

issue, noted the decision of the New York court in *Winston v. Saugerties Farms, Inc.*,⁸⁰ holding that a statute prohibiting a corporation from issuing stock except for "value," does not strictly require payment from the person to whom the stock is issued, but merely requires that the corporation receive full value for all stock issued. However, in the light of the history of uncompromising interpretation of the Massachusetts statute,⁸¹ whether the cited decision will be decisive of the question is far from a certainty. This doubt is further buttressed by decisions in Massachusetts which have construed jointly⁸² section fifteen⁸³ with section seventeen,⁸⁴ which provides that "no corporation shall issue a *share* for a less amount to be paid in thereon than the par value of the shares at the date of issue." (Emphasis supplied.)

It would appear that adoption by the court of the "New York" view would have much to recommend it, since a contrary view amounts more to a windfall than to a legitimate protection of the creditor. Since protection of corporate creditors and not the punishment of directors is the end to be sought,⁸⁵ the manifest injustice to the directors under a strict interpretation of the statute in the hypothetical situation, should be enough to convince the court of the impropriety of a further extension of this theory.⁸⁶

PETER J. NORTON

Creditors' Rights—Federal Income Tax Lien—Cash Surrender Value of Life Insurance Policy—Equitable Doctrine of Marshaling Inapplicable.—*Meyer v. United States*.¹—The petitioner's husband was the owner of four life insurance policies, of which she was the revocable beneficiary, having a total face value of \$50,000. In 1943, the husband pledged the policies to a bank as collateral security for a loan. The bank was given the right to satisfy its claim from the net proceeds of the policies, *i.e.*, the amount which would be paid by the insurers upon the husband's death. Subsequently, the Commissioner of Internal Revenue assessed deficiencies against the hus-

⁸⁰ Supra note 7.

⁸¹ Supra note 2.

⁸² *Boucher v. Hamilton Mfg. Co.*, 259 Mass. 259, 156 N.E. 424 (1927); *Mitchell v. Mitchell Woodbury Co.*, 263 Mass. 160, 160 N.E. 539 (1928).

⁸³ Supra note 2.

⁸⁴ Mass. Gen. Laws ch. 155, § 17 (1932).

⁸⁵ *Frank Kumin Co. v. Marean*, 283 Mass. 332, 186 N.E. 780 (1933).

⁸⁶ Analogously, even under the provisions of the Uniform Fraudulent Conveyance Act, Mass. Gen. Law ch. 109A, §§ 1-13 (1932), which allow a creditor to set aside a fraudulent conveyance which is detrimental to his rights, recovery is limited to that property, the conveyance of which tended to result in a fraud on the creditor. If recovery is limited to such a "cause-effect" relation under a statute dealing with a person guilty of "fraudulent" conduct, a fortiori, should not such a limit be imposed in the hypothetical situation? This is not to construe the Uniform Fraudulent Conveyance Act and the applicable sections of Mass. Gen. Law ch. 156 *in pari materia*, but merely to compare the theories of recovery in so far as the underlying policy of both is the protection of creditors. See also, N.Y. Bus. Corp. Law § 720.

¹ 375 U.S. 233 (1963).

band for income taxes due for 1946 and 1947. A notice of lien was filed in July 1955. Later that same year, the husband died. At the time of his death, the cash surrender value of the policies was \$27,285.87 and the amount of the bank's claim was \$26,844.66. The insurers paid the latter amount to the bank and distributed the balance to the petitioner (some \$24,000). In an action commenced by the United States against the petitioner, individually as well as executrix of her husband's estate, the United States District Court, by applying the equitable doctrine of marshaling, held that the Government could satisfy its lien, to its full extent, from the insurance proceeds in the petitioner's hands. The Circuit Court of Appeals for the Second Circuit affirmed per curiam. The United States Supreme Court, with three justices dissenting, **HELD**: Reversed. Because of the state policy protecting life insurance beneficiaries from creditors of the insured, marshaling is not properly applicable and, therefore, the Government can satisfy its lien only to the extent of the excess of the cash surrender value over the amount of the bank's claim, *i.e.*, \$441.21 (\$27,285.87 — 26,844.66).²

In addition to the issue of the applicability of the doctrine of marshaling, *Meyer* presents three topics for consideration. These may be stated as: (1) To what part of the sum payable by the insurer upon the insured's death did the lien attach? (2) What effect did the insured's death have upon the lien? (3) What is the effect upon the lien of a state statute protecting insurance beneficiaries from creditors of the insured?

To what part of the sum payable by the insurer upon the insured's death did the lien attach? Section 6321 of the Internal Revenue Code of 1954 provides that:

If any person liable to pay any tax neglects or refuses to pay the same after demand, the amount . . . shall be a lien in favor of the United States upon *all property and rights to property*, whether real or personal, belonging to such person. (Emphasis supplied.)³

Several court decisions have made it clear that the insured does not have "property" or "rights to property" in the entire amount payable by the insurer upon the insured's death. In *Rowen v. Commissioner*,⁴ the court stated: "[T]he *entire* proceeds were never an asset belonging to the decedent" (Emphasis in original.) The United States Supreme Court, in an important 1958 decision,⁵ observed that the taxpayer could never have reached or enjoyed the entire proceeds of his life insurance policy. Based on this observation, the Court held: "We therefore do not believe that . . . [the taxpayer] had 'property' or 'rights to property' in the proceeds, within the meaning of § 3670 [of the Internal Revenue Code of 1939], to which the federal tax lien might attach."⁶

It is equally clear that the insured does have a property interest in the

² See also *Wintner v. United States*, 312 F.2d 749 (6th Cir. 1963), reversed per curiam, 375 U.S. 393 (1964). *Wintner* involves the same issues as presented in *Meyer*.

³ Section 3670 of the 1939 Code contained the same provision. Int. Rev. Code of 1939, § 3670, 53 Stat. 448.

⁴ 215 F.2d 641, 647 (2d Cir. 1954).

⁵ *United States v. Bess*, 357 U.S. 51 (1958).

⁶ *Id.* at 56.

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cash surrender value of the policy sufficient to support the lien. The nature of this element of a life insurance contract was examined by Judge Addison Brown in the case of *In re McKinney*.⁷ His statement, twice quoted by the Supreme Court,⁸ follows:

[T]he surrender value of the policy arises from the fact that the fixed annual premium is much in excess of the annual risk during the earlier years of the policy, an excess made necessary in order to balance the deficiency of the same premium to meet the annual risk during the latter years of the policy. This excess in the premium paid over the annual cost of insurance, with accumulations of interest, constitutes the surrender value. Though this excess of premiums paid is legally the sole property of the company, still in practical effect, though not in law, it is moneys of the assured deposited with the company in advance to make up the deficiency in later premiums to cover the annual cost of insurance, instead of being retained by the assured and paid by him to the company in the shape of greatly increased premiums, when the risk is greatest So long as the policy remains in force the company has not practically any beneficial interest in it, except as its custodian, with the obligation to maintain it unimpaired and suitably invested for the benefit of the insured.⁹

The thrust of this language is that the cash surrender value is a fund held by the insurer for the account of the insured. It has been decided many times that the federal tax lien *does* attach to this fund. The Supreme Court, in *United States v. Bess*,¹⁰ held: "It is therefore clear that . . . [the taxpayer] had 'property' or 'rights to property' within the meaning of § 3670, in the cash surrender value." In *United States v. Metropolitan Life Ins. Co.*,¹¹ the court noted: "[I]t has been squarely held that, where the provisions of the taxing statute are followed, a tax lien is perfected upon the cash surrender value of a policy of insurance issued to taxpayer upon his life."¹²

What effect did the insured's death have upon the lien? It is often contended that the cash surrender value becomes non-existent when the insured dies. The contention is based on the reasoning that the life insurance contract involves two promises of the insurer; one to pay the cash surrender value while the insured lives and another to distribute the face value of the policy to those entitled to it upon the death of the insured. The two promises are said to be not only separate, but mutually exclusive as well.

⁷ 15 Fed. 535 (S.D.N.Y. 1883).

⁸ *Burlingham v. Crouse*, 228 U.S. 459, 469 (1913); *Hiscock v. Mertens*, 205 U.S. 202, 211 (1907).

⁹ *In re McKinney*, supra note 7, at 537.

¹⁰ Supra note 5, at 56.

¹¹ 256 F.2d 17, 22 (4th Cir. 1958).

¹² The statement is followed by citations to seven cases. See also *United States v. Wilson*, 195 F. Supp. 332, 335 (D.N.J. 1961), "Thus it appears that taxpayer had a property right in the cash surrender value to which the plaintiff's lien attached. . . ." and *United States v. Hopkins*, 193 F. Supp. 207, 209-10 (S.D.N.Y. 1960), "As to the life insurance policy . . . , I conclude that the Government has an enforceable lien on the cash surrender value of that policy."

Judge Learned Hand addressed himself to this argument in *United States v. Behrens*.¹³ After examining the nature of the life insurance contract and the legal relations of the parties to it, he stated: "It follows from what we have said that there is no logical escape from holding that the 'surrender value' comes to an end on the insured's death, if we dispose of the controversy in accordance with the ordinary rules governing contracts."¹⁴ However, after noting that many courts had spoken of the cash surrender value as a fund, he held that if that were so, "the lien would follow it into the 'proceeds.' " He concluded by saying:

Regardless of what . . . [we] might have held, had the question come up as *res nova*, we think that this interpretation is imperative, and therefore we all agree that the "proceeds" were subject to the lien.¹⁵

Judge Hand cited a prior decision of his court, *Rowen v. Commissioner*,¹⁶ wherein it was held: "[T]he proceeds to the extent of the cash surrender values which were included therein were property once belonging to the decedent in his lifetime."¹⁷ The holding is based on a theory that though the cash surrender value became merged into the face value when the insured died, it did not lose its separate identity for purposes of determining property owned by the decedent. The theory was stated by the Supreme Court in *Bess*. "Thus in economic reality the insurer pays the beneficiary the insured's 'fund,' plus another amount sufficient to perform the insurer's promise to pay the proceeds on the insured's death."¹⁸

Thus, it has been held that the cash surrender value is not extinguished upon the insured's death, but rather it is a part of the proceeds distributed to the beneficiaries by the insurer. The tax lien, which attached to the cash surrender value, merely follows it into the hands of the recipients. The effect is attachment of the lien to so much of the proceeds as once was the surrender value.

What is the effect upon the lien of a state statute protecting insurance beneficiaries from creditors of the insured? In its *Bess* decision, the Court held: "[O]nce it has been determined that state law creates sufficient interests in the insured to satisfy the requirements of § 3670, state law is inoperative to prevent the attachment of liens created by federal statutes in favor of the United States."¹⁹ In *Commissioner v. Stern*,²⁰ decided the same day as *Bess*, the Court, in discussing the effect of a state exemption statute when no lien had been created, stated: "We agree that state law may not destroy a tax lien which has attached in the insured's lifetime." In *Leuschner v. First Western Bank & Trust Co.*,²¹ a case involving a

¹³ 230 F.2d 504 (2d Cir. 1956).

¹⁴ *Id.* at 506-07.

¹⁵ *Id.* at 507.

¹⁶ 215 F.2d 641 (2d Cir. 1954).

¹⁷ *Id.* at 647.

¹⁸ *United States v. Bess*, *supra* note 5, at 59.

¹⁹ *Id.* at 56-57.

²⁰ 357 U.S. 39, 47 (1958).

²¹ 261 F.2d 705 (9th Cir. 1958).

California statute protecting the beneficiaries of spendthrift trusts and its efficacy against the claim of the United States for income taxes, the court held: "There is no doubt that the paramount right to collect taxes of the federal government overrides a state statute providing for exemptions."²²

Distinguished from the above discussion, is the situation where the Government is not basing its claim on an unsatisfied lien, but rather is proceeding under Section 6901 of the Internal Revenue Code of 1954. This section, in part, provides for the liability, *pro tanto*, of transferees of property of delinquent taxpayers. The *Stern* case²³ involved this type of proceeding. The Court held that, in the absence of a lien, a claim for taxes could be asserted against the beneficiary "only to the extent that state law imposes such liability in favor of other creditors of the insured."²⁴ Thus, in *Bess*, where the Commissioner had obtained the lien during the insured's lifetime, the state statute could not operate to prevent satisfaction of the lien from proceeds in the hands of the beneficiary, whereas in *Stern*, where no lien had been acquired, the statute shielded completely the beneficiary from the Government. There is thus a premium on the Commissioner for "winning a race with the archangel of death."²⁵ Transferee liability was also the subject of the decision in *Rowen v. Commissioner*.²⁶ It was there held that since the insurance beneficiaries had no liability to the insured's creditors under New York law, they likewise were not liable as transferees to the United States for his unpaid income taxes.

In light of the above discussion, it may be assumed that the Government was confident when it presented its argument before the Supreme Court in *Meyer v. United States*.²⁷ The tax lien of a little more than \$6,000 had attached to the cash surrender value of more than \$27,000. True, New York has a statute protecting beneficiaries of life insurance policies,²⁸ but the Supreme Court in *Bess* and *Stern* had specifically stated that this type of state exemption statute was incapable of destroying the lien once it attached. Finally, the fact that the policies had been pledged to a bank as collateral for a loan probably gave the Government no cause for concern. Since the bank could satisfy its lien out of the entire proceeds and the United States could satisfy its lien only from that portion of the proceeds which had constituted the "cash surrender value," the situation was ripe for the application of the equitable doctrine of marshaling. Judge Learned

²² *Id.* at 708.

²³ *Commissioner v. Stern*, *supra* note 20.

²⁴ The quotation is taken from *United States v. Bess*, *supra* note 5, at 53, wherein *Stern* was distinguished.

²⁵ Grayck, *The Liability of a Life Insurance Beneficiary for the Insured's Income Taxes*, 14 *Tax L. Rev.* 137, 148 (1958).

²⁶ *Supra* note 16.

²⁷ *Supra* note 1.

²⁸ N.Y. Ins. Law, § 166. Section 1 provides in part:

If any policy of insurance has been or shall be effected by any person on his own life in favor of a third person beneficiary, . . . such third person beneficiary . . . shall be entitled to the proceeds and avails of such policy as against the creditors, personal representatives, trustees in bankruptcy and receivers in state and federal courts of the person effecting the insurance.

Hand, when presented in *United States v. Behrens*²⁹ with a similar state of facts also involving a New York beneficiary, applied the doctrine with these words:

[T]he "proceeds" were large enough to pay both claims, and it is well settled law that, when one creditor has a claim against two funds as security and another creditor has a claim against only one of them, the loan of the first will be marshalled against that fund which is security for his loan only.³⁰

Therefore, by application of the doctrine in the instant case, the bank's claim would be marshaled against the portion of the proceeds which were security for its claim only, *i.e.*, the entire proceeds less the "cash surrender value" part of them. The United States would then be free to satisfy its lien from that "fund." Thus, such confidence as may have existed on the part of the Government counsel litigating *Meyer* was certainly justifiable.

The Supreme Court, however, refused to apply the doctrine of marshaling. It noted that the doctrine was "founded . . . in equity, being designed to promote fair dealing and justice."³¹ The Court determined that the New York exemption statute reflected the state's "beneficent policy"³² of protection to the widow from creditors of her deceased husband³³ and that to apply marshaling would be an inequitable overturning of that policy. The Court cited several cases wherein the doctrine was refused because one of the funds was exempt under state law. However, none of these cases involved federal liens created by federal statute.

The equitable nature of the doctrine was well stated in *Farmers' Loan & Trust Co. v. Kip*,³⁴ a case involving the settlement of an estate.

Broadly defined, it is a rule which courts of equity sometimes invoke to compel a creditor who has the right to make his debt out of either of two funds to resort to that one of them which will not interfere with or defeat the rights of another creditor who has recourse to only one of these funds. It is not a vested right or lien founded on contract, but rests upon equitable principles called into action by the benevolence of the court.³⁵

The court in *In re Snell's Estate*³⁶ quoted a legal encyclopaedia³⁷ as follows:

²⁹ Supra note 13.

³⁰ Id. at 507.

³¹ *Meyer v. United States*, supra note 1, at 237.

³² Professor Cooley has stated well the policy considerations behind this type of exemption statute.

All statutes bearing on the exemption of life policies or their proceeds seem based on the theory that, in the absence of an expressed contrary intent, the object of the ordinary life insurance policy should be considered as the protection of the insured's family after his death, and this object and desire is laudable and in accordance with public policy.

Cooley, *Briefs on Insurance* 6508 (2d ed. 1928).

³³ In fact, the statute protects all third party beneficiaries. See note 28, supra.

³⁴ 192 N.Y. 266, 85 N.E. 59 (1908).

³⁵ Id. at 283, 85 N.E. at 64.

³⁶ 227 Wis. 455, 279 N.W. 24 (1938).

³⁷ 19 American and English Encyclopaedia 1284 (2d ed. 1901).

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The doctrine of marshalling [assets] being a rule of equity and having its foundation in principles of natural justice, its application will not be enforced when it would so operate as to work substantial injustice or injury to any party in interest. Thus marshalling will not be applied to the detriment of a third person having an equity equal or superior to that of the person seeking to invoke the rule.³⁸

A New York court once wrote: "But where equities are lacking the doctrine of marshalling has been rejected."³⁹

The general rule that marshaling is a matter of the court's equitable discretion is most often applied in cases wherein a party with equal or superior equity would be adversely affected by invocation of the doctrine.⁴⁰ The widow in *Meyer* would have been so affected, but it is questionable whether her standing in equity is equal or superior to that of the United States. As Mr. Justice White pointed out in his dissenting opinion, "It is not unreasonable to suppose that the beneficiary enjoyed the benefits of the bank loan which is here used to insulate the cash surrender value from the government lien."⁴¹ Also, it is not unreasonable to suppose that she benefited from her husband's failure to pay his income taxes properly.

Another objection raised by Mr. Justice White relates to whether the Court accurately stated New York's public policy. He reasoned that the policy should be interpreted as protection of the beneficiary from all creditors other than those who obtain a security interest in the proceeds during the lifetime of the insured. Thus, the state's public policy would not have been relevant in the *Meyer* fact situation. It is interesting to note that the effect of the New York statute upon United States taxes had been twice considered by federal courts. In *United States v. Goddard*,⁴² the court held: "Section 166 of the New York Insurance Law . . . is ineffective to exempt the proceeds of . . . [the policy] from the claim of the United States for unpaid income tax and victory tax . . . [owed by the insured]."⁴³ In *Fried v. New York Life Ins. Co.*,⁴⁴ the court stated: "The New York Court of Appeals agrees that New York may not interfere with the power of Congress to levy, and then collect, federal taxes on income."⁴⁵ The Court's use of the statute in *Meyer* has thus given it a potency it never before pos-

³⁸ In re Snell's Estate, supra note 36, at 467, 279 N.W. at 29-30.

³⁹ In re Berwind's Estate, 181 Misc. 559, 564, 42 N.Y.S.2d 58, 64 (Surr. Ct. 1943).

⁴⁰ Illustrative is *United States v. Bleser*, 34 F. Supp. 653 (D. Wis. 1940). There the pledgee bank held both life insurance policies and corporate securities. Three years after the pledge, the United States filed a tax lien. Subsequent to the insured's death, when the Government claimed it was entitled to marshaling, the bank contended that it should be permitted to satisfy its claim from the readily-available insurance proceeds rather than be compelled to seek satisfaction from the hard to market securities. The court quoted In re Snell's Estate, supra note 36, and held: "The case at bar is not one where the court should attempt to marshal the assets." *United States v. Bleser*, supra at 655.

⁴¹ *Meyer v. United States*, supra note 1, at 246.

⁴² 111 F. Supp. 607 (W.D.N.Y. 1952).

⁴³ Id. at 608.

⁴⁴ 241 F.2d 504 (2d Cir.), cert. denied, 354 U.S. 922 (1957).

⁴⁵ Id. at 506.

sessed. It can now do indirectly what it cannot do directly, *i.e.*, interfere with, and even defeat entirely, a federal lien.

Mr. Justice White began the conclusion of his dissent by writing: "Finally, the federal revenue deserves more protection than it receives today."⁴⁶ He viewed the majority's decision as an invitation for more taxpayers to invest in life insurance policies and to obtain bank loans by pledging them. The harm of such an invitation is, however, not so real as it may appear. It is to the advantage of the vast majority of married taxpayers to file joint tax returns. As a result of this practice, generally both the husband and the wife are individually liable for the full amount of any tax deficiency.

The majority opinion must be read as holding that the New York statute makes marshaling inequitable as to all those under its protection. As pointed out above,⁴⁷ New York extends its statutory shield to all third party beneficiaries regardless of their relationship to the insured. The Commissioner would receive comfort if *Meyer* could be viewed as illustrative that widows, as well as sureties, are the "darlings of the court." However, this solace is not available to him.

CHARLES BRADFORD ABBOTT

Federal Jurisdiction—"Federal Common Law" vs. State Law.—*United States v. Sommerville*.¹—The Farmers Home Administration (FHA), an agency of the Department of Agriculture, made loans² over a four year period to Flickinger, which were secured in part by certain livestock. A security agreement, which stated that it was "intended by the parties to serve as both 'Financing Statement' and 'Security Agreement' under Pennsylvania law," was executed and the security interest perfected in accordance with the laws of that state.³ Nine months after the security agreement was duly filed as a financing statement, Flickinger delivered three of his cows to the defendant for sale at the latter's auction. The plaintiff did not know of this delivery or consent to it, and the defendant-auctioneer did not have actual knowledge⁴ of the Government's security interest in the livestock. The three cows were sold at the defendant's auction, and the purchase money, less commissions, was turned over to Flickinger. Upon learning of this sale, FHA urged Flickinger to liquidate all of his assets, which he did. The proceeds were then applied to the balance of the loans leaving a debt slightly in excess of five-hundred dollars. Plaintiff, on behalf of FHA,

⁴⁶ *Meyer v. United States*, supra note 1, at 246.

⁴⁷ See note 33, supra.

¹ 324 F.2d 712 (3d Cir. 1963).

² The loans were made in compliance with the Bankhead-Jones Farm Tenant Act, 60 Stat. 1071, et seq. (1946), 7 U.S.C. 1007, et seq. (1958), now 75 Stat. 310, et seq. (1961), 7 U.S.C. 1941, et seq. (1963).

³ Pa. Stat. Ann. tit. 12A § 9-101 et seq. (Uniform Commercial Code).

⁴ An auctioneer is the agent of the owner of the property to be sold, and is guilty of conversion if the principal has no title to the property, even though the agent acts without knowledge of the title defect. Restatement (Second), Agency § 349 (1959).