expressly rejected the reasoning in the Park case supra.
21. 360 Mo. 971, 231 S.W.2d 817 (1950); accord, Connor v. Temm, 270 S.W.2d 541 (St. L. Mo. App. 1954).
22. See note 10 supra.
23. See, e.g., In re Geel's Estate, 143 S.W.2d 327 (St. L. Mo. App. 1940), trust; Ball v. Mercantile Trust Co., 220 Mo. App. 1165, 297 S.W. 415 (St. L. Ct. App. 1927), joint tenancy; Commonwealth Trust Co. v. DuMontimer, 193 Mo. App. 290, 183 S.W. 1137 (St. L. App. 1916), gift; Schrader, Bank Deposits as Will Substitutes in Missouri, 28 Mo. L. REV. 482 (1963).
determine if the survivor has the right to the money deposited by the decedent. In \textit{Watts}, the court upheld the right of survivorship by regarding the deposit agreement as a contract. Thus, the parol evidence rule barred evidence of the intent of the deceased depositor; this made an inquiry into the actual contribution of the depositors immaterial since all of the money in the account passed under the right of survivorship.\footnote{24} In \textit{Nieman}, the creditor argued that it should follow logically from \textit{Watts} that parol evidence to show ownership of the money in the joint bank account would be inadmissible in a garnishment suit by an individual creditor.

The Kansas City Court of Appeals stated that the parol evidence rule did not apply because the creditor was a stranger to the deposit contract.\footnote{25} Moreover, the court suggested that, since the depositors were living, it was more equitable to admit evidence of actual ownership.\footnote{26} The Ohio Supreme Court in a case similar to \textit{Nieman} explained:

\begin{quote}
Here, we are concerned wholly with a subsisting deposit intact and the rights, intention and attitude of the depositors with respect thereto during their joint lives . . . the 'realities of ownership' may be shown.\footnote{27}
\end{quote}

Furthermore, the court may have been reluctant to make the deposit contract conclusive because its terms are ambiguous in respect to the inter vivos rights of the parties to the account,\footnote{28} even though explicit as to the right of survivorship.

Courts give effect to the survivorship feature of the joint bank account on the theory that the depositors had joint interests in the account during their lives.\footnote{29} It would seem that, since there must be a present interest in the joint account in order to validate the right of survivorship, the creditor of the debtor


28. \textit{See} note 6 \textit{supra}. But in some jurisdictions, the power to withdraw is one thing, the right to appropriate the withdrawn funds to the exclusive use of one party to the account may be another. \textit{See}: Campagna v. Campagna, 337 Mass. 599, 150 N.E.2d 699 (1958); Stanger v. Epler, 382 Pa. 411, 115 A.2d 197 (1955).

29. Because of the formal requirements on testamentary instruments, the courts have held that an account in the form "\textit{A}, payable at death to \textit{B}" does not pass the fund under the right of survivorship. Thus, in order to sustain the survivorship feature of the account, a court must find that \textit{B} had some interest in the account during the lifetime of \textit{A}, so that the fund did not pass simply because of the death of \textit{A}. For a more detailed discussion, see Kepner, \textit{Five More Years of the Joint Bank Account Muddle}, 26 U. CHI. L. REV. 376, 376-77 (1959).}
depositor should be able to garnish the account to the extent of this present interest. The court, in *Nieman*, did not consider the rationale of the survivorship cases in the context of a garnishment action by the individual creditor of one party to the joint bank account. Nevertheless, to deny that the debtor depositor had a present interest in the account is simply to deny the reasoning by which the survivorship feature is given effect. The justification is that this present interest is merely a guise by which courts assure the survivorship feature of the joint bank account. However, it is certainly not desirable to have such an inconsistency of concepts between survivorship and creditor cases. The suggestion, often reiterated, that the joint account be recognized as a specialized technique to hold and pass property, has lost none of its merit.

As a final point it should be noted that in *Nieman* the court did not indicate whether ownership depended solely upon the source of the money, or whether ownership meant the respective interest of each depositor at the time of the garnishment. It is submitted that ownership should be broad enough to encompass a gift of all or part of the money in the account. Since the depositors clearly have greater access to information concerning their respective interest in the account, the burden of showing that the debtor depositor did not have a financial investment in the joint account should be placed upon the depositors. Many


31. "In practice, the depositor of the funds credited to the joint account does not surrender control during his lifetime. The gift is as conditional as a will and is, in fact, perfected only by the death of the donor. The inter vivos disputes clearly established that the transaction is gratuitous, that it is inchoate until the death of the donee...." Kepner, *Five More Years of The Joint Bank Account Muddle*, 26 U. Chi. L. Rev. 376, 396 (1959).

32. For a model statute, see Kepner, *The Joint and Survivorship Bank Account — A Concept Without a Name*, 41 Calif. L. Rev. 596 (1953). See also Schrader, *Bank Deposits as Will Substitutes in Missouri*, 28 Mo. L. Rev. 482 (1963); Note, 53 Colum. L. Rev. 103 (1953).

33. Cf. *In re Michael's Estate*, 26 Wis.2d 382, 398, 132 N.W.2d 557, 565 (1965) the court said:

The joint bank account is a comparatively new device in the long development of the law.... Such an account provides a useful technique for transferring property, and need not fit any of the historical and traditional property concepts associated with the law of inter vivos gifts and joint tenancy.

34. The court suggested that ownership was based upon the monetary contribution of each party to the joint account. However, the court did not have to define ownership because the creditor relied solely upon the form of the joint bank account as the basis of his claim. The form of the account does not control in a suit by an individual creditor; *Union Properties v. Cleveland Trust Co.*, 152 Ohio St. 430, 89 N.E.2d 638 (1949). But this does not foreclose a contention by an individual creditor that the actual contributor intended a gift of part or all of the account to the debtor depositor; *Leaf v. McGowan*, 13 Ill. App. 58, 141 N.E.2d 67 (1957).

35. Hayden *v. Gardner*, 238 Ark. 351, 381 S.W.2d 752 (1964); *Leaf v. McGowan*, supra note 34.

courts state that the appearance of joint ownership in a joint bank account gives rise to a rebuttable presumption that all of the money in the account belongs to the debtor depositor.\textsuperscript{37} In \textit{Nieman}, the court did not discuss the matter of presumptions. However, in future cases, it would seem equitable to regard a showing that the debtor was a party to a joint bank account as prima facie proof of ownership of the entire account.\textsuperscript{38}

In summary, the rule adopted in \textit{Nieman} that the garnishment of a joint bank account can reach only that portion owned by the debtor is sound. Since the form of the joint bank account does not always mirror the actual banking relationship of the depositors, evidence of actual ownership should be admissible in order to avoid irreparable harm to the interest of the non-debtor depositor. Because of the ability of the depositors to obscure the nature of their relationship, it seems justifiable to presume, prima facie, that the debtor owns all of the money in the joint bank account, and to place the burden upon the depositors to rebut this presumption.

\textbf{Edward H. Sheppard}

\section*{SUBCHAPTER S—NET OPERATING LOSS CARRYBACK}

\textit{Richard L. Plowden}\textsuperscript{1}

Taxpayers Plowden and Roberts formed a corporation in 1953 under the laws of South Carolina. Each contributed initial capital of $1,000 and received in return fifty per cent of the stock issued by the corporation. On January 1, 1962, the corporation elected to be taxed as a small business corporation under the provisions of subchapter \textit{S} of the Internal Revenue Code of 1954.\textsuperscript{2}

For the taxable year 1962, the corporation reported taxable income of $30,887.32, of which $30,852.64 was undistributed. For the following year, 1963, the corporation reported a net operating loss of $109,229.80. In their individual returns for 1963 taxpayers each claimed one-half of the corporation’s net operating loss for that year; with these deductions included, Plowden reported a net operating loss of $36,909.21 and Roberts reported a net operating loss of $34,078.71 for 1963. Thereafter each taxpayer filed a timely application requesting the carryback of his 1963 net operating loss to the taxable years 1960, 1961 and 1962.\textsuperscript{3} The district director approved the applications and made appropriate refunds for those

\begin{itemize}
\item \textsuperscript{37} Hayden v. Gardner, 238 Ark. 351, 381 S.W.2d 752 (1964); Leaf v. McGowan, 13 Ill. App.2d 58, 141 N.E.2d 67 (1957).
\item \textsuperscript{38} Hayden v. Gardner, \textit{supra} note 37; Leaf v. McGowan, \textit{supra} note 37.
\item 1. 48 T.C. No. 64 (1967). This case is now on appeal to the United States Court of Appeals for the Fourth Circuit.
\item 3. A net operating loss for any taxable year ending after December 31, 1957 may be carried back three years and forward five years. \textit{Int. Rev. Code} of 1954, § 172(b)(1).
\end{itemize}
years. The Commissioner subsequently asserted deficiencies against taxpayers for those years, limiting each taxpayers' pro rata share of the corporation's 1963 net operating loss as follows:

<table>
<thead>
<tr>
<th></th>
<th>Plowden</th>
<th>Roberts</th>
</tr>
</thead>
<tbody>
<tr>
<td>Loss claimed per return</td>
<td>$54,614.90</td>
<td>$54,614.90</td>
</tr>
<tr>
<td>Original cost of stock</td>
<td>$1,000.00</td>
<td>$1,000.00</td>
</tr>
<tr>
<td>1962 undistributed taxable income</td>
<td>15,426.32</td>
<td>15,426.32</td>
</tr>
<tr>
<td>Corporate indebtedness to shareholders</td>
<td>5,000.00</td>
<td></td>
</tr>
<tr>
<td>Total loss allowed</td>
<td>16,426.32</td>
<td>21,426.32</td>
</tr>
<tr>
<td>Loss disallowed</td>
<td>$38,188.58</td>
<td>$33,188.58</td>
</tr>
</tbody>
</table>

Each taxpayer had income from other sources which exceeded his allowable share of the corporation's net operating loss. Because of this, the Commissioner determined that neither taxpayer had sustained a net operating loss for the year 1963 and therefore no operating loss carrybacks were available as deductions for the years 1960-1962.

Section 1374(c)(2) of the 1954 Code limits a shareholder's portion of the net operating loss of an electing small business corporation for any taxable year to an amount not to exceed the sum of the adjusted basis of his stock in the corporation plus the adjusted basis of any indebtedness of the corporation to the shareholder. Taxpayers contended respondent should not have used the general basis provisions of the Code in computing the adjusted basis of their stock for purposes of applying section 1374(c)(2). They argued that the term "adjusted basis" has a unique meaning when applied to subchapter S stock, and pointed out that the subchapter S provisions do not define adjusted basis. The court summarily dismissed this contention by reference to Byrne v. Commissioner, where taxpayer argued unsuccessfully that the adjusted basis of his subchapter S stock should be its fair market value at the time the corporation elected to be taxed under subchapter S, rather than the taxpayer's cost.

Taxpayers' principal contention was that the limitation contained in section 1374(c)(2) applies only in determining the amount of the deduction to which the shareholder is entitled for the year in which the corporation sustained the loss; it does not preclude the use of the balance of the corporation's net operating loss as a carryback to shareholders' prior taxable years. Taxpayers argued that if the corporation were the taxpaying entity it would be able to take full advantage of the carryback privilege and that they should have the same latitude the corporation would have if there were no subchapter S election. The court's answer to this argument was based on the definition of net operating loss, which, subject to certain modifications, is "the excess of the deductions allowed by this chapter

5. 361 F.2d 939 (7th Cir. 1966).
6. Id. at 941-42.
over the gross income.”7 The court interpreted section 1374(c)(2) as limiting the allowable deduction to a shareholder for an S corporations net operating loss. The court said that taxpayers argument would be more properly addressed to Congress.

Subchapter S, consisting of sections 1371 through 1377 of the Internal Revenue Code, was enacted as part of the Technical Amendments Acts of 1958,8 and permits certain domestic corporations to be taxed in several ways similar to a partnership. Its purpose was “to allow businesses to select their form of organization without the necessity of taking into account major differences in tax consequences.”9

One of the similarities between the taxation of subchapter S corporations and the taxation of partnerships under subchapter K is that net operating losses are passed through the business entity and are deductible by the stockholders or partners as individuals.10 A partner’s distributive share of the partnership loss is limited to the adjusted basis of his interest in the partnership at the end of the partnership year in which the loss occurred. This provision is analogous to section 1374(c)(2) of subchapter S, and is designed to limit the net operating loss deduction to situations where the taxpayer has suffered a true economic loss. However, the law establishes a suspense account for any net operating loss in excess of the partner’s basis, and the partner is allowed a deduction at the end of any succeeding partnership year in which his adjusted basis increases sufficiently to absorb the unused loss. This gives the partner a perpetual right to carry forward the partnership’s net operating loss.

In general, the basis of a partner’s interest in the partnership includes his capital contribution to the partnership, increased by his distributive share of partnership earnings, and decreased by his withdrawals.11 An increase in partnership liabilities is considered a contribution to the partnership and an addition to basis.12 Conversely, a decrease in partnership liabilities is considered a withdrawal and a reduction of basis.13 The ability to manipulate the basis of his interest in the partnership by additional capital contributions14 or by varying the amount of partnership liabilities, coupled with the perpetual carry forward privilege give the partner great flexibility in timing his net operating loss deduction. For example, if a partner does not wish to take his full share of the partnership loss in the current year, partnership debts may be decreased to limit the amount of allowable loss in the current year and then increased in a subsequent year when the deduction would be more advantageous.

7. INT. REV. CODE of 1954, § 172(c).
13. Ibid.
14. There may be an implied condition that the capital contribution have a valid business purpose, Corum v. United States, 268 F. Supp. 109 (W.D. Ky. 1967).
By comparison, the subchapter S stockholder has less flexibility in timing his net operating loss deduction, and to the extent it exceeds his basis he may forfeit the deduction. The stockholder can avoid forfeiture by increasing his basis, prior to the close of the taxable year in which the loss occurred, to an amount equal to his portion of the net operating loss. However, the means by which the stockholder can adjust his basis possess inherent dangers which militate against their use.

The stockholder may increase his basis by contributing additional equity capital or making a loan to the corporation. Stockholder loans create problems under subchapter S because they may be classified as a second class of stock and thus result in a forfeiture of the corporation’s status as a small business corporation. The other alternative is for the shareholder to contribute additional equity capital, but the disadvantage in this method is that the stockholder may not be able to withdraw the money at a later date without adverse tax consequences.

The decision in Richard L. Plowden is significant in that it illustrates a flaw in the implementation of the subchapter S philosophy. If the purpose of subchapter S is to allow a small business to select its form of organization free from any major tax consideration, then this purpose has been thwarted by section 1374(c)(2). The very restrictive provision governing net operating loss deductions for subchapter S shareholders could discourage a newly formed business from electing subchapter S. In view of this, section 1374(c)(2) should be amended to provide for the preservation of that portion of the net operating loss which exceeds the stockholder’s basis. This excess loss would then be available to the stockholder in subsequent years when additional capital contributions or corporate earnings increase his basis sufficiently to absorb the loss.

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15. INT. REV. CODE of 1954, § 1374(c)(2).
16. Ibid.
17. One of the requirements with which a subchapter S corporation must comply in order to qualify for its special tax status is that the corporation must have only one class of stock. INT. REV. CODE of 1954, § 1371(a). This is a continuing requirement, and a loan agreement between a shareholder and the corporation could create a disqualifying second class of stock. Catalina Homes, Inc., 23 CCH Tax Ct. Mem. 1361 (1964); Henderson v. United States, 245 F. Supp. 782 (M.D. Ala. 1965); W. C. Gamman, 46 T.C. 1 (1966).
18. To the extent a small business corporation has accumulated earnings which exceed previously taxed income, any withdrawal by a shareholder will be treated as a dividend distribution. Thus, the shareholder would have to withdraw all the earnings of the corporation in the taxable year, and be taxed on them, before his withdrawals would be treated as a reduction of capital.