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Recent Developments

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Taxation—Corporate Reorganization—Stock For Stock And Cash

Taxpayer owned all of the outstanding stock of a Nevada corporation. In 1952 he entered into an agreement by which he was to receive cash plus shares in a New York corporation in exchange for all of his Nevada stock.[1] Taxpayer reported the transaction as one which qualified under the reorganization provisions of the 1939 Internal Revenue Code[2] and paid a tax at capital gain rates only on the "boot"[3] received. The Commissioner proposed a deficiency, claiming that the entire gain was taxable.[4] The Ninth Circuit agreed with the Commissioner.[5] In order to resolve a conflict which existed between the holding of the Seventh Circuit in *Howard v. Commissioner*[6] and the holding of the Ninth Circuit in the principal case, the Supreme Court granted certiorari.[7] *Held*: The exchange of all the stock in one corporation for cash and stock in another is not a reorganization under the 1939 Internal Revenue Code definitions; therefore, the gain realized on the exchange is to be fully recognized. *Turnbow v. Commissioner*, 368 U.S. 337 (1961).

Under the general rule of federal taxation, upon the sale or exchange of property the entire amount of gain or loss is recognized.[8] If the property is a capital asset,[9] the sale is accorded capital gains

[1] The taxpayer received 82,375 shares valued at $1,235,625 plus $3,000,000 in cash. The amount of stock he received was less than 80% of the outstanding stock of the New York corporation.

[2] Int. Rev. Code of 1939, §§ 112(b)(3), -(c)(1). Similar provisions are found in Int. Rev. Code of 1954, §§ 354(a), 356(a).

[3] "Boot" was defined in this context as that "other property" or dissimilar property accompanying the major or principal property. In the Internal Revenue Code and Regulations, "boot" is referred to as "other property." See Int. Rev. Code of 1954, § 356; Treas. Regs. §§ 1.356-1 to -3 (1955). The Ninth Circuit in Commissioner v. Turnbow, 286 F.2d 669, 670 (9th Cir. 1960), referred to the cash received as the "so-called 'boot.'"

[4] The Tax Court, following its earlier decision in Luther Bonham, 33 B.T.A. 1100 (1936), and the opinion of the Seventh Circuit in Howard v. Commissioner, 238 F.2d 943 (7th Cir. 1956), held that the gain was recognizable only to the extent of the boot received. 32 T.C. 646 (1959).

[5] 286 F.2d 669, 675 (9th Cir. 1960).

[6] 238 F.2d 943 (7th Cir. 1956). In this case the acquiring corporation obtained 80.19% of the stock of the acquired corporation in a stock-for-stock exchange. The remaining 19.81% of the outstanding shares was acquired for cash. Petitioner Howard received only stock in exchange for his shares. The Commissioner proposed that Howard realized gain which was to be fully recognized. The Court ruled, however, that the gain was not to be recognized since the taxpayer received only stock.

[7] 366 U.S. 923 (1961).

[8] Int. Rev. Code of 1954, § 1002; Int. Rev. Code of 1939, § 112(a). The principal case arose under the 1939 Code. All code section references used here will be to the 1939 Code unless otherwise indicated.

[9] See Int. Rev. Code of 1954, §§ 1221, 1231.

treatment.[10] Through the years, however, Congress has excepted from taxation certain otherwise taxable exchanges.[11] The first such exceptions were enacted in 1918. They provided for the non-recognition of gain or loss realized in connection with reorganizations of corporations under the various state merger or consolidation statutes only if the stock exchanged had the same par or face value.[12] In 1921, this latter limitation was removed.[13] However, the stock received had to be issued by a corporation which was either a party to or the direct result of the reorganization.[14] The Revenue Act of 1924[15] further expanded the definitions, which have remained practically unchanged since that time.

Under the 1939 Code, there is no recognition of gain or loss realized on the exchange of shares in a corporation which is a party to a reorganization.[16] That Code enumerates six transactions which qualify as reorganizations.[17] Moreover, section 112(c)(1)[18] permits

[10] See Int. Rev. Code of 1954, § 1201.

[11] The exceptions as they now stand in the 1954 Code provide for the following: (1) exchanges of property for like kind held either for trade or business or as an investment, Int. Rev. Code of 1954, § 1031(a); (2) exchanges of property for stock, Int. Rev. Code of 1954, § 1032; (3) exchanges of common stock for common stock, or the exchange of preferred stock for preferred stock in the same corporation, Int. Rev. Code of 1954, § 1036; (4) certain involuntary conversions, Int. Rev. Code of 1954, § 1033; (5) sale or exchange of a residence, Int. Rev. Code of 1954, § 1034; and (6) exchanges pursuant to corporate reorganizations, Int. Rev. Code of 1954, §§ 354, 361.

[12] Revenue Act of 1918, § 202(b), ch. 18, 40 Stat. 1060, provided that no gain or loss should be deemed to occur when, in connection with a reorganization, merger, or consolidation of a corporation, a person received in place of stock or securities owned by him new stock or securities of no greater aggregate par or face value.

[13] Revenue Act of 1921, § 202(c), ch. 136, 42 Stat. 230.

[14] *Ibid.*

[15] Revenue Act of 1924, § 203(h)(1), 43 Stat. 253.

[16] Int. Rev. Code of 1939, § 112(b)(3) provides:

> Stock for stock on reorganization. No gain or loss shall be recognized if stock or securities in a corporation a party to a reorganization are, in pursuance of the plan of reorganization, exchanged solely for stock or securities in such corporation or in another corporation a party to the reorganization.

[17] Int. Rev. Code of 1939, § 112(g)(1) provides:

> The term "reorganization" means (A) a statutory merger or consolidation, or (B) the acquisition by one corporation, in exchange solely for all or a part of its voting stock, of at least 80 per centum of the voting stock and at least 80 per centum of the total number of shares of all other classes of stock of another corporation, or (C) the acquisition by one corporation, in exchange solely for all or a part of its voting stock, of substantially all of the properties of another corporation, but in determining whether the exchange is solely for voting stock the assumption by the acquiring corporation of a liability of the other or the fact that property acquired is subject to a liability, shall be disregarded, or (D) a transfer by a corporation of all or part of its assets to another corporation if immediately after the transfer the transferor or its shareholders or both are in control of the corporation to which the assets are transferred, or (E) a recapitalization, or (F) a mere change in identity, form, or place of organization, however effected.

[18] Int. Rev. Code of 1939, § 112(c)(1) provides:

> Gains from exchanges not solely in kind. (1) If an exchange would be within the provisions of subsection (b)(1), (2), (3), or (5), or within the

the receipt of boot[19] and limits recognized gain to the amount of boot received in transactions which qualify under sections 112(b)(1), (2), (3), or (5). Courts have strictly interpreted the exceptions by requiring the taxpayer to follow closely the statutory provisions[20] and by enunciating three additional criteria which must be satisfied.[21]

> provisions of subsection (*1*), of this section if it were not for the fact that the property received in exchange consists not only of property permitted by such paragraph or by subsection (*1*) to be received without the recognition of gain, but also of other property or money, then the gain, if any, to the recipient shall be recognized, but in an amount not in excess of the sum of such money and the fair market value of such other property.

[19] See note 3 *supra* for a definition of "boot."

[20] See Helvering v. Southwest Consol. Corp., 315 U.S. 194 (1942), in which a corporation with a large indebtedness defaulted in interest payments on outstanding bonds. Pursuant to a plan of reorganization, a new corporation was formed which acquired the assets of the defaulting corporation in exchange for voting common stock and class A and class B stock purchase warrants. Most of the common stock was to go to the bondholders; a small portion, together with the class A warrants, was to be issued to the unsecured creditors. Nonparticipating security holders received cash obtained by a loan from a bank. The loan indebtedness was assumed by the new corporation. The Court held that such a transaction was not a tax-free reorganization, because it was not an exchange "solely" for voting stock.

[21] The first test to appear in judicial opinions was the "continuity of interest" test, which requires that the parties have a continuing proprietary interest. The following three cases are exemplary of the application of this test.

In Pinellas Ice & Cold Storage v. Commissioner, 287 U.S. 462 (1933), there was a sale by one corporation to another corporation of all its property for money paid partly in cash and the remainder in installments evidenced by promissory notes. The Court held the notes were not securities for statutory purposes. "Certainly, we think that to be within the exemption the seller must acquire an interest in the affairs of the purchasing company more definite than that incident to ownership of its short-term purchase-money notes." 287 U.S. at 470.

Similarly, in Le Tulle v. Scofield, 308 U.S. 415 (1940), in which one corporation transferred all its property to another corporation for cash and bonds, the Court held that the bonds did not satisfy the statutory requirements. "Where consideration is . . . part cash and part such bonds, we think it cannot be said that the transferor retains any proprietary interest in the enterprise. On the contrary, he becomes a creditor of the transferee . . . ." 308 U.S. at 421. See also Silverson, *The Meaning of Le Tulle v. Scofield,* 18 Taxes 492 (1940).

However, in Helvering v. Alabama Asphaltic Limestone Co., 315 U.S. 179 (1942), in which a creditors' committee of a bankrupt corporation arranged a sale of the assets and received stock in the purchasing corporation, the Court found that there was a continuity of interest, since the transfer was merely a shift in ownership of the equity.

The second criterion, the "business purposes" test, was developed in Gregory v. Helvering, 293 U.S. 465 (1935). There, a taxpayer wanted to get possession (so she could sell at a profit) of stock held by her wholly owned corporation *M*. In order to avoid having the distribution to her taxed as a dividend, she formed corporation *A* and had *M* transfer the stock to *A*, all of *A*'s stock going to the taxpayer. The taxpayer then liquidated *A*, sold the stock, and paid a capital gain tax on the net gain. The Court held that the transaction was

> a mere device which put on the form of a corporate reorganization as a disguise for concealing its real character, and the sole object and accomplishment of which was the consummation of a preconceived plan, not to reorganize a business or any part of a business, but to transfer a parcel of corporate shares to the petitioner. 293 U.S. at 469.

See also 48 Harv. L. Rev. 852 (1935).

The third non-statutory requirement applied by the courts has been termed the "step transaction" test. Under this doctrine, the court views all of the transfer and transactions made by the taxpayer as a whole. Although the individual steps may qualify under the exact

The effect of these tests is to require a "continuity of interest" of the parties and a "business purpose" in the transaction. Also, under the "step transaction" requirement, the plan, when viewed as a whole, must meet the reorganization requirements.

In the principal case, it was undisputed that the transaction was not a "reorganization" as defined in section 112(g)(1)(B), because the exchange in question did not involve *solely* voting stock. It was also conceded that the transaction failed to come within section 112(b)(3), since the exchange was not "in pursuance of [a] plan of reorganization." However, Taxpayer, arguing in line with the *Howard* case,[22] claimed that he could limit his gain to the amount of boot received according to the provisions of section 112(c)(1). He contended that section 112(c)(1) authorized the assumption that the exchange constituted a type *B* reorganization, since it *would have been* such had it not been for the boot. He argued that it was necessary and proper to look to section 112(b)(3) *after omitting* the cash payment received in the transaction.[23] The Commissioner urged that section 112(c)(1) modified section 112(b)(3) only when the provisions of section 112(b)(3) would have otherwise been applicable had it not been for the boot received. Since section 112(b)(3) also required the exchange to be "in pursuance of [a] plan of reorganization," section 112(c)(1) did not apply unless there was such a plan of reorganization, as defined in section 112(g)(1).[24] The Court stated that

> to indulge [in] such an assumption [that the taxpayer qualified for the benefits of §112(c)(1), notwithstanding the lack of a plan of reorganization] would actually be to permit the negation of Congress' carefully composed definition and use of "reorganization" in those subsections, and to permit nonrecognition of gains on what are, in reality, only sales, the full gain from which is immediately recognized and taxed under the general rule. . . .[25]

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statutory provisions, if the plan taken as a whole fails to meet the reorganization requirements, non-recognition is denied. As an example see Helvering v. Elkhorn Coal Co., 95 F.2d 732 (4th Cir. 1938). Corporation *M* desired to acquire the operating assets of Corporation *E* but not its large investments. *E* therefore organized Corporation *X* and transferred to it all of the investment assets. *X* issued all of its stock to *E*, which distributed it to *E* shareholders. *E* then transferred its remaining assets to *M* for stock of *M*; *E* was dissolved and the *M* stock was distributed to *E* shareholders. Each step taken individually was tax-free; however, the court looked at all of the transactions as a whole and taxed the reorganization. See also Bausch & Lomb Optical Co. v. Commissioner, 267 F.2d 75 (2d Cir.), *cert. denied*, 361 U.S. 835 (1959); Grede Foundries, Inc. v. United States, 202 F. Supp. 263 (E.D. Wis. 1962).

[22] 238 F.2d 943 (7th Cir. 1956); see discussion note 6 *supra*.

[23] 32 T.C. 646, 650 (1959).

[24] 368 U.S. at 343.

[25] *Ibid.*

However, the Court made it clear that its opinion should not be interpreted to mean that section 112(c)(1) was without purpose or function; but rather, that section would have applied if some part of the property exchanged actually had met the particular description contained in the applicable section of the Code.[26]

The instant case was cited and followed in a recent Tax Court case[27] involving a similar transaction that was decided under the Internal Revenue Code of 1954.[28] The dissenting opinion attempted to distinguish the new case on the ground that there the "boot" received was only $27.36.[29] The majority refused to accept that distinction and stated: "[T]he Supreme Court [in *Turnbow*] emphasized the word 'solely' . . . , and we believe that that requirement is to be literally construed."[30]

Writing for the majority in the instant case, Mr. Justice Whittaker stated that the Court's holding "determines this case and [that] is all we decide."[31] This limiting language, coupled with the Court's statement that section 112(c)(1) was applicable when the property exchanged met the particular description contained in the Code provisions, indicates that a different result may be anticipated if a different type of reorganization is used. For example, if the corporations involved in the instant case had been chartered in states which had corporation laws providing for statutory mergers or consolidations,[32] then a type A reorganization, "a statutory merger or consolidation," under the 1939 and 1954 Codes[33] would have been possible. Assuming that such a plan of reorganization were used in a case involving facts similar to those in the instant case, then, following the Court's analysis of the problem, one could forceably argue that a taxpayer should report his gain only to the extent of the cash received.

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[26] *Id.* at 344.

[27] Richard M. Mills, 39 T.C. No. 36 (1962). G Corporatoin acquired all of the stock of three corporations controlled by petitioners in exchange for a part of its stock (valued at $27,912.50) and $27.36 in cash in lieu of fractional shares of stock.

[28] Int. Rev. Code of 1954, §§ 354(a), 356(a), 368(a)(1)(B).

[29] 39 T.C. No. 36 (1962).

[30] *Ibid.*

[31] *Ibid.*

[32] See, *e.g.*, art. 5.07 of the Tex. Bus. Corp. Act Ann. (1956).

[33] Int. Rev. Code of 1939, § 112(g)(1)(A); Int. Rev. Code of 1954, § 368(a)(1)(A).

Securities Regulation—Section 16(b)—Partnership and Partner as Insiders

Plaintiff stockholder on behalf of his corporation sued an investment banking partnership and one of its partners who was a director of the corporation. The suit was brought under section 16(b) of the Securities Exchange Act of 1934[1] to recover all profits realized from the purchase and sale within six months of some of the corporation's stock. There was no evidence that the partnership had purchased the stock pursuant to any inside information or that the partnership had designated the director-partner to represent the partnership's interests on the board. The director-partner was unaware of the partnership's purchase. After learning of it, he orally disclaimed all interest in any potential profits. *Held: inter alia,* (1) Section 16(b) does not apply to a partnership simply because a partner is a corporate director; (2) a partner who is a director realizes only his proportional share of partnership profits, is liable only for that amount, and his waiver of any interest in the transaction is ineffective. *Blau v. Lehman,* 368 U.S. 403 (1962).[2]

Prior to the Securities Exchange Act of 1934, an insider of a company listed on a stock exchange was relatively free to use his position to his personal advantage, since the common law actions of deceit and misrepresentation were inadequate remedies for the sheep who were ultimately fleeced through the media of the impersonal national

[1] Section 16(b) of the Securities Exchange Act of 1934 provides:
For the purpose of preventing the unfair use of information which may have been obtained by such beneficial owner, director, or officer by reason of his relationship to the issuer, any profit realized by him from any purchase and sale, or any sale and purchase, of any equity security of such issuer (other than an exempted security) within any period of less than six months, unless such security was acquired in good faith in connection with a debt previously contracted, shall inure to and be recoverable by the issuer, irrespective of any intention on the part of such beneficial owner, director, or officer in entering into such transaction of holding the security purchased or of not repurchasing the security sold for a period exceeding six months. Suit to recover such profit may be instituted at law or in equity in any court of competent jurisdiction by the issuer, or by the owner of any security of the issuer in the name and in behalf of the issuer if the issuer shall fail or refuse to bring such suit within sixty days after request or shall fail diligently to prosecute the same thereafter; but no such suit shall be brought more than two years after the date such profit was realized. This subsection shall not be construed to cover any transaction where such beneficial owner was not such both at the time of the purchase and sale, or the sale and purchase, of the security involved, or any transaction or transactions which the Commission by rules and regulations may exempt as not comprehended within the purpose of this subsection. 48 Stat. 896 (1934), 15 U.S.C. § 78p(b) (1958).

[2] The opinions of the lower federal courts are found in 173 F. Supp. 590 (S.D.N.Y. 1959) and 286 F.2d 786 (2d Cir. 1960).

exchange.[3] Since the passage of section 16(b) "for the purpose of preventing the unfair use of information which may have been obtained"[4] by an officer, director, or ten per cent stockholder, such an insider has had little incentive to purchase and sell or sell and purchase equity securities of his corporation within periods of less than six months, because under that section of the Act any profits realized by him may be recovered by the corporation. If the corporation fails to sue within sixty days after request or fails to prosecute the suit diligently, the owner of *any* equity security of the corporation may litigate in its behalf.[5] All recovery goes to the corporate treasury, and the shareholder who brings the suit can expect at best only a generous allowance for attorney's fees.[6] The burden of evidence in a suit under 16(b) is considerably less stringent than under the common law actions, since the subjective intent of the insider or the actual use of inside information is immaterial.[7] Even though the purpose of the section is to prevent the use of information obtained by an insider, difficulties of proof have necessitated imposition of liability independent of any such use.

In *Smolowe v. Delendo, Inc.*, the first section 16(b) case to reach the courts, the Second Circuit stated that it considered the legislative purpose was "to squeeze all possible profits out of stock transactions, and thus to establish a standard so high as to prevent any conflict between the selfish interest of a fiduciary officer, director, or stockholder and the faithful performance of his duty."[8] In the *Smolowe* case this strict standard[9] of statutory interpretation was

[3] See Yourd, *Trading in Securities by Directors, Officers and Stockholders: Section 16 of the Securities Exchange Act,* 38 Mich. L. Rev. 133, 143-52 (1939), for a comparison of 16(b) and the common law.

[4] 48 Stat. 896 (1934), 15 U.S.C. § 78p(b) (1958). For general treatments of § 16, see Cole, *Insiders' Liabilities Under the Securities Exchange Act of 1934,* 12 Sw. L.J. 147 (1958); Cook & Feldman, *Insider Trading Under the Securities Exchange Act,* 66 Harv. L. Rev. 385, 612 (1953); Comment, 27 Texas L. Rev. 840 (1949).

[5] *Ibid.*

[6] Smolowe v. Delendo, Inc., 136 F.2d 231, 239 (2d Cir.), *cert. denied,* 341 U.S. 751 (1951); see Cole, *supra* note 4, at 185; Rubin & Feldman, *Statutory Inhibitions Upon Unfair Use of Corporate Information by Insiders,* 95 U. Pa. L. Rev. 468, 479 (1947).

[7] 48 Stat. 896 (1934), 15 U.S.C. § 78p(b) (1958); see Adler v. Klawans, 267 F.2d 840 (2d Cir. 1959); Ferraiolo v. Newman, 259 F.2d 342 (2d Cir.), *cert. denied,* 359 U.S. 927 (1958); Gratz v. Claughton, 187 F.2d 46, 49-50 (2d Cir.), *cert. denied,* 341 U.S. 920 (1951). In the *Gratz* case, the court said: "On the other hand it is manifest that the intent of the fiduciary cannot be the test; first, because he generally has no ascertainable intent; and second, because that would open the door even more widely to the evil in question." 187 F.2d at 51. See also Smolowe v. Delendo, Inc., 136 F.2d 231 (2d Cir.), *cert. denied,* 341 U.S. 751 (1951).

[8] Smolowe v. Delendo, Inc., *supra* note 7, at 239.

[9] Adler v. Klawans, 267 F.2d 840 (2d Cir. 1959) (referring to Smolowe v. Delendo, Inc., *supra* note 7, and Gratz v. Claughton, 187 F.2d 46 (2d Cir.), *cert. denied,* 341 U.S. 920 (1951)). In the *Adler* case it was stated:

> These prior holdings do not answer the problem presented here, but they

applied in the adoption of a formula for computing the amount of profits realized.[10] Rejecting (1) an ear-marking of securities theory,[11] (2) the income tax methods of inventory,[12] and (3) the average of purchases and average of sales prices,[13] the Second Circuit adopted the "maximum profit possible" rule[14] from which no court has ever deviated.[15] An insider is not allowed to minimize his profits and, therefore, his liability by setting off losses against gains from dealings in a particular security.[16] Likewise, in deciding whether a particular transaction is a "purchase," the courts have considered whether that transaction is of a kind which can possibly lend itself to the speculation intended to be prevented by section 16(b).[17] Along the same line, liability has been imposed on a defendant who sold stock acquired before he became a director within six months from the acquisition date;[18] in another case liability was imposed upon a defendant who was not technically an officer.[19] Prior to the instant case the vast majority of the decisions of United States Courts of Appeal applied a rule of strict (anti-insider) construction to section 16(b). One notable exception was *Rattner v. Lehman.*[20] In that case, on almost the same facts as those in the principal case, the Second Circuit held the partner-director liable for only his proportional share of the profits made by the partnership and did not hold the partnership liable for any amount. *Rattner* was followed in the present case without re-examination by the Second Circuit, and it was cited by the Supreme Court.

In holding that "it was Thomas, not Lehman Brothers as an entity, that was the director of Tide Water"[21] the Supreme Court gave

do show a pattern of this court's view that the purpose of the statute is remedial, rather than penal, and that it must be strictly construed in favor of the corporation and against any person who makes profit dealing in the corporation stock. 267 F.2d at 846-47.

[10] Smolowe v. Delendo, Inc., 136 F.2d 231, 239 (2d Cir.), *cert. denied,* 341 U.S. 751 (1951).

[11] *Id.* at 238.

[12] *Ibid.*

[13] *Id.* at 239.

[14] "The only rule whereby all possible profits can be surely recovered is that of lowest price in, highest price out—within six months—as applied by the district court." *Id.* at 239.

[15] If the remedial purpose of section 16(b) is to be accomplished, there appears to be no alternative. Cook & Feldman, *supra* note 4, at 614.

[16] Adler v. Klawans, 267 F.2d 840 (2d Cir. 1959); Gratz v. Claughton, 187 F.2d 46 (2d Cir.), *cert. denied,* 341 U.S. 920 (1951).

[17] Ferraiolo v. Newman, 259 F.2d 342, 346 (2d Cir.), *cert. denied,* 359 U.S. 927 (1958); see also Comment, *The Scope of "Purchase and Sale" Under Section 16(b) of the Exchange Act,* 59 Yale L.J. 510, 513 (1950).

[18] Adler v. Klawans, 267 F.2d 840 (2d Cir. 1959).

[19] Colby v. Klune, 178 F.2d 872 (2d Cir. 1949).

[20] 193 F.2d 564 (2d Cir. 1952); see 25 So. Cal. L. Rev. 475 (1952); 100 U. Pa. L. Rev. 463 (1951) (defense of *Rattner* result).

[21] 368 U.S. at 410.

section 16(b) a literal interpretation. Section 16(b) applies only to a "person" who is a director. Since section 3(a)(9)[22] of the Act provides that " 'person' means . . . partnership" and section 3(a)(7)[23] that " 'director' means any director of a corporation or any person performing similar functions with respect to any organization, whether incorporated or unincorporated," the Court recognized that a partnership could be a director under the Act. However, the majority stated that a partner-director must be "deputized" to act on behalf of his partnership before 16(b) liability will apply to the entity itself.[24] Unfortunately, the Court did not define "deputized," and it is not clear how much formal designation is required to make the partnership liable. The dissent took a contrary approach, asserting that "formal designation was no more significant than informal approval."[25] This view is more in line with the previous cases which strictly construe 16(b) in favor of liability[26] and which approach the problem from a broad perspective applying public policy reasons for liability. It is obvious that the dissent realized that the effect of the majority's holding might be to encourage such insider speculation by other investment banking partnerships.

The limited application of 16(b) to the partner-director and the refusal to apply 16(b) to the partnership do not foster the purpose of the Act.[27] It is difficult to say that Congress intended such a result. The practical effect of this decision, as stated by the dissent, is to allow "all but one partner to share in the feast which the one places on the partnership table. They in turn can offer feasts to him in the 99 other companies of which they are directors."[28] The startling fact about the decision is that immunity from liability is given to those partnerships which are most likely to have inside information and most able to use it to the best advantage.[29] An argu-

[22] 48 Stat. 883 (1934), 15 U.S.C. § 78c(a)(9) (1958).

[23] 48 Stat. 883 (1934), 15 U.S.C. § 78c(a)(7) (1958).

[24] The theory of "deputization" comes from a concurring opinion by Judge Learned Hand in Rattner v. Lehman, 193 F.2d 564, 566-67 (2d Cir. 1952). The majority opinion and concurring judges in the Second Circuit disagreed with the dictum, but the Supreme Court indicated possible approval. Blau v. Lehman, 286 F.2d 786, 789 (2d Cir. 1960). No court has given a satisfactory definition of "deputization" in applying the term to section 16(b) liability.

[25] 368 U.S. at 415.

[26] See cases cited notes 7, 9 *supra.*

[27] See note 1 *supra* for a quotation of section 16(b).

[28] 368 U.S. at 420; see Note, *Second Circuit Limits Insider-Partner's 16(b) Liability,* 14 Stan. L. Rev. 192, 198 (1961). It was pointed out that "Lehman Brothers has partners on 100 boards." 368 U.S. at 414. See also Comment, *Securities Regulation: Insider Status in Legal Fiction and Financial Fact—A Proposed Revision to Section 16(b),* 50 Calif. L. Rev. 500, 511 (1962).

[29] "[T]he investment banking-corporation alliances are consciously constructed so as to increase the profits of the bankers." 368 U.S. at 415.

ment in support of the result of the case is that the petitioner-plaintiff did not prove the allegations in his complaint and, therefore, was not entitled to recover. The complaint alleged that "Lehman Brothers [the partnership] 'deputed . . . Thomas, to represent its interests as a director on the Tide Water Board of Directors,'" and that insider profits were made because director-partner Thomas "by reason of his special and inside knowledge of the affairs of Tide Water, advised and caused the defendants, Lehman Brothers, to purchase and sell" the stock.[30] The trial court found that the plaintiff had not proved either of his allegations.[31] However, liability should not rest on "formal deputization" to represent the partnership, since that act would be almost impossible to prove and it is not a prequisite to liability under the statute. The fact that plaintiff alleged but did not prove actual use of inside information should be of no consequence because the law is well established that actual use of information is immaterial.[32] The only practical way to prevent the use of inside information is with a statute which does not require proof of actual use.

With respect to the amount realized by the individual insider, the Supreme Court also rejected the stockholder's contention that the director-partner realized the entire amount of profits taken in the name of the partnership. The act requires that an insider must disgorge all profits "realized by him." Unfortunately, there is no precise judicial or legislative definition of "realized" as it is used in 16(b). However, under section 51 of the New York Partnership Law, which is identical with section 25 of the Uniform Partnership Act, the partners are co-owners in all partnership property, which of course includes proceeds from the sale of equity securities. The partners were then co-owners of the profits realized in the instant transaction. However, the Court rejected the reference to local partnership law and refused to hold that the insider realized all the profits. Instead, in by-passing an excellent opportunity to clear up the confusion on this point by a precise definition of "realized," the majority simply declared: "It would be nothing but a fiction to say that Thomas 'realized' all the profits earned by the partnership of which he was a member. It was not error to refuse to hold Thomas liable for profits he did not *make*." (Emphasis added.)[33] By holding that the partner-director was liable for any amount, the Court admitted that he was an insider, that he had entered into a trans-

[30] 368 U.S. at 405.
[31] 173 F. Supp. 590, 593-94 (S.D.N.Y. 1959).
[32] See cases cited note 7 *supra*.
[33] 368 U.S. at 414.

action prohibited by the statute, and that his oral disclaimer of any interest in the transaction was ineffective to protect him from all liability. However, by holding that the partner-director is liable for only the amount of his interest in the partnership profit on this transaction, the Court is softening the application of the "maximum profits possible" theory.[34] The logical result of the case is that the larger the firm, the smaller any one partner's liability is likely to be.

This is the first Supreme Court case under section 16(b). Although the fact situation seemingly called for the imposition of maximum liability, the Court chose to follow one of those rare court of appeals cases[35] which had construed 16(b) in favor of the insider. Under the theory of the present case, investment banking partnerships are now in a strategic position to realize maximum profits and to incur only minimum liabilities for inside manipulations in equity securities. Moreover, in future litigation against director-partners, the courts must struggle with the theory of "deputization," which the Supreme Court impliedly accepted but did not clearly define. That theory is an ineffective weapon against insider speculation because of the difficulty in proving that a director-partner has been "deputized." In short, the Court did not follow the policy of the statute and adopt the most effective deterrent to insider manipulations, which in this case would have required holding the partnership liable as a director.[36] Finally, as a very serious indirect manifestation, there is the further possibility that this decision may weaken the strict construction of the statute previously applied by the lower federal courts in other 16(b) problems.

William M. Boyd

Service of Process—Foreign Corporations—Carrying on Business Within State Through Subsidiary

Defendant, Curtis Publishing Company, was a Pennsylvania corporation. An alleged libelous article in one of Defendant's magazines was distributed in Kansas by Defendant's national distributor, a wholly owned subsidiary. The distributor purchased magazines

[34] See note 14 *supra* accompanying text.

[35] Rattner v. Lehman, 193 F.2d 564 (2d Cir. 1952); see discussion note 24 *supra*.

[36] "Both the petitioner and the Commission contend on policy grounds that the Lehman partnership should be held liable even though it is neither a director, officer, nor a 10% stockholder." 368 U.S. at 410-11. A more plausible argument is that since the language of the statute does not preclude the partnership from being a director, public policy demands that the partnership be held liable as a director. The latter statement does not require judicial legislation as does the former.

from Defendant to fill subscription orders and remitted payments to Defendant. Defendant paid the distributor a commission on the orders. The distributor also purchased newsstand copies from Defendant at an agreed price for delivery to points designated by the distributor; the distributor received credit from Defendant for unsold copies. Finally, the distributor was required to use its best efforts to advertise Defendant's publications, and for so doing it was reimbursed by Defendant. Defendant maintained no office or personnel in Kansas; the distributor had an office in Wichita. Service of process was allegedly made on Defendant by service on the Secretary of State in accordance with a Kansas statute.[1] After the suit was removed to federal court on grounds of diversity, Defendant moved to quash the service. *Held:* The activities of a wholly owned, but independent subsidiary acting as agent of a parent corporation within a state constitute "doing business" by the parent for purposes of service of process in that state. *Curtis Publishing Co. v. Cassel,* 302 F.2d 132 (10th Cir. 1962).

Since the United States Supreme Court's decision in *Pennoyer v. Neff,*[2] the scope of a state's jurisdiction over nonresident individuals and foreign corporations has been greatly expanded.[3] By an evolutionary process, the Court has accepted and then rejected "consent" and "presence" as standards for measuring the extent of a state's judicial power over foreign corporations.[4] At the present time, in order for a state to subject a defendant to a judgment in personam when he is not present within the forum, the courts require only that the defendant have certain minimum contacts with the forum state so that the maintenance of the suit does not violate due process, *i.e.,* that "traditional notions of fair play and substantial justice are not offended."[5] However, it is essential that a defendant purpose-

[1] Kan. Gen. Stat. Ann. § 17-509 (1949). The material portions of the statute provide:

> In the event of any foreign corporation doing business within the state of Kansas, and failing to appoint the secretary of state as agent upon whom service of summons or other process can be had . . . any person having any cause of action against such foreign corporation, which cause of action arose in Kansas out of the said foreign corporation's doing business within the state of Kansas, may file suit against such foreign corporation . . . and service of summons or any process upon the secretary of state shall be sufficient to warrant the rendition of personal judgment against said corporation.

Since the statute does not define "doing business," the court concluded that the term must be given a practical definition consonant with the constitutional requirements of due process.

[2] In Pennoyer v. Neff, 95 U.S. 714 (1877), the Court held that a state court could not acquire jurisdiction over a nonresident defendant merely by service of process on him outside the forum state or by publication within the forum state.

[3] See Comment, *Expanding Jurisdiction Over Foreign Corporations,* 37 Cornell L.Q. 458 (1952).

[4] McGee v. International Life Ins. Co., 355 U.S. 220 (1957).

[5] International Shoe Co. v. Washington, 326 U.S. 310 (1945). In cases involving service under a state statute, the particular statute must be carefully examined because the broadened

fully invoke the benefits and the protection of the laws of the forum state by conducting activities within its bounds.[6] The Supreme Court has given the following three reasons for thus expanding the jurisdiction of state courts: (1) there have been large increases in interstate commercial transactions and vast improvements in transportation and communications;[7] (2) it is good policy to permit the enforcement of small or moderate claims, since individual claimants frequently cannot afford the cost of bringing an action in a foreign forum;[8] and (3) if a corporation exercises the privilege of conducting activities within a state, it enjoys the benefits and protection of the laws of that state and, accordingly, should assume certain local obligations.[9]

To date, no decision has promulgated definite standards which will determine if "due process" has been satisfied.[10] Indeed, whether there is due process of law must depend upon the quality and nature of the corporate activity vis-a-vis the state's interest in the fair and orderly administration of its laws;[11] thus, the facts of each individual case will determine if a corporation is subject to a state's judicial power.[12] One of the causes of the confusion and lack of harmony in the cases is that the test of "doing business" has been applied for

concept of "doing business" applied in *International Shoe* does not automatically widen the statute's definition of "doing business," but merely permits such enlargement. Ackerley v. Commercial Credit Co., 111 F. Supp. 92 (D.N.J. 1953).

[6] In Hanson v. Denckla, 357 U.S. 235 (1958), a nonresident trustee had conducted *no activity* within the forum state, and because he was made an indispensible party to the action by a Florida statute, it was ruled that the state court had no jurisdiction to consider the matter. In this opinion the Court did not discard the concept of territorial limitations on state power; however, it did not question the validity of the "minimum contact—fair treatment" rule of the *International Shoe* case, *supra* note 5.

[7] International Shoe Co. v. Washington, 326 U.S. 310 (1945).

[8] McGee v. International Life Ins. Co., 355 U.S. 220 (1957).

[9] Rosenburg Bros. & Co. v. Curtis Brown Co., 260 U.S. 516 (1923).

[10] Westcott-Alexander, Inc. v. Dailey, 264 F.2d 853 (4th Cir. 1959).

[11] Perkins v. Benquet Consol. Mining Co., 342 U.S. 437 (1952). Much confusion has resulted from the failure to distinguish between those cases in which the corporation is "generally doing business" within the state (such as in the *Perkins* case) and those in which the corporation is "doing business" within the meaning of a particular statute. In the latter class of cases, the contact of the corporation with the state must be directly related to the cause of action; whereas, in the former, the corporation will become subject to jurisdiction irrespective of the contact with the state. The most definite guideposts for deciding whether a corporation was "doing business" were set forth in Steinway v. Majestic Amusement Co., 179 F.2d 681 (10th Cir. 1949). There the court stated that it was generally understood that to constitute "engaging in or transacting business" for purposes of personal service, a nonresident corporation's activities within the state had to be "substantial," "continuous," and "regular," as distinguished from "casual," "single," or "isolated" acts.

[12] Favell-Utley Realty Co. v. Harbor Plywood Corp., 94 F. Supp. 96 (N.D. Cal. 1950). "The problem must be solved in the light of commercial actualities not in the aura of judicial semantics." 94 F. Supp. at 99. Jurisdiction of a state court is more likely to be upheld when a corporation commits a tort within the state than when the suit is for a nontortious act. Reese & Galston, *Doing an Act or Causing Consequences as Bases of Judicial Jurisdiction*, 44 Iowa L. Rev. 249 (1959).

three distinct legal purposes: (1) to see if a license is necessary under the licensing statutes; (2) in fixing tax liability for corporate activities;[13] and (3) to determine availability for service of process.[14] Even when it has been determined that a corporation is subject to the jurisdiction of the state court, it is still necessary to decide whether this potential jurisdiction can be exercised, *i.e.*, whether there has been proper service of process on the corporation.[15]

In the past it was generally recognized that (1) mere ownership by a foreign corporation of a majority of the stock of a resident corporation and (2) exercise of control by voting that stock were not sufficient to constitute "doing business."[16] The courts felt that stock ownership alone did not make the subsidiary the representative of the foreign parent corporation.[17] Hence, the courts did not permit service upon the subsidary to constitute service upon the parent, theorizing that the parent could have conducted such business through an independent agency without subjecting itself to the jurisdiction of the state.[18] Previously, this rule was applied only when the corporate separation was carefully maintained.[19] The fiction of the corporate entity was disregarded when one corporation was so organized and controlled, and its affairs so conducted, that it was, in fact, a mere instrumentality or adjunct of another corporation.[20] In other words, when a domestic subsidiary was acting within the state as a mere agent for the foreign corporation, and there was no effective corporate separation, proper service on the subsidiary would subject the parent to the judicial powers of the state.[21] Furthermore, service was generally approved when the non-resident corporation was organized for the very purpose of holding and controlling the stock of a resident corporation.[22]

With respect to foreign publishing corporations, courts have followed traditional developments in the law of service of process.[23]

[13] Isaacs, *An Analysis of Doing Business*, 25 Colum. L. Rev. 1018, 1045 (1925): The business which must be transacted by a foreign corporation to subject such a corporation to taxation for doing business must show that the corporation is "present" and "active." In order that qualification be rendered necessary, the corporation must not only be "present" and "active," but its activity must be "continuous."

[14] Fletcher, Private Corporations § 8712 (perm. ed. rev. repl. 1955).

[15] Ezell v. Rust Eng'r Co., 75 F. Supp. 980 (W.D.S.C. 1948). In the principal case proper service was not questioned.

[16] Steinway v. Majestic Amusement Co., 179 F.2d 681 (10th Cir. 1949).

[17] Peterson v. Chicago, R.I. & Pac. Ry., 205 U.S. 364 (1907).

[18] Cannon Mfg. Co. v. Cudahy Packing Co., 267 U.S. 333 (1925).

[19] Industrial Research Corp. v. General Motors Corp., 29 F.2d 623 (N.D. Ohio 1928).

[20] *Ibid.*

[21] Bator v. Boosey & Hawkes, 80 F. Supp. 294 (S.D.N.Y. 1948).

[22] Steinway v. Majestic Amusement Co., 179 F.2d 681 (10th Cir. 1949).

[23] Sonnier v. Time, Inc., 172 F. Supp. 576 (W.D. La. 1959).

Under the old "presence test," courts generally held that foreign publishers were not doing business in a state if their activities through subsidiary corporations[24] or wholesale newsdealers[25] did not extend beyond (1) gathering and reporting news,[26] (2) soliciting and promoting,[27] or (3) distributing their publications within the state if the separate corporations or newsdealers were not empowered to bind the foreign corporation in some business transaction.[28] Although these rules still have a general application, since the decision in *International Shoe*[29] courts have become more liberal in approving citation upon foreign publishing companies. The Seventh Circuit has ruled that the functions of a magazine publishing company obviously include gathering materials to be printed, obtaining advertisers and subscribers, printing, selling, and delivering the publications. Consequently, if a non-resident corporation sees fit to perform any one of these essential functions in a given jurisdiction, it necessarily is "doing business" for purposes of service of process.[30] Other courts have not gone this far, probably because the factors in each case are so variable[31] that general rules are hard to determine.

The question in the principal case was whether the carefully maintained corporate separation was to be ignored in determining the existence of jurisdiction. The Tenth Circuit held that it was when an agency relationship was established between the parent and the subsidiary. Although no other court has specifically stated the law in this manner, *i.e.*, that service upon an independent subsidiary acting as agent is sufficient, it has been held that when an independent agent is maintained in a state, service of process on that agent will suffice for service on the principal.[32] The gulf between the latter

[24] Creager v. P. F. Collier & Sons Co., 36 F.2d 783 (S.D. Tex. 1929).

[25] Insull v. New York World Telegram Corp., 172 F. Supp. 615 (N.D. Ill. 1959).

[26] Layne v. Tribune Co., 71 F.2d 223 (D.C. Cir. 1934).

[27] Cannon v. Time, Inc., 115 F.2d 423 (4th Cir. 1940).

[28] Reed v. Real Detective Publishing Co., 63 Ariz. 294, 162 P.2d 133 (1945).

[29] International Shoe Co. v. Washington, 326 U.S. 310 (1945), in which the activities of from eleven to thirteen salesmen who lived in the forum state and who worked there under the control of the foreign corporation were held sufficient to subject the corporation to a state action to collect contributions to the state unemployment compensation fund. The Supreme Court concluded that: "Due process is satisfied by such contacts of the corporation with the state of the forum as make it reasonable, in the context of our federal system of government, to require the corporation to defend the particular suit which is brought there." 326 U.S. at 317.

[30] Consolidated Cosmetics v. D-A Publishing Co., 186 F.2d 906 (7th Cir. 1951).

[31] Bergold v. Commercial Nat'l Underwriters, 61 F. Supp. 639 (D. Kan. 1945).

[32] See National Carbide Corp. v. Commissioner, 336 U.S. 422 (1948), in which the importance of the agency relationship was emphasized by the Court's reference to Cannon v. Cudahy, 267 U.S. 333 (1925), as authority for the proposition that: "As principal it would have been subject to service of process through its agents; as owner of the subsidiary it was not." See also Bromze v. Nardis Sportswear, 165 F.2d 33 (2d Cir. 1948), where a foreign corporation having no office or employees in New York employed an independent company there as sales agent. The sales agent, which had no authority to enter

case and the principal case is neither deep nor wide. As previously noted, public policy strongly favors the expansion of jurisdiction of the courts over foreign corporations,[33] and in instances, as exemplified by the principal case, when the contacts of the subsidiary-agent are essential to the existence of the parent, this policy would appear to be stronger.[34]

In interpreting the instant case, care should be taken not to extend its rule to cases where another form of relationship, other than principal-agent, exists between the parent and the subsidiary. The rule announced by the court[35] applies only where an agency relationship exists; it was not merely derived from the fact of the parent-subsidiary status.[36] The law set forth by the court is sound, but the opinion could have been made stronger by a more definite establishment of the agency relationship.[37] Within the framework of those statutes giving the state courts jurisdiction when a foreign corporation is generally "doing business" within the state, the principal case enunciates a new proposition of law which is merely another step in the expanding concept of jurisdiction over foreign corporations—a concept which should continue to grow until any corporation with the slightest contact with a state will be answerable in that state for its activities there.[38]

W. Wiley Doran

into contracts, received its compensation in the form of commissions and paid its own expenses. The court held that the defendant foreign corporation was engaged in business in New York. See also Polizzi v. Cowles Magazines, Inc., 345 U.S. 663 (1953), where Justices Black and Jackson dissented and stated that the maintenance of a regular agent to carry on business and activity within a state was sufficient to constitute doing business within that state. The majority opinion noted that the federal venue statute, 28 U.S.C. § 1391(c) (1958), had no application to a suit which had been removed, and remanded for determination of whether the defendant was doing business within the state.

[33] See text accompanying notes 7, 8, 9 *supra*.

[34] See Sonnier v. Time, Inc., 172 F. Supp. 576 (W.D. La. 1959), in which a publisher had no agent in Louisiana and distributed through independent purchasing distributors to newsstands and by mail to regular subscribers. The court held that the publisher was engaged in business in Louisiana, because its activities resulted in a large volume of state business.

[35] The activities of a wholly-owned, but independent subsidiary acting as agent of a parent corporation within a state constitute "doing business" by the parent for purposes of service of process in that state. 302 F.2d 138.

[36] In Favell-Utley Realty Co. v. Harbor Plywood Corp., 94 F. Supp. 96 (N.D. Cal. 1950), the court held that a principal-agent relationship does not follow merely from the fact of the parent-subsidiary status.

[37] Two cases had previously ruled in similar circumstances that the Curtis Circulation Co., the distributor in the principal case, was not an agent. Schmidt v. Esquire, 210 F.2d 908 (7th Cir. 1954); Moorhead v. Curtis Publishing Co., 43 F. Supp. 67 (W.D. Ky. 1942). Support for the agency relationship finding in similar circumstances is found in Fiat Motor Co. v. Alabama Imported Cars, 292 F.2d 745 (D.C. Cir. 1961), in which the defendant had no officers or employees within the district. However, it had a distributorship contract substantially identical to that of the distributor in the principal case which required promotion of the sales of defendant's products. The court held that the presence of the distributor in the district authorized suit in the district against the defendant manufacturer.

[38] The relevant Texas statute, Tex. Rev. Civ. Stat. Ann. art. 2031b (Supp. 1962), does

Taxation—Medical Expenses—Deductibility of Lodging Expenses

Taxpayer, a lawyer, suffered four coronary occlusions in the course of the disease atherosclerosis. Special treatment of the disease was required during the winter months. As a regimen of medical treatment, an eminent heart specialist presented two alternatives: hospitalization during the winter or temporary removal to a warm climate.[1] Pursuant to the latter alternative, Taxpayer with his wife and child traveled to Fort Lauderdale, Florida, and there lived in a rented apartment during the winters of 1954 and 1955. In his income tax returns for those years, Taxpayer deducted the entire rental expense as a "medical care" deduction.[2] The Commissioner disallowed

not specify the minimum circumstances under which a foreign corporation is amenable to the jurisdiction of the state courts. The case law on the question is inadequate, because any appearance was treated as a general appearance in Texas until promulgation of a special appearance rule in September 1962 and because most cases are removed to the federal courts. From those cases which proceeded through the Texas courts before the enactment of art. 2031b it appears that in order to constitute doing business for purposes of jurisdiction the foreign corporation must engage in a continuous course of business in Texas including acts local in nature. Louisiana W.R.R. v. Conques, 10 S.W.2d 975 (Tex. Comm. App. 1928); Gray Co. v. Ward, 145 S.W.2d 650 (Tex. Civ. App. 1940) *error dism., judgm. cor.* This requirement is a stricter test than the "minimum contact—fair treatment" rule enunciated in the *International Shoe* case, 326 U.S. 310 (1945). In cases construing art. 2031b, the stricter Texas approach has been followed by the Fifth Circuit without reaching the constitutional question of due process. Acme Eng'rs v. Foster Eng'r Co., 254 F.2d 259 (5th Cir. 1958); Davis v. Asano Basan Co., 212 F.2d 558 (5th Cir. 1954); Robbins v. Benjamin Air Rifle Co., 209 F.2d 173 (5th Cir. 1954); Nielsen v. Arabian Am. Oil Co., 206 F.2d 391 (5th Cir. 1953); Mississippi Wood Preserving Co. v. Rothschild, 201 F.2d 233 (5th Cir. 1953). See also Comment, *Jurisdiction Over Foreign Corporations Under Article 2031b*, 39 Texas L. Rev. 214 (1960).

With the advent of the recent amendment to the Texas Rules of Civil Procedure permitting special appearances in Texas after September 1, 1962, Tex. R. Civ. P. 120a, it will be interesting to notice whether the Texas courts will continue to follow the older more strict test or whether an adoption of the "minimum contact—fair treatment" test is on the horizon. There appears to be no reason why the more liberal test cannot be adopted within the framework of art. 2031b. The latter article, in § 4, contains three separate jurisdictional provisions: a single contract provision, a single tort provision, and a residual provision of "doing business." When the single contract provision was squarely before a federal district court it was held unconstitutional, but the single tort provision and the residual provision of doing business remain uncertain. See Lone Star Motor Import, Inc. v. Citroen Cars Corp., 185 F. Supp. 48 (S.D. Texas 1960), *rev'd on other grounds*, 288 F.2d 69 (5th Cir. 1961). For a discussion of the application of art. 2031b to a case having similar facts to the principal case see 16 Sw. L.J. 523, 525 (1962).

[1] Medically, hospitalization was less desirable. Confinement for an extended period of time with attendant inactivity would have increased the danger of recurrent attacks as a result of "inner stress and strain," and, in addition, would have restricted the taking of much needed mild exercise. See Robert Bilder, 33 T.C. 155, 157 (1959).

[2] The Commissioner was willing to accept a statement of facts most favorable to the taxpayer; he also accepted the Tax Court's finding that the "sojourns in Fort Lauderdale during the years at issue were not vacations; they were taken as a medical necessity and as a primary part of necessary medical treatment of a disease . . . ." Robert Bilder, *supra* note 1, at 156. Before the Supreme Court the Commissioner limited his argument to the "question of deductibility *vel non* of the cost of lodging during a medically-necessitated trip . . . ." Brief for Petitioner, p. 21.

the deduction, contending that the rental was not a deductible medical expense under section 213 of the Internal Revenue Code of 1954 but was a nondeductible personal living expense under section 262. *Held*: The cost of lodging incurred while temporarily away from home on a medically necessitated trip is not deductible as a "medical care" expense under section 213 of the Internal Revenue Code of 1954. *Commissioner v. Bilder*, 369 U.S. 499 (1962).

Personal living expenses including lodging, food, transportation, and medical care were nondeductible under the first income tax laws.[3] In 1942, the Internal Revenue Code of 1939 was amended by the addition of section 23(x), which provided for the deduction of expenses incurred for medical care "not otherwise compensated for by insurance."[4] Another section specifically disallowed all "personal, living, or family expenses, except extraordinary medical expenses deductible under section 23(x)."[5] The term "medical care" was defined as including "amounts paid for the diagnosis, cure, mitigation, treatment, or prevention of disease, or for the purpose of affecting any structure or function of the body (including amounts paid for accident or health insurance),"[6] but no greater specificity was indicated. Treasury Regulations promulgated pursuant to section 23(x) provided that travel expenses could be a proper medical expense if proved to have been incurred during "travel primarily for and essential to the rendition of the medical services or to the prevention or alleviation of a physical or mental defect or illness. . . ."[7] In differentiating between expenditures which were primarily "personal, living, or family expenses" and those which

[3] Income Tax Act of 1913, § II B, 38 Stat. 167. An exception added in 1921 and continued to date allows deduction of amounts expended for meals and lodging while traveling away from home on business. See Revenue Act of 1921, § 214(a)(1), 42 Stat. 239; Int. Rev. Code of 1954, § 162(a)(2).

[4] Revenue Act of 1942, § 127(a), 56 Stat. 825. Prior to that time Congress had not extended the benefits of such a deduction to taxpayers, and such expenditures had been viewed by the courts as nondeductible "personal, living, or family expenses" under § 24(a) of the 1939 Code.

[5] Section 24(a) of the 1939 Code, which formerly disallowed all medical expenses as personal, living, or family expenses, was amended to add subdivision (1), which is quoted in the text. This amendment was added by the same act of October 20, 1941 (Section 127(b) of the Revenue Act of 1942, 56 Stat. 825), that added § 23(x) to the 1939 Code.

[6] Section 23(x) of the 1939 Code, as amended in 1942, provided in part that deductions allowed included:

> Expenses paid during the taxable year, not compensated for by insurance or otherwise, for medical care of the taxpayer, his spouse, or a dependent. . . . The term "medical care" as used in this subsection, shall include amounts paid for the diagnosis, cure, mitigation, treatment, or prevention of disease, or for the purpose of affecting any structure or function of the body (including amounts paid for accident or health insurance).

[7] See Treas. Reg. 111, § 29.23(x)-1 (1943); *cf.* L. Keever Stringham, 12 T.C. 580, 583-84 (1949), *aff'd per curiam*, 183 F.2d 579 (6th Cir. 1950).

were "extraordinary medical expenses," the courts made the basis of the distinction a question of fact.[8] Some of the factors accorded weight were: (1) whether the expense was incurred at the suggestion of a physician;[9] (2) whether the expense was "primarily" for the prevention or mitigation of a particular physical or mental defect;[10] and (3) whether the expense was directly and proximately related to the diagnosis, cure, mitigation, treatment, or prevention of the particular disease.[11] In most cases the courts allowed as deductions only those travel expenses which, in all likelihood, would not have been incurred but for the existence of an illness and the taxpayer's obedience to the resulting medical advice. Those travel expenses incurred in the improvement of one's "general" health—as opposed to travel expenses necessitated by some specific condition—were disallowed.[12] Thus, by the time of the enactment of the 1954 Code, a taxpayer had to discharge a heavy burden of proof in demonstrating that an expense which was normally personal had taken on the characteristics of a "medical care" expense because it was necessary for the alleviation or cure of a particular physical or mental defect or disease.[13] As a result, the deduction of travel expenses, including transportation, board, and lodging, was sustained only in rare situations.

Section 213(e)(1)(A) of the 1954 Code defines medical care in language identical to that of section 23(x) of the 1939 Code. Another provision permits deduction of transportation expenses (not travel) incurred "primarily for and essential to medical care. . . ."[14]

[8] Bertha M. Rodgers, 25 T.C. 254, 260 (1955), *aff'd*, 241 F.2d 552 (8th Cir. 1957); William B. Watkins, 13 CCH Tax Ct. Mem. 320, 323 (1954); Frances Hoffman, 17 T.C. 1380, 1385 (1952).

[9] Edward A. Havey, 12 T.C. 409 (1949).

[10] L. Keever Stringham, 12 T.C. 580 (1949); Edward A. Havey, *supra* note 9.

[11] Ochs v. Commissioner, 195 F.2d 692 (2d Cir. 1952); Vincent P. Ring, 23 T.C. 950 (1955); Gunnar E. Erickson, 13 CCH Tax Ct. Mem. 1045 (1954); L. Keever Stringham, *supra* note 10; see also Treas. Reg. 118, § 39.23(x)-1(d)(1) (1953). Additional factors might include: (1) Was the treatment proximate in time to the onset, recurrence, or continuance of the disease? (Hollander v. Commissioner, 219 F.2d 934 (3d Cir. 1955); Frances Hoffman, 17 T.C. 1380 (1952)); (2) What was the motive or purpose of the taxpayer? (L. Keever Stringham, *supra*); (3) Was the taxpayer in the care of a physician where relocated? (William H. Duff, 12 CCH Tax Ct. Mem. 1305 (1953)); see generally Annot., 37 A.L.R.2d 551 (1954), concerning medical expenses deductible for federal income tax purposes.

[12] Samuel Dobkin, 15 T.C. 886 (1950); L. Keever Stringham, *supra* note 10; Martin W. Keller, 8 CCH Tax Ct. Mem. 685 (1949).

[13] This construction of the 1939 Code was continued after 1954. See Embry v. Gray, 143 F. Supp. 603 (1956), *appeal dismissed*, 244 F.2d 718 (6th Cir. 1957); Stanley D. Winderman, 32 T.C. 1197 (1959); Bertha M. Rodgers, 25 T.C. 254 (1955), *aff'd*, 241 F.2d 552 (8th Cir. 1957); see also Rev. Rul. 55-261, 1955-1 Cum. Bull. 307.

[14] Section 213 of the 1954 Code allows as deductions in computing net income "the expenses paid during the taxable year, not compensated for by insurance or otherwise, for

Also, the exception for "extraordinary medical expense" found in section 24(a)(1) of the 1939 Code was omitted in its 1954 counterpart, section 262, which now provides that unless expressly authorized, no deduction shall be allowed for personal, living, or family expenses.[15] When proposed by the Treasury, the 1954 changes were intended to:

> permit deduction of cost of transportation necessary for health but not ordinary living expenses incurred during trip.
>
> Overall effect of proposed changes is to 1. Liberalize and extend relief in real hardship situations due to heavy medical expenses but curb deduction of ordinary or luxury living expenses in guise of medical costs.[16]

In approving these changes, committees of both houses of Congress offered the following explanation:

> Subsection (e) defines medical care to mean amounts paid for the diagnosis, cure, mitigation, treatment or prevention of diseases or for the purpose of affecting any structure or function of the body (including amounts paid for accident or health insurance), or for transportation primarily for and essential to medical care. The deduction permitted for "transportation primarily for and essential to medical care" clarifies existing law in that it specifically excludes deduction of any meals and lodging while away from home receiving medical treatment. For example, if a doctor prescribes that a patient must go to Florida in order to alleviate specific chronic ailments proven injurious to the health of the taxpayer, and the travel is prescribed for reasons other than the general improvement of the patient's health, the cost of the patient's transportation to Florida would be deductible but not his living expenses while there. However, if a doctor prescribed an appendectomy and the taxpayer chose to go to Florida for the operation not even his transportation costs would be deductible. The subsection is not intended otherwise to change the existing definitions of

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medical care of the taxpayer, his spouse, or a dependent . . . ." Subdivision (e)(1) defines "medical care" expenses as "amounts paid"

> (A) for the diagnosis, cure, mitigation, treatment, or prevention of disease, or for the purpose of affecting any structure or function of the body (including amounts paid for accident or health insurance), or
>
> (B) for transportation primarily for and essential to medical care referred to in subparagraph (A).

[15] In fact, the exact words of section 262 are: "Except as otherwise expressly provided in this chapter, no deduction shall be allowed for personal, living, or family expenses."

[16] *Hearings on the Internal Revenue Code of 1954 Before the Senate Committee on Finance*, 83d Cong., 2d Sess. 103 (1954). The statement is contained in a document presented by Marion B. Folsom, Undersecretary of the Treasury, at the opening of the Senate Finance Committee hearings. See also S. Rep. No. 1622, 83d Cong., 2d Sess. 35 (1954), stating: "A new definition of 'medical expense' is provided which allows the deduction of only transportation expenses for travel prescribed for health, and not the ordinary living expenses incurred during such a trip." To the same effect is H.R. Rep. No. 1337, 83d Cong., 2d Sess. 30 (1954).

> medical care, to deny the cost of ordinary ambulance transportation nor to deny the cost of food or lodging provided as part of a hospital bill.[17]

Although section 213(e)(1)(B) mentions only transportation and makes no express mention of the deductibility or nondeductibility of the cost of meals and lodging, the Treasury was confident of the Congressional intent. It issued regulations stating that:

> Expenses paid for transportation primarily for and essential to the rendition of the medical care are expenses paid for medical care. However, an amount allowable as a deduction for "transportation primarily for and essential to medical care" shall not include the cost of any meals and lodging while away from home receiving medical treatment.[18]

Notwithstanding the language in the committee reports and the Treasury Regulations, Taxpayer in the instant case was successful before the Tax Court[19] and the Third Circuit[20] in his contention that section 213 did not deny the deductibility of the cost of lodging if the expense would have been deductible under section 23(x) of the 1939 Code. However, contemporaneously in *Carasso*,[21] the Tax Court and the Second Circuit, after recourse to the legislative history of section 213, had disallowed lodging costs on substantially similar facts. In view of the conflict between the circuits, the Supreme Court granted certiorari. The Court, reversing the Third Circuit and holding in accord with the Second Circuit in *Carasso*, stated that although transportation expenses incurred on a medically necessitated trip were deductible, the cost of lodging was not. In reaching this result, the Court relied upon the legislative intent as expressed in the committee reports.

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[17] H.R. Rep. No. 1337, 83d Cong., 2d Sess. A60 (1954); S. Rep. No. 1622, 83d Cong., 2d Sess. 219-20 (1954); see also H.R. Rep. No. 1337, *supra* at 4055, and S. Rep. No. 1622, *supra* at 4666, where it is stated: "A new definition of 'medical expenses' is provided which incorporates regulations under present law and also provides for the deduction of transportation expenses for travel prescribed for health, but not the ordinary living expenses incurred during such a trip."

[18] Treas. Reg. § 1.213-1(e)(1)(IV) (1954).

[19] 33 T.C. 155, 158 (1959): "In view of the clarity of the wording of Section 213 of the 1954 Code, we see no reason to resort to Congressional history for its meaning."

[20] 289 F.2d 291 (1960). The Third Circuit affirmed and expanded the Tax Court opinion by allowing the total apartment rental to be deducted; whereas, the Tax Court had allowed only such proportion as was attributable to the individual taxpayer. The court characterized the legislative history as ambiguous and accorded more weight to the fact that exact wording of § 23(x) was carried forward to § 213, concluding that the court's interpretations under § 23(x) were meant to be applicable under § 213.

[21] 34 T.C. 1139 (1960), *aff'd*, 292 F.2d 367 (2d Cir. 1961). In *Carasso*, the taxpayer, recovering from a severe illness which had necessitated the removal of a major portion of his stomach, was ordered by his physician to travel to Bermuda for convalescence. The Tax Court found that the trip in question was undertaken solely for medical reasons. *Id.* at 1141.

At one time, recourse to legislative history[22] was improper unless the statute under consideration was ambiguous or of doubtful meaning.[23] However, recent decisions encourage an examination of the legislative background. For instance, in *Harrison v. Northern Trust Co.*,[24] when a court of appeals refused to examine legislative history because the "plain meaning" of the statute was unambiguous, the Supreme Court reversed the decision. Judge Murphy stated: "[W]ords are inexact tools at best and for that reason there is wisely no rule of law forbidding resort to explanatory legislative history no matter how 'clear the words may appear on superficial examination.'"[25] Under the 1939 Code the courts allowed travel expenses as "medical care" deductions with some reliance on legislative history,[26] which disclosed that subdivision (x) of section 23 was added because of the "desirability of maintaining the present high level of public health and morale."[27] It may be argued that the reenactment of the same language in the 1954 Code without specifying the nondeductibility of meals and lodging indicated Congressional approval of the existing statutory construction. However, as noted above, the 1954 Code's legislative history discloses that Congress was advised that the new definition of "medical care" was intended to preclude deductions for the cost of lodging and board incurred on trips medically necessitated.[28] Indeed, the committee reports set forth a hypothetical situation in which a taxpayer's ordinary living ex-

[22] As the term "legislative history" is used here it refers to the passage of a particular statute in the legislature, including reference to the debates, amendments, and committee reports. The term does not refer to the history of those statutes which have dealt with the subject matter. See Annot., 70 A.L.R. 5 (1931), concerning the use of constitutional or legislative debates, committee reports, and the like as aids in the construction of a statute.

[23] Caminetti v. United States, 242 U.S. 470, 490 (1917); Annot., 70 A.L.R. 5, at 15-16 nn.13, 14 (1931).

[24] 317 U.S. 476 (1943).

[25] *Id.* at 479; see Boston Sand & Gravel Co. v. United States, 278 U.S. 41, 48 (1928), in which Justice Holmes stated: "It is said that when the meaning of language is plain we are not to resort to evidence in order to raise doubts. That is rather an axiom of experience than a rule of law, and does not preclude consideration of persuasive evidence if it exists." See also United States v. Rosenblum Truck Lines, 315 U.S. 50, 55 (1942); United States v. Dickerson, 310 U.S. 554, 562 (1940); Association of Westinghouse Salaried Employees v. Westinghouse Elec. Corp., 348 U.S. 437, 444 (1955), in which Justice Frankfurter stated: "And considering that the construction we have found seems plain, the so-called 'plain meaning rule,' on which construction is from time to time rested also in this Court, likewise makes further inquiry needless and indeed improper. But that rule has not dominated our decisions."

[26] L. Keever Stringham, 12 T.C. 580, 583 (1949): "As the broad and comprehensive language of this section is susceptible to a variety of conflicting interpretations, we feel impelled, in order to determine the limits of its construction, to inquire into the Congressional intent which lay behind the enactment of this legislation."

[27] S. Rep. No. 1631, 77th Cong., 2d Sess. 6 (1954); 1942-2 Cum. Bull. 504, 508.

[28] See note 16 *supra* and accompanying text for statements by those officials in the Treasury charged with introducing and explaining the proposed changes to Congress.

penses were stated to be nondeductible although incurred on a medically prescribed trip to Florida.[29]

Although the committee reports may be occasionally "inartistic," their import makes inescapable the result in the instant case. The reports do appear, however, to misconstrue what are ordinary living expenses. Presumably, food and lodging costs incurred in travel are disallowed as deductions because such expenses are ordinary living expenses. Yet medically necessitated temporary travel can easily involve food and lodging costs well above the "ordinary" costs of such items to a taxpayer when he is at home. The committee reports do not indicate that these factors were considered, and the Supreme Court's decision may preclude their consideration by future courts. For instance, had the taxpayer in *Bilder* known of the nondeductibility of his Florida lodging costs, he might have been forced by economic considerations to remain hospitalized in Newark—an admittedly less desirable alternative. As a result of the decision, taxpayers are encouraged to accept institutional facilities, because of the deductibility of the expenses, even though other alternatives may be more beneficial to them.[30]

The court in the instant case found it unnecessary to consider the Commissioner's alternative argument that section 262 allowed no deduction for "personal, living, or family expenses . . . except as otherwise expressly provided in this chapter" and that apart from "transportation" expenses provided in section 213(e)(1)(B), no

[29] See note 17 *supra* and accompanying text.

[30] Taxpayer's brief suggests the inequities that will follow the decision in two examples:

> Example 1: Following nine operations for cancer at a hospital near his home, Taxpayer A went to the University Hospital at Madison, Wisconsin for further surgery. There, he was operated on daily for 26 consecutive days during which he lost nearly 40 pounds. His condition both physically and emotionally was poor. His attending physicians believed that the crowded conditions at the hospital, the hospital fare, and the hospital atmosphere were all combining to retard his recovery. Accordingly, arrangements were made to transfer Taxpayer A to a quiet room in a nearby hotel from which the hospital could be reached in five minutes time by ambulance. As a preliminary to the transfer, Taxpayer A's wife was trained by his doctors on how to take care of him and what to do in the event of an emergency. In the quieter, more pleasant (and less expensive) surroundings of the hotel, and with food of his choice delivered to his room, there was a marked improvement in Taxpayer A's condition. He remained at the hotel for an extended period during which he could not be moved farther away because of the necessity to return to the hospital each day for post-surgical treatment.
>
> Example 2: After Taxpayer B became stricken with lung cancer, his local doctors had done an "exploratory" and determined the case to be inoperable. Taxpayer B thereupon traveled to the Cancer Research Center at Madison, Wisconsin for treatment. The attending doctors at Madison wish to admit him to the hospital, but there is no bed for him and a long waiting list of other cancer patients ahead of him. Consequently, Taxpayer B stays at a nearby hotel and travels back and forth daily by taxi for the drastic irradiation and Chemotherapy treatments, which have met with some measure of success at Madison.

other express exception could be found in the statute.[31] If the Supreme Court had accepted this argument, the entire concept of deductible medical expenses would have been jeopardized because of the general nature of section 213. The refusal to consider this argument, therefore, leaves the general definition of medical care contained in (a) of section 213 (e) (1) flexible. Those decisions which are now discredited by *Bilder* in so far as they allowed lodging and food costs as deductions will continue to provide the precedent for distinguishing between expenses primarily "personal, living, or family" and those deductible because incurred for the "diagnosis, cure, mitigation, treatment, or prevention of disease. " Furthermore, the deductibility of transportation expenses under section 213 (e) (1) (B) will require a showing that such expenses were directly and proximately related to medical care.[32] When considered from the standpoint of historical policy underlying medical deductions, perhaps the *Bilder* decision represents a restriction detrimental to the taxpayer; nevertheless, the result is explicable in light of the committee reports accompanying the legislation.[33]

Ronald M. Holley

Water Rights—Spanish Land Grants—Appurtenant Irrigation Rights

Defendants, who claimed title under original Spanish and Mexican land grants, owned land which they alleged was susceptible of irrigation with water from the Rio Grande River, although such right was not specifically set out in their grants. The State of Texas, in a class action, representing the rights of all appropriators of the water, claimed that there were no riparian rights of irrigation appurtenant to Defendants' grants. *Held*: Rights of irrigation are not appurtenant to original Spanish and Mexican land grants unless expressly included. *Valmont Plantations v. State*, —Tex.—, 355 S.W.2d 502 (1962) (adopting opinion of court of civil appeals, 346 S.W.2d 853 (1961)).

In general there are two broad classes of water rights in Texas: (1) those given to the general public, and (2) those given to specific

[31] 369 U.S. at 451 n.9.

[32] In *Carasso*, following a finding that the taxpayer's travel to Bermuda was medically prompted, the Tax Court allowed transportation expenses stating: "We hold that the expenses of the Bermuda trip, except for hotel and meals, are deductible." Max Carasso, 34 T.C. 1139, 1141 (1960), *aff'd*, 292 F.2d 367 (2d Cir. 1961). In the *Bilder* case, the Commissioner had acquiesced in the Tax Court's allowance of transportation expenses. 1960 Int. Rev. Bull. No. 16, at 9; see also Treas. Reg. § 1.213-1 (e) (1) (10) (1960).

[33] For a subsequent case, see Leo Cohn, 38 T.C. 387 (1962).

individuals. The latter class consists primarily of (a) riparian rights[1] which "arise out of the ownership of land through or by which a stream of water flows,"[2] and (b) appropriation rights which are acquired by compliance with the appropriation statutes.[3] However, the mere fact that land is of a riparian character does not always give rise to appurtenant riparian rights.[4] It is well settled that the rights of those holding title under grants from prior sovereigns are controlled by the laws in effect when the grants were made.[5]

The Texas Supreme Court has held that the Spanish law of waters in effect when the Spanish and Mexican titles were issued to lands situated in the former Mexican states of Coahuila, Texas, and Tamaulipas was the law as found in *Las Siete Partidas*.[6] Although the *Partidas* do not discuss how individuals acquire the right to irrigate with river waters,[7] the central concept of Hispanic-American water law was that all water belonged to the sovereign.[8] Therefore "it is a legitimate conclusion . . . that no one, without the permission of the Prince (could) conduct public waters to his lands for irrigation, especially in this New Spain. . . ."[9] Additional evidence that Spanish

[1] See Hilt v. Weber, 252 Mich. 198, 233 N.W. 159, 168 (1930):
Generally speaking, riparian rights are:
1) Use of the water for general purposes, as bathing, domestic use, etc.
2) To warf out to navigability.
3) Access to navigable waters.

[2] Watkins Land Co. v. Clements, 98 Tex. 469, 86 S.W. 733, 735 (1905); Matagorda Canal Co. v. Markham Irr. Co., 154 S.W. 1176 (Tex. Civ. App. 1913).

[3] Tex. Rev. Civ. Stat. Ann. art. 7467-7621 (1954).

[4] See, *e.g.*, Tex. Rev. Civ. Stat. Ann. art. 7619 (1954): "Nothing in this chapter [Use of State Water] shall be construed as a recognition of any riparian right in the owner of any lands the title to which shall have passed out of the State of Texas subsequent to the first day of July, A.D. 1895."

[5] In Manry v. Robison, 122 Tex. 213, 56 S.W.2d 438, 442 (1932), the court stated: "The rule is an elementary one that, in determining the rights of holders of title under Mexican grants, the laws of Mexico in effect when the grants were made control." See also State v. Balli, 144 Tex. 195, 190 S.W.2d 71 (1945); State v. Grubstake Inv. Ass'n, 117 Tex. 53, 297 S.W. 202 (1927); State v. Sais, 47 Tex. 307, 318 (1877); State v. Cuellar, 47 Tex. 295, 305 (1877); Harris v. O'Connor, 185 S.W.2d 993 (Tex. Civ. App. 1944) *error ref. w.o.m.*

[6] State v. Balli, 144 Tex. 195, 190 S.W.2d 71 (1945); Manry v. Robison, 122 Tex. 213, 56 S.W.2d 438 (1932); Miller v. Letzerich, 121 Tex. 248, 49 S.W.2d 404 (1932); State v. Grubstake Inv. Ass'n, 117 Tex. 53, 297 S.W. 202 (1927); Motl v. Boyd, 116 Tex. 82, 286 S.W. 458 (1926); see Cox, *The Texas Board of Water Engineers*, 7 Texas L. Rev. 86, 88 (1928).

[7] 1 Kinney, Irrigation and Water Rights § 573 (1912); Davenport, *Riparian vs. Appropriative Rights: The Texas Experience*, in Water Law, Texas Conferences 138, 152 (1952-1954); Davenport & Canales, *Law of Flowing Waters*, 8 Baylor L. Rev. 139, 162 (1956).

[8] Clough v. Wing, 2 Ariz. 371, 17 Pac. 453, 456 (1888); State v. Red River Valley Co., 51 N.M. 207, 182 P.2d 421, 428 (1946); Dobkins, The Spanish Element in Texas Water Law 98 (1959).

[9] Oñate, Memorandum on Rights in Waters of the Lower Rio Grande in the Spanish Colonial and Early Mexican Periods 16 (1959), prepared for the state's attorneys in the principal case by Lic. Santiago Oñate, member of the Bar of the Republic of Mexico. This

and Mexican law did not recognize the legal consequences of riparian ownership inherent in common law doctrine is the fact that the use of the streams was not limited to riparian owners but also extended to nonriparian title holders.[10]

Regardless of the Spanish history, because of dictum in the case of *Motl v. Boyd*,[11] it was believed prior to the instant case that insofar as Mexican law was interpreted in Texas, the rights of riparian owners were recognized even though not expressly set out in the original land grant. However, the courts of this state had not decided whether Spanish and Mexican land grants had appurtenant irrigation rights similar to the common law riparian right involved in the principal case.[12] Indeed, there is highly regarded opinion to the effect "that when a title of land did not mention waters, a right of water was never considered to exist, solely by reason of proximity or accession, and, therefore the topographical location of riparians did not give such lands any (riparian) right."[13] Nevertheless, the dissenters in the principal case maintained that the *Motl* dictum,[14] by virtue of its long standing, should have constituted a "rule of property."[15]

In the *Valmont* case, the majority opinion of the court of civil appeals,[16] which was adopted by the supreme court,[17] followed the Texas authorities concerning judicial consideration of dicta.[18] Justice

work cites *Recopilación de Leyes de Indias*, law 4, tit. XII, Bk. 4; law 8, tit. XII, Bk. 4; law 18, tit. XII, Bk. 4; de la Vega, *Reglamento General de las Medidas de las Aguas, Publicado En El Ano de 1761*, as translated in Collection of Roman, Spanish and Mexican Laws and Commentaries 110 (1960), prepared by the state's attorneys.

One nineteenth century Spanish writer reported that the riparian owners along small streams did have what today might be called "riparian rights." See White & Wilson, *The Flow and Underflow of Motl v. Boyd—The Conclusion*, 9 Sw. L.J. 377, 414 (1955), quoting Escriche, Of Small Streams and Riparian Rights. But what may be said about small streams is not necessarily applicable to all flowing waters, and Escriche's work has been criticized by a number of modern authorities as being more opinion than an accurate statement of the prevailing doctrine. See Dobkins, *op. cit. supra* note 8, at 146; White & Wilson, *supra* at 414 n.138; Wiel, *Origin and Comparative Development of the Law of Watercourses in the Common Law and in the Civil Law*, 6 Calif. L. Rev. 245, 256 (1918). For a discussion of the divergent views of five Texas authorities on water law concerning the extent of the vested riparian right as it relates to the use of water for irrigation, see Hutchins, The Texas Law of Water Rights 145 (1961).

[10] 1 Kinney, *op. cit. supra* note 7, at § 580.

[11] 116 Tex. 82, 286 S.W. 458, 465 (1926): "[W]e believe we are clearly warranted in saying that, in so far as the Mexican Law in Texas is concerned, it was one which distinctly recognized the rights of riparian owners of land."

[12] 346 S.W.2d at 879 (Tex. Civ. App. 1961): "We assert that no Texas Court has heretofore been called upon to decide whether Spanish and Mexican land grants have appurtenant irrigation rights similar to the common law riparian right."

[13] Oñate, *op. cit. supra* note 9, at 22.

[14] See quotation note 11 *supra*.

[15] 355 S.W.2d at 503 (Tex. Sup. Ct.); 346 S.W.2d at 882 (Tex. Civ. App.).

[16] 346 S.W.2d at 853.

[17] 355 S.W.2d at 502.

[18] Luttes v. State, 159 Tex. 500, 324 S.W.2d 167 (1958); State *ex rel.* Childress v. School

Pope said, "We do not presume to overrule the [*Motl*] case. . . . We are not, however, bound by dicta. . . ."[19] In rejecting the highly criticized "rule" of the *Motl* case,[20] the principal case at long last seems to square the Texas law with its Spanish history. The dictum in the *Motl* case to the effect that land fronting on a river has riparian rights apparently was based upon the assumption that because land in Texas was divided by the Spanish into one of three classes (irrigable, arable, or pasture), "irrigable" land had an implied right to irrigate similar to common law riparian rights.[21] However, all lands adjacent to rivers were not classified as "irrigable," nor did all irrigable lands have appurtenant irrigation rights. This idea behind the *Motl* dictum had been promulgated earlier in *Tolle v. Correth*,[22] in which the Texas Supreme Court stated: "The fact that lands were valuable in the ratio of their irrigable qualities, and that the irrigable lands were not subject to monopoly, is conclusive that the government in granting the lands, granted the irrigable rights and privileges thereof."[23] Furthermore, the Spaniard, Lasso de la Vega, writing in the mid-eighteenth century, is said to have written that in granting land, if the waters "either form a part of it, or are necessary to its enjoyment, then the waters and their sources are also granted."[24] The language of the *Tolle* case[25] and the dictum in the *Motl* case[26] necessarily appear to be in error because, "as a matter of pure statutory construction, the use of such terms as 'irrigable,' 'suitable for irrigation,' and 'facility of irrigation' in those very early land laws did not mean and was not intended to mean *all* lands, and lands *only*, riparian to rivers, streams and similar water sources."[27] Such phrases "did not have any reference to whether or

Trustees, 150 Tex. 238, 239 S.W.2d 777, 782 (1951); Mitchell v. Town of Refugio, 265 S.W.2d 261 (Tex. Civ. App. 1954) *error ref.*; Maruska v. Missouri K. & T.R., 10 S.W.2d 211 (Tex. Civ. App. 1928) *error ref.*

[19] 346 S.W.2d at 879.

[20] Dobkins, *op. cit. supra* note 8, at 145; White & Wilson, *The Flow & Underflow of Motl v. Boyd*, 9 Sw. L.J. 1, 2 (1955); see McKnight, Book Review, Miss. Valley Historical Rev. 710, 711 (1960): "Although this case still stands as authority, its critics argue (with reason) that the court there misapprehended the Hispano-Mexican law of water, thus wrongly reading it into oblivion."

[21] Motl. v. Boyd, 116 Tex. 82, 286 S.W. 458, 465 (1926).

[22] 31 Tex. 362 (1868).

[23] *Id.* at 365. Note that Dobkins, *op. cit. supra* note 8, at 135, states that the *Tolle* case was concerned with the use of the waters of the Comal River in New Braunfels, Texas. However, neither the *Tolle* case itself nor Mrs. Dobkins state the origin of the title involved.

[24] Translated by Davenport, *supra* note 7, at 153. See also Davenport & Canales, *supra* note 7, at 17. However, see note 31 *infra* and accompanying text.

[25] See text accompanying note 22 *supra*.

[26] See quotation note 11 *supra*.

[27] White & Wilson, *supra* note 9, at 386-87. No emphasis was supplied by Messrs. White and Wilson.

not the land fronted on a stream";[28] and conversely, "the mere fact that a survey fronts on a stream does not determine that all, or any part of the survey is in fact 'irrigable.' "[29] Moreover, the language by de la Vega quoted above[30] is not completely accurate, since the quotation is not taken in its full context.[31]

The dissenters in both the court of civil appeals[32] and the supreme court[33] offered no real justification for their defense of *Motl v. Boyd* as an inviolable rule of property. Although the *Motl* case has been cited nearly eighty times, it has never been cited for the particular problem in point in the *Valmont* case,[34] *i.e.*, whether or not Spanish land grants carried appurtenant water rights. It may be true that the general thought on the subject was that the dictum in *Motl* was controlling on the issue. However, there has been no judicial reliance on this belief and certainly there is no reason to raise such a belief

[28] Wilson, *Reappraisal of Motl v. Boyd*, in Water Law, Texas Conference 40, 43 (1955). Wilson also notes that the Spanish used an irrigating ditch system that ran parallel to the river so that the tracts got their water from their relationship to the ditch and not to the river. *Id.* at 39-40.

[29] Walker, *Legal History of the Riparian Right of Irrigation in Texas Since 1836*, in Water Law, Texas Conference 43 (1959). Walker indicates that the *Tolle* case, besides being a most confusing opinion, was decided by the "military court" during the reconstruction period, and therefore, in the view of many, is of small precedential value. *Id.* at 50.

[30] See text accompanying note 24 *supra*.

[31] See de la Vega, *op. cit. supra* note 9, at 113: "3. Pero si en la concession de las tierras, se conceden juntamente las aguas sus originales, por considerarse partes ó fructos de las dichas tierras mercenadas, es doctrina del padre Avendaño nuestro Regnícola en su *Thesauro Indico* (6). . . ."

But compare (1) the translation in Hamilton, Mexican Law 111 (1882), as quoted by the court in the principal case at 867 (Tex. Civ. App.): "But if in concessions of lands, concessions are made jointly of the waters originating upon it, as appurtenances of the lands granted, it is a doctrine laid down by Padre Avendano in his *Thesauro Indico* . . ." *and* (2) the translation in Collection of Roman, Spanish and Mexican Laws and Commentaries 114 (1960), prepared by the state's attorneys: "3. But if in the granting of lands, the waters originating on them are conceded jointly with them by virtue of being considered as parts or fruits of the lands granted, the applicable doctrine is that of Father Avendano, our native writer, in his *Thesaurus Indicus* (6) . . ." *with* (1) the translation by Davenport, *supra* note 7, at 153: "either form a part of it, or are necessary to its enjoyment, then the waters and their sources are also granted . . . " *and* (2) the full translation by Davenport & Canales, *supra* note 7, at 171: "3. But, in granting the land, if the waters either form part of it, or are essential to its enjoyment; *then the water and its sources are also granted;* this is the doctrine of Father Avendano, our Royal Authority on land law, as stated in his *Thesauro Indico* . . . ." (Emphasis added.)

[32] 346 S.W.2d at 882.

[33] 355 S.W.2d at 503.

[34] *Cf.* San Antonio River Authority v. Lewis, ___ Tex. ___, 363 S.W.2d 444 (1962), involving Spanish land grants containing express grants of irrigation. In *Lewis* the court of civil appeals, 343 S.W.2d 475, 479 (1960), in dictum had recognized an individual's right to extract irrigation water without an express grant. On the same day as the *Valmont* case, the Texas Supreme Court reversed, 5 Tex. Sup. Ct. J. 255 (1962), but later withdrew its opinion. Subsequent to *Valmont*, the court in a substituted opinion affirmed the court of civil appeals in *Lewis*. However, the court reaffirmed the *Valmont* rule that "while the sovereign could, indeed, grant the [river] beds to individuals, it will not be presumed to have done so . . . in the absence of direct and certain evidence that such was its intention." 363 S.W.2d at 447-48.

to the status of a rule of property. The *Valmont* decision has at last cleared the waters muddied by the *Motl* mess.

Fred Kolodey

Labor Law—Section 301(a) Labor-Management Relations Act—State Court Application of Federal Substantive Law

Employer discharged one of its employees for unsatisfactory work. The employee's union, in violation of the collective bargaining agreement it had with Employer, called a strike to protest the discharge. Employer sought damages in a state court for losses caused by the strike. *Held*: Although section 301(a) of the Labor Management Relations Act of 1947[1] gives competent state courts jurisdiction concurrent with federal district courts to hear actions arising out of breaches of collective bargaining contracts, federal substantive law must be applied in both courts. *Local 174, Teamsters Union v. Lucas Flour Co.*, 368 U.S. 95 (1962).

Section 301(a) was enacted to give federal district courts jurisdiction over actions involving breaches of collective bargaining agreements without the parties having to establish the normal jurisdictional amount or diversity of citizenship requirements.[2] Federal courts have interpreted jurisdictional and substantive law problems created by section 301(a)[3] in four ways: the section provides for (1) exclusive jurisdiction in the federal courts over actions involving collective bargaining agreements, (2) an exclusive state substantive law, (3) concurrent jurisdiction in state and federal courts, but the state may apply the state law, and (4) concurrent jurisdiction in state and federal courts but creates an exclusive federal substantive law.

The first interpretation would establish a uniform federal law for the enforcement of collective bargaining agreements. The opinions[4]

[1] 61 Stat. 156 (1947), 29 U.S.C. § 185(a) (1958) provides:
> Suits for violation of contracts between an employer and a labor organization representing employees in an industry affecting commerce . . . may be brought in any district court of the United States having jurisdiction of the parties, without respect to the amount in controversy or without regard to the citizenship of the parties.

[2] Textile Workers v. Lincoln Mills, 353 U.S. 448 (1957).

[3] See note 1 *supra* for the wording of the section.

[4] United Elec. Workers v. Oliver Corp., 205 F.2d 376 (8th Cir. 1953); Milk Drivers v. Gillaspie Milk Prod., 203 F.2d 650 (2d Cir. 1953); Textile Workers, C.I.O. v. Artesia Mills, 193 F.2d 529 (4th Cir. 1951); Shirley-Herman Co., Inc. v. International Hod Carriers Union, 182 F.2d 806 (2d Cir. 1950); Schatte v. International Alliance of Theatrical State Employees, 182 F.2d 158 (9th Cir. 1950).

which construed the section in this manner reasoned that Congress had intended the section to create a new, federal, substantive right, and, therefore, whenever a section 301(a) action was brought in a state court, the defendant could properly remove the suit to a federal district court which exerted exclusive jurisdiction.[5] The second interpretation meant that when diversity was lacking, a federal district court should not accept jurisdiction of an arbitration action, since the state substantive law was exclusive.[6] That view was based upon the theory that the suit did not violate a contract,[7] that a federal question was not involved,[8] and that the bringing of the suit did not violate a collective bargaining agreement.[9] The fullest development of the thesis occurred in Justice Frankfurter's dissent in *Textile Workers v. Lincoln Mills.*[10] The third interpretation of section 301(a) stated that the federal courts were given concurrent jurisdiction with competent state courts to entertain suits involving breaches of collective bargaining agreements,[11] and, therefore, the federal courts should apply state law rather than a federal substantive law. The fourth interpretation, *i.e.*, that there is concurrent jurisdiction but an exclusive federal substantive law, has been approved by the Supreme Court in the principal case. Previously, in *Fay v. American Cystoscope Makers,*[12] a federal district court had held that when plaintiff's labor union represented employees in an industry affecting commerce, removal to the federal district court on the basis of a federal question was proper even though the federal question was not fully alleged in the complaint.[13] The theory underlying the *Fay* case was that a well-pleaded complaint would necessarily assert a federal question.[14]

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[5] *Ibid.*

[6] Bussey v. Local 3, Plumbers Union, 286 F.2d 165 (10th Cir. 1961); Tutt v. Brotherhood of Locomotive Fireman, 272 F.2d 120 (7th Cir. 1959); Peterson v. Brotherhood of Locomotive Fireman, 272 F.2d 115 (7th Cir. 1959); Matter of Arbitration between Hall and Sperry Gyroscope Co., 183 F. Supp. 891 (S.D.N.Y. 1960); Wamsutta Mills v. Pollack, 180 F. Supp. 826 (S.D.N.Y. 1960); International News Serv. v. Gregory, 160 F. Supp. 5 (S.D.N.Y. 1958); Associated Tel. Co. v. Communication Workers, 114 F. Supp. 334 (S.D. Cal. 1953).

[7] Wamsutta Mills v. Pollock, *supra* note 6.

[8] Associated Tel. Co. v. Communication Workers, 114 F. Supp. 334 (S.D. Cal. 1953).

[9] Matter of Arbitration between Hall and Sperry Gyroscope Co., 183 F. Supp. 891 (S.D.N.Y. 1960).

[10] 353 U.S. 448 (1957); see text accompanying note 20 *infra.*

[11] Association of Westinghouse Salaried Employees v. Westinghouse Elec. Corp., 348 U.S. 437 (1955); United Steelworkers v. Galland-Henning Mfg. Co., 241 F.2d 323 (7th Cir. 1957); International Ladies Garment Workers v. Jay Ann, Inc., 228 F.2d 632 (5th Cir. 1956); Oil Workers v. Mercury Oil Ref. Co., 187 F.2d 980 (10th Cir. 1951).

[12] 98 F. Supp. 278 (S.D.N.Y. 1951).

[13] *Id.* at 280.

[14] 1A Moore, Federal Practice ¶ 0.167(7), at 1010 (1961): "[A] suit may be removed where the real nature of the claim asserted in the complaint is federal, irrespective of whether

In the first case in which section 301(a) was considered by the Supreme Court—*Association of Westinghouse Salaried Employees v. Westinghouse Elec. Corp.*[15]—the Court held that section 301(a) did not give the federal courts jurisdiction over suits for wages brought by a union.[16] Viewing the legislative history[17] of the section, the Court concluded that Congress did not intend to burden the federal courts with bargaining disputes and that an employee as an individual could rely upon state courts to protect his rights. One concurring opinion[18] said that in suits under section 301(a), a federal court should apply state law only if it was not contrary to the federal policies stated in the Labor Management Relations Act.[19]

In *Textile Workers v. Lincoln Mills*[20] and two companion cases,[21] the Court took the position that the federal courts had jurisdiction to decree specific performance of an arbitration agreement. The underlying theme in these three decisions indicated the desire of the courts to establish a uniform body of labor law.[22] By holding that section 301(a) was more than jurisdictional, the Court effectively created rights based on a uniform federal labor policy. This view evolved from federal court decisions enforcing collective bargaining agreements.[23] The Court, however, left unanswered the question of whether state courts had concurrent jurisdiction.

The first court to render a decision on the question of concurrent jurisdiction was the California Supreme Court in *McCarroll v. Los Angeles County Dist. Council of Carpenters*,[24] which held that section 301(a) did not expressly or impliedly exclude a state court

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it is characterized, or where the plaintiff inadvertently, mistakenly or fraudulently conceals the federal question that would necessarily have appeared if the complaint had been well pleaded."

[15] 348 U.S. 437 (1955).

[16] This approach was followed in Textile Workers v. Cone Mill Corp., 166 F. Supp. 654 (N.D.N.C. 1958), but was held to be no longer authoritative as precedent in Smith v. Evening News Ass'n, ___ U.S. ___, 83 Sup. Ct. 267 (1962).

[17] *Hearings on S. 55 and S. Res. 22 Before the Senate Committee on Labor and Public Welfare*, 80th Cong., 1st Sess., pts. I-IV (1947).

[18] 348 U.S. at 464. In that opinion Justice Reed concurred on the ground that the dispute was not a violation of a contract between a union and an employer.

[19] See Board of Comm'rs v. United States, 308 U.S. 343 (1939).

[20] 353 U.S. 448 (1957).

[21] Goodall-Sanford, Inc. v. United Textile Workers, 353 U.S. 550 (1957); General Elec. Co. v. Local 205, United Elec. Workers, 353 U.S. 547 (1957).

[22] Oil Workers v. Delta Ref. Co., 277 F.2d 694 (6th Cir. 1960); Enterprise Wheel & Car Corp. v. United Steelworkers, 269 F.2d 327 (4th Cir. 1959); Textile Workers v. Cone Mill Corp., 268 F.2d 920 (4th Cir. 1959); Minkoff v. Scanton Frocks, Inc., 172 F. Supp. 870 (S.D.N.Y. 1959). *Contra*, Mississippi Valley Elec. Co. v. Local 130, Int'l Bhd. of Elec. Workers, 278 F.2d 764 (5th Cir. 1960); see Comment, 34 So. Cal. L. Rev. 63 (1960).

[23] Comment, 59 Colum. L. Rev. 269 (1959).

[24] 49 Cal. 2d 49, 315 P.2d 322 (1957). Another case subsequent to the *McCarroll* case was Anchor Motor Freight v. Local 445, Teamsters Union, 171 N.Y.S.2d 506 (Sup. Ct. 1958).

from jurisdiction. The court based its decision upon the permissive language of section 301(a): "[S]uits for violation of a contract between an employer and a labor organization representing employees in an industry affecting commerce . . . *may* be brought in any district court."[25] (Emphasis added.)

In *Charles Dowd Box Co. v. Courtney*,[26] the United States Supreme Court answered the question of whether state jurisdiction in a labor dispute was preempted by federal law. The Court held that an action arising under section 301(a) did not divest the state court of jurisdiction. The *Dowd Box* case followed the general rule of federal procedure that concurrent jurisdiction will be granted when it is not expressly excluded by or incompatible in its exercise with the nature of the case.[27] The Court, however, did not decide in *Dowd Box* whether federal substantive law was exclusive.[28]

In the instant case, the Supreme Court accepted the fourth view above, *i.e.*, that the federal courts have not preempted a qualified state court from exercising jurisdiction in a section 301(a) dispute.[29] However, the Court held that regardless of which court decided the action, federal substantive law was to be applied. This latter rule indicates that the Court, realizing the dimensions of the issues raised in suits covered by section 301(a), determined that such subject matter must be directed by a uniform federal labor policy. The courts will not now be faced with conflicting state and federal concepts, since the former must give way to the principles of federal labor law. The Court noted that the *Dowd Box* case had not specifically decided whether a state court should apply federal law in exercising jurisdiction over section 301(a) litigation.

The principal case illustrates the difference between preemption of jurisdiction and preemption of substantive law. It is important that there be an effective uniform policy in the area of labor-management relations. Therefore, federal substantive law must be applied in both state and federal courts. Section 301(a), as interpreted, creates a reverse "Erie Railroad"[30] problem, because *state*

[25] 61 Stat. 156 (1947), 29 U.S.C. § 185(a) (1958).

[26] 368 U.S. 502 (1962).

[27] Brown v. Gerdes, 321 U.S. 178 (1944); Missouri v. Taylor, 266 U.S. 200 (1924); Robb v. Connolly, 111 U.S. 624 (1884).

[28] The *Dowd Box* decision upheld concurrent jurisdiction in federal and state courts but failed to pass upon the question of whether federal substantive law was preemptive. Hence, the Court disclaimed any approval of the *Fay* case which was based upon (1) concurrent jurisdiction and (2) exclusive federal substantive law. However, the principal case, along with the *Dowd Box* case, established that the *Fay* case had preempted state law.

[29] 368 U.S. at 101 (1962).

[30] In Erie R.R. v. Tompkins, 304 U.S. 64 (1938), the Court held that in matters of substantive law, if the cause of action arose under state law, the federal courts were bound by the decisions of the highest state court.

courts must now follow and apply *federal* substantive law. The approach taken is the best way to establish a practical, uniform procedure for handling cases involving breaches of collective bargaining agreements and simultaneously utilize the dual system of federal-state courts.

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