ADMINISTRATIVE LAW—CIRCUITS DISAGREE ON VALIDITY OF FPC ORDERS OUTLAWING INDEFINITE PRICE-ESCALATION CLAUSES IN CONTRACTS FOR SALE OF NATURAL GAS

In a series of orders issued pursuant to section 16 of the Natural Gas Act, the Federal Power Commission stated that it would thereafter summarily reject all applications for certificates of public convenience and necessity and all contracts for the sale of natural gas which contained indefinite price-escalation clauses. Pursuant to the act, several inde-

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1 The Commission shall have power . . . to prescribe, issue, make, amend, and rescind such orders, rules, and regulations as it may find necessary or appropriate to carry out the provisions of this chapter . . . .


2 Price-escalation clauses provide for future increases in the price to be paid to the natural gas producer for his product. These clauses become operative on the occurrence of certain events described in the contract. See generally Trigg, Escalation Clauses in Public Utility Rate Schedules, 106 U. PA. L. Rev. 964 (1958).

The FPC orders are as follows: Order No. 232:
Any provision for a change of price of the seller by reason of indefinite escalation clauses . . . contained in a contract for the sale or transportation of natural gas subject to the jurisdiction of the Commission tendered for filing on or after April 1, 1961, shall be inoperative and of no effect at law.


Order No. 232A:
In contracts executed on or after April 3, 1961, for the sale or transportation of natural gas subject to the jurisdiction of the Commission, any provision for a change of price other than the following provisions shall be inoperative and of no effect at law; the permissible provisions for a change in price are:

(1) . . . [provisions dealing with price changes to cover tax increases];
(2) provisions that change a price to a specified amount at a definite date; and
(3) provisions that, once in five-year contract periods . . ., change a price at a definite date by a price-redetermination based upon and not higher than a producer rate or producer rates which are subject to the jurisdiction of the Commission, are not in issue in suspension or certificate proceedings, and are in the area of the price in question.


Order No. 242:
Any contract executed on and after April 2, 1962, and filed in support of an applicant's gas supply showing will be given no consideration in determining adequacy of gas supply if it contains any price-changing provisions other than those defined as permissible in [Order No. 232A] . . . hereof.
On or after April 2, 1962 (the application [for a certificate of public convenience and necessity] . . . shall be rejected if any contract submitted in support thereof contains any price-changing provisions other than those defined as permissible in [Order No. 232A] . . . hereof.


3 (c) Under such rules and regulations as the Commission may prescribe, every natural-gas company shall file with the Commission . . . schedules showing all rates and charges for any transportation or sale subject to the jurisdiction of the Commission . . . together with all contracts which in any manner affect or relate to such rates, charges, classifications, and services.
dependent producers filed contracts for the sale of natural gas with the FPC and, at the same time, applied for certificates of public convenience and necessity to enable them to sell this gas to a pipeline company for resale in interstate commerce. After finding in these contracts price-escalation clauses not conforming to the previously announced criteria, the Commission rejected the applications without a hearing. On review, the Ninth Circuit held that the Commission had general rulemaking power to issue the challenged orders, and that the Commission was not required to hold adjudicative hearings on individual applications which on their face violated the price-escalation regulations. Superior Oil Co. v. FPC, 322 F.2d 601 (9th Cir.), petition for cert. filed, 32 U.S.L. WEEK 3228 (U.S. Dec. 24, 1963) (No. 684). The Tenth Circuit, however, held the order invalid. Texaco, Inc. v. FPC, 317 F.2d 796 (10th Cir.), cert. granted, 375 U.S. 902 (1963).

In Phillips Petroleum Co. v. Wisconsin, the Supreme Court held that independent producers of natural gas are within the FPC's jurisdiction under the Natural Gas Act. After the Phillips decision the Commission was deluged with rate filings and applications for certificates of public convenience and necessity from these independent producers; as a result the Commission has been faced with a growing backlog of cases. Much

(e) Whenever any such new schedule is filed the Commission shall have authority . . . to enter upon a hearing concerning the lawfulness of such rate, charge, classification, or service; and, pending such hearing and the decision thereon, the Commission . . . may suspend the operation of such schedule and defer the use of such rate, charge, classification, or service, but not for a longer period than five months beyond the time when it would otherwise go into effect . . . and after full hearings . . . the Commission may make such orders with reference thereto as would be proper in a proceeding initiated after it had become effective. . . . At any hearing involving a rate or charge sought to be increased, the burden of proof to show that the increased charge is just and reason-able shall be upon the natural-gas company . . . .


(c) No natural-gas company or person which will be a natural-gas company upon completion of any proposed construction or extension shall engage in the transportation or sale of natural gas, subject to the jurisdiction of the Commission . . . unless there is in force with respect to such natural-gas company a certificate of public convenience and necessity issued by the Commission authorizing such acts or operations . . . .

(e) . . . The Commission shall have the power to attach to the issuance of the certificate and to the exercise of the rights granted thereunder such reasonable terms and conditions as the public convenience and necessity may require.


6 Only Order No. 242 was declared void. The court held that Orders No. 232 and No. 232A were merely advisory and could not serve as a basis for summary rejection of producer filings. Id. at 807.

7 347 U.S. 672 (1954).

8 In Phillips Petroleum Co., 24 F.P.C. 537, 546 (1960), the FPC said:
If our present staff were immediately tripled, and if all our new employees would be as competent as those we now have, we would not reach a current
of the difficulty stems from the Natural Gas Act's requirement that the Commission hold individual hearings when it questions the reasonableness of proposed rate filings or contract provisions. These hearings are of necessity long and complicated.

The FPC argues that this problem is aggravated by the presence of indefinite price-escalation clauses in contracts between producers and pipeline companies. One such clause is the so-called favored-nation clause under which the pipeline company agrees with the producer that the price paid to the latter shall never be less than that paid to other producers for gas of like quality delivered under comparable conditions within a defined area. Since these clauses are now generally included in producer-pipeline company contracts, a rate increase or a new contract calling for a higher rate for one producer will automatically lead to simultaneous rate filings by all other producers in the same area who sell to the same pipeline company. Another prominent indefinite price-escalation clause is the price-redetermination provision which allows the producer to require a redetermination of the original contract price at intermittent bargaining sessions with the pipeline company. The new rate which the parties agree upon is then submitted to the Commission for approval. Since the pipeline company can usually pass along any increased cost to its customers and ultimately to the consumers, it does not have a strong incentive to resist a new rate filing. Thus, these "bargaining" sessions are likely to be nothing more than determinations by the producer and the pipeline company of the highest reasonable rate, and the filing is not necessarily based on any increased costs of the producer.

The Commission has contended that sections 4, 5, and 7 of the Natural Gas Act provide it with substantive power to prohibit these clauses. Section 4 requires the Commission to approve all new contracts and rate increases and empowers it to modify those which are not just and reasonable. Section 5 gives the Commission power to institute investigations into con-
pany contracts and rates on its own motion and to modify unjust or unreasonable contract terms. Finally, section 7 empowers the Commission to issue certificates of public convenience and necessity for the transportation or sale of natural gas in interstate commerce. In order to protect the public interest, the Commission may condition the issuance of certificates with “such reasonable terms and conditions as the public convenience and necessity may require.”

The FPC claims that indefinite price-escalation clauses are not in the public interest because they lead to simultaneous rate filings which have no economic justification, and because the clauses themselves are often so complicated that the Commission must spend much of its time construing them rather than determining whether the proposed increase is just and reasonable, itself a complicated and burdensome process. Thus, the increased administrative workload caused by the triggering of indefinite price-escalation clauses decreases the Commission’s ability to protect the public interest.

The gas producers, on the other hand, argue that the industry’s economic structure requires indefinite escalation clauses. They contend that a gas company cannot reasonably undertake the tremendous investment needed to construct a pipeline unless it is assured of a long-term supply of gas, which is usually obtained through long-term contracts with the producer. Price-escalation provisions are defended as an insurance of the continued fairness of the producer’s selling price over the length of the contract period.

The Supreme Court has said that in determining what rates and contracts are in the public interest the Commission should consider the triggering effect of a producer’s proposed rate. Atlantic Ref. Co. v. Public Serv. Comm’n (Cato), 360 U.S. 378, 391 (1959). It would seem to follow that the Commission should also consider whether a proposed contract contains filing provisions—favored-nations clauses—that may be triggered by subsequent rates.

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14 (a) Whenever the Commission, after a hearing ... shall find that any rate, charge, or classification demanded, observed, charged, or collected by any natural-gas company in connection with any transportation or sale of natural gas, subject to the jurisdiction of the Commission, or that any rule, regulation, practice, or contract affecting such rate, charge, or classification is unjust, unreasonable, unduly discriminatory, or preferential, the Commission shall determine the just and reasonable rate, charge, classification, rule, regulation, practice, or contract ....


16 See note 3 supra.

17 See United Gas Pipe Line Co. v. Mobile Gas Serv. Corp., 350 U.S. 332 (1956). Under the Mobile doctrine, if a producer cannot get the acceleration clause he wants written into the contract and accepted by the FPC, he will not be allowed at a later date to file unilaterally for increases which would have been covered by the proposed contract provisions.

18 See Brief for Respondent, pp. 12-19; Texaco, Inc. v. FPC, 317 F.2d 796 (10th Cir. 1963).

19 See Phillips Petroleum Co., 24 F.P.C. 537 (1960); Brief for Respondent, pp. 12-19, Superior Oil Co. v. FPC, 322 F.2d 601 (9th Cir. 1963).


21 See Texaco, Inc. v. FPC, 317 F.2d 796, 799 (10th Cir. 1963).
the public interest, but counters that the limited price-escalation clauses permitted by its orders are sufficient to protect the producers' interests.

Since the clauses result in increased rates, they may be unfair to the ultimate gas consumer even though they cannot cause an immediate increase in the price of natural gas. The act allows the Commission to suspend new rates for a maximum of five months while it conducts hearings; under the present circumstances, it is unlikely that the Commission will be able to hold a hearing within the five-month period due to the complexity of many of the indefinite price-escalation clauses, the difficulty of fixing a fair rate, and the Commission's present backlog. After the five months have elapsed, the company may put the new rates into effect, subject to refund by the company if the Commission eventually finds the new rate excessive. There is no guarantee, however, that the refund will be passed all the way back to the consumer. If a particular consumer has died, moved away, or is a leaseholder whose rent included the cost of gas, he will receive little protection from the FPC's power retroactively to declare the rate excessive. Furthermore, even absent these contingencies, the consumer as a class may not benefit from the FPC's rate determination since local public utilities commissions may not reduce the local rate, or the local rate reduction may be prospective only.

When the Commission speaks of "economically justified" rate increase filings, it seems to be referring to proposed rates which can be justified by the producer's operating costs. Under this rationale it seems clear that the FPC orders are within its statutory power, because only those filings which are cost justified are in the public interest. The Commission's

23 See note 2 supra (Order No. 232A).
24 See note 3 supra. The Commission's only alternative method of modifying rates and contract provisions is through a § 5 investigation initiated on its own motion. See note 14 supra and accompanying text. However, a § 5 proceeding is not an adequate substitute to protect the public interest, since it contains no refund provision, and under its terms the Commission, rather than the company, has the burden of proving that the proposed rate or contract term is not in the public interest. See Atlantic Ref. Co. v. Public Serv. Comm'n (Catco), 360 U.S. 378, 389-90 (1959).
26 See Brief for Respondent, pp. 12-19, Texaco, Inc. v. FPC, 317 F.2d 796 (10th Cir. 1963). This would be the standard demanded by City of Detroit v. FPC, 230 F.2d 810 (D.C. Cir. 1955), cert. denied, 352 U.S. 829 (1955); however, if the FPC's new method of rate-making is upheld, see note 27 infra, the standard would be the area field price.
27 See City of Detroit v. FPC, supra note 26. In Phillips Petroleum Co., 24 F.P.C. 537 (1960), the FPC announced its intention to substitute an area price scheme for the traditional individual rate base or cost of service formula. However, the Commission decided the Phillips case by using the latter method. This decision was affirmed by the Supreme Court in Wisconsin v. FPC, 373 U.S. 294 (1963), but the
orders protect the producer’s right to file for cost-justified increases by permitting redetermination clauses which allow the parties to agree on an increase to rates no higher than those already approved by the FPC for that area. While protecting the producer, this limitation also affords the consumer additional protection because the rates will have been approved by the Commission in a rate hearing before they ever go into effect. Under the prohibited clauses, on the other hand, the new rate filings, which may go into effect after five months, are based on rates which have not yet received FPC approval, due to the current backlog of cases. Thus, the new regulations not only will decrease the Commission’s workload, but also will allow the Commission to hold the price line, without sacrificing the producer’s right to file for an increase, in accordance with his contract terms, when there is a general price increase in his area. If an individual producer believes that his own cost situation is so unusual as to justify increases out of line with rates already approved by the Commission, he may ask for a waiver of the indefinite price-escalation orders when he files his contract.  

The waiver of the order would be necessary in order to leave the producer free to file later for a rate higher than one already approved. However, to obtain such a waiver the producer would have to file a petition setting forth the specific facts relied upon to support the petition. The Commission would then decide whether the petition on its face had sufficient merit to warrant a hearing on the waiver issue. In these cases, the facts relied upon would relate to circumstances peculiar to the particular company requesting the waiver or to the particular transaction in question.

The companies argue, however, that private parties have the right to set their price and escalation terms by contract under the Natural Gas Act. In Willmut Gas & Oil Co. v. FPC, the court of appeals held that, under the general rulemaking provision of the act, the Commission had no statutory authority to promulgate an order which deprived a gas company of its right to file for a rate increase. The orders involved here, Court refused to pass on the validity of area pricing. If this method of setting rates is eventually upheld by the Supreme Court, the Commission’s limitation on price-redetermination clauses will substantially cut down on the complexity of hearings necessitated by filings under such clauses, because when the producer files for an increase under the type of price-redetermination clause which the Commission now allows, his proposed rates will be within rates already approved by the Commission for that area.

28 See Brief for Respondent, p. 17, Superior Oil Co. v. FPC, 322 F.2d 601 (9th Cir. 1963).
30 The Natural Gas Act permits the relations between the parties to be established initially by contract, the protection of the public interest being afforded by supervision of the individual contracts, which to that end must be filed with the Commission and made public.


The Court of Appeals for the District of Columbia Circuit has recently expressed the opinion that the general rule-making provision of the Natural Gas Act, 52 Stat.
however, do not deprive a company of the right to file for a specific increase, as was the case in *Wilimut*, but merely limit the contractual methods that may be employed to those which are in the public interest. Moreover, the general limitation on the right to file imposed by these orders is not inconsistent with the act's reliance on private contract as the means by which Congress intended to protect producers who might be faced with sharply rising production costs during the periods covered by their contracts.33

It is argued that even if the FPC has the authority to disallow these clauses, the substantive sections on which the Commission relies require a hearing, and therefore the Commission may limit permissible contract provisions only by individual adjudication. However, in *United States v. Storer Broadcasting Co.*,34 the Supreme Court held that the Federal Communications Commission could reject without a hearing Storer's application for a license despite hearing provisions in the Federal Communications Act similar to those in the Natural Gas Act. The Court based its decision on the fact that the application on its face showed a violation of substantively valid FCC regulations. Once the substantive validity of the FPC regulations involved in the present cases is established,35 the *Storer* doctrine should be equally applicable to the FPC.

Although it was claimed that if given the opportunity at a hearing the company would have shown that the price-redetermination and favored-nation clauses contained in its contract are directly related to the economic requirements of the industry in general and to its own economic position in particular,36 industry-wide conditions were considered by the Commission when it framed its orders,37 and particular conditions relating to a single producer or a single transaction can be brought to the Commission's attention by applying for a waiver of the FPC orders when the contract is filed.38 Since none of the producers in these cases applied for a waiver, it appears that if they were granted an adjudicatory hearing they would only

830 (1938), 15 U.S.C. § 717o (1958), gives the FPC a broad grant of power. In upholding a Commission order dealing with the issuance of temporary certificates of public convenience and necessity, the court said:

All authority of the Commission need not be found in explicit language. Section 16 demonstrates a realization by Congress that the Commission would be confronted with unforeseen problems of administration in regulating this huge industry and should have a basis for coping with such confrontation. While the action of the Commission must conform with the terms, policies and purposes of the Act, it may use means which are not in all respects spelled out in detail.


34 351 U.S. 192 (1956).

35 See notes 13-16 *supra* and accompanying text.

36 Superior Oil Co. v. FPC, 322 F.2d 601, 609, 610 (9th Cir. 1963).

37 Id. at 605-08; see 25 F.P.C. 379 (1961).

38 See notes 28-29 *supra* and accompanying text.
be presenting to the Commission arguments which it heard and rejected during the rulemaking proceeding.\(^3\)

Such industry-wide facts are "legislative" rather than "adjudicative"\(^4\) — the Commission's resolution of these issues does not turn on factors which are peculiar to one company, thus calling for an adversary trial type hearing, but rather are the kinds of facts which are helpful in formulating general policies. There is less danger of arbitrary or discriminatory action since the orders are not applicable to an individual company. Furthermore, the Commission should be able to evaluate competing factors of industry-wide significance on the basis of its administrative expertise in the regulation of natural gas producers. Since these are clearly legislative facts, the rulemaking procedure is proper and deprives the company of no procedural right.\(^4\)

### CORPORATION — Corporation Enjoined From Issuing Non-voting Common Stock Which Would Cause Delisting From Stock Exchange When Previous Prospectus Impliedly Promised To Remain Listed

In 1957, Carter Products, Inc., a closed corporation controlled by defendant majority shareholder (Hoyt), sold 500,000 shares of the corporation's voting stock to underwriters who in turn sold those shares to the public. The prospectus stated that "the Company intends to make application for the listing of the Common Stock on the New York Stock Exchange" (NYSE). The stock was subsequently listed. In 1962, the directors recommended the creation of a class of nonvoting common stock.\(^1\)

\(^3\) The Commission sought and received comments, memoranda, and briefs on its proposed rules, pursuant to Administrative Procedure Act §4, 60 Stat. 238 (1946), 5 U.S.C. §1004 (1958). See Superior Oil Co. v. FPC, 322 F.2d 601, 605-07 (9th Cir. 1963).

\(^4\) See NLRB v. Seven-Up Bottling Co., 344 U.S. 344 (1953); Davis, Administrative Law Text §§ 7.04, 7.06, 15.03 (1959).


The Tenth Circuit also held that since there is no record made at a rulemaking proceeding, there is no way for a court to review the basis for the Commission's action. See Texaco, Inc. v. FPC, 317 F.2d 796, 804-06 (10th Cir. 1963). However, once the application of the FPC order is challenged and the Commission is forced to defend its substantive position before an appellate court, its brief and oral argument will spell out the rationale behind its rulemaking. Furthermore, this argument would serve to discredit all administrative rulemaking proceedings. It ignores the fact that the very nature of legislative finding of facts applicable to an entire industry requires that such administrative action be subject to a narrower scope of review than the more particularized determination of adjudicative facts. See NLRB v. Seven-Up Bottling Co., 344 U.S. 344 (1953); 1 Davis, Administrative Law Treatise §§ 5.03 to .05, 7.06 (1958); 2 id. § 15.03.

\(^1\) Md. Ann. Code art. 23, § 43(a) (1957), permits corporations to deny voting rights to any class of stock by so providing in the charter.
to be used for future acquisitions. The admitted purpose of the nonvoting characteristic was to enable Hoyt to retain majority control of the corporation. Although the shareholders were warned that under NYSE rules the issuance of nonvoting common stock would cause delistment; they approved the recommendation by the statutory two-thirds majority. Minority shareholders sued to enjoin the corporation and Hoyt from effecting the plan. The Circuit Court of Baltimore City held that Hoyt, as a controlling shareholder, breached his fiduciary duty by voting his stock for personal benefit against the interests of the corporation. It also applied the doctrine of promissory estoppel to find an implied promise by the corporation and Hoyt to remain listed, the abandonment of which was not justified by a sufficient corporate purpose. *United Fund, Inc. v. Carter Prods. Inc.*, No. 102A/450, A 42888, Baltimore Cir. Ct., May 16, 1963.

The traditional reluctance of courts to interfere with the internal affairs of corporations has yielded to the realization that controlling shareholders may be motivated by personal rather than corporate interests. Hence, many jurisdictions now recognize that when control uses its voting power for its own benefit, regardless of the adverse interests of the corporation and its stockholders, as such, a fiduciary duty to the corporation and the stockholders arises entitling them to relief. This duty has been

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2 The NYSE has refused to list companies with a class of nonvoting stock since 1927. Since 1957 the Exchange has considered the creation of such a class of stock a cause for delistment. See *New York Stock Exchange, Constitution and Rules § 249.10(3) (CCH 1962).*

3 Md. Ann. Code art. 23, § 11(c)(3) (1957). If Hoyt's votes were excluded from the computation, the proposed amendment would not have received the approval of two-thirds of the remaining shares. See instant case, Finding of Fact No. 31 (last paragraph).

4 Complainants were three mutual funds which had substantial holdings in Carter stock. When disenfranchised with a company, institutional investors today frequently voice their objections to management policies rather than dispose of their holdings. See The Wall Street Journal, Sept. 23, 1963, p. 1, col. 6.

5 Hoyt was also a director and chairman of the board. The opinion treats him in his capacity as a majority shareholder, and therefore rests on the more modern concept of control's fiduciary duty rather than the traditional fiduciary duty of directors.


7 These interests include fringe benefits, pension rights, the effect of the graduated income tax, and the use of assets to buy control of other corporations. The minority shareholder also has interests besides profit-making; he is interested in the payment of dividends and having his stock remain freely marketable at a fair price. Berle, "Control" in Corporate Law, 58 Colum. L. Rev. 1212, 1214 (1958). See the detailed description of the rights and duties of corporate control in Bayne, *A Philosophy of Corporate Control*, 112 U. Pa. L. Rev. 22, 29-54 (1963).


recognized by the Maryland courts in recent dicta. Modern courts closely inspect alleged breaches of duty, and decisions in favor of control tend to be based on specific findings rather than a laissez-faire judicial attitude. The fiduciary label, however, does not negate a broad range of discretion in corporate managers. The dividing line between permissible discretion and breach of duty is not settled. To upset a corporate plan, dissenting shareholders must show more than that a better plan might have been devised or that damage might result to them, but they need not necessarily show fraud or injury to the corporation. Benefit to the corporation should not automatically preclude a finding of a breach of duty, but many courts simply ask whether the plan was for the benefit of the corporation or control.


In most cases articulating the control concept there has been an inextricable bond between control and management. The language of the courts, however, seems broad enough to impose a fiduciary duty on a majority shareholder who does not participate in the formulation of corporate policy. Yet, a possible distinction might be raised in an unlikely case in which control merely holds the stock for investment. DeBoy v. Harris, 207 Md. 212, 224, 113 A.2d 903, 909 (1955) (dictum); Baker v. Standard Lime & Stone Co., 203 Md. 270, 282-85, 100 A.2d 822, 828-30 (1953) (dictum); Cooperative Milk Service v. Hepner, 198 Md. 104, 114, 81 A.2d 219, 224 (1951) (dictum).

10 The denomination of the majority shareholder as a fiduciary is not dispositive of the problem. "To whom is he a fiduciary? What obligations does he owe as a fiduciary? In what respect has he failed to discharge these obligations? And what are the consequences of his deviation from duty?" SEC v. Chenery Corp., 318 U.S. 80, 86 (1943) (Frankfurter, J.).


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15 Equally unfounded is the contention that the [majority] . . . cannot be held liable because it was not guilty of fraud or mismanagement. The essential of the liability to account sought to be enforced in this suit lies not in fraud or mismanagement, but in the fact that, having become a fiduciary . . . the [majority] . . . has secured fruits which it has not shared with the minority. Southern Pac. Co. v. Bogert, 250 U.S. 483, 492 (1919).

16 Not only does the majority shareholder owe a duty to the corporation, Lebold v. Inland Steel Co., 125 F.2d 369 (7th Cir. 1941), cert. denied, 316 U.S. 675 (1942), he also must consider the interests of minority shareholders, Zahn v. Transamerica Corp., 162 F.2d 36 (3d Cir. 1947); Kavanaugh v. Kavanaugh Knitting Co., 226 N.Y. 185, 123 N.E. 148 (1919).

17 In Seagrave Corp. v. Mount, 212 F.2d 389 (6th Cir. 1954), the corporation was planning to purchase stock of another company to add new lines and strengthen its competitive position. The plan was nevertheless enjoined because the proposed financing would have enabled the controlling shareholders to sell their stock to minority members of the board at a five dollar premium.

Courts have looked critically into transactions which are allegedly designed to perpetuate or shift control at the expense of other stockholders. In the leading case of Elliott v. Baker, the court canceled an issuance of treasury stock, holding that a corporation may not sell stock with intent to give voting control to a particular party. In a converse situation, the court in Andersen v. Albert & J. M. Andersen Mfg. Co. held that treasury stock could not be withheld from the market simply to perpetuate current control. When issuance of stock only incidentally shifts or perpetuates control, courts are not likely to enjoin. In Dunlay v. Avenue M Garage & Repair Co., the court approved the issuance of previously authorized shares to one of the defendants who combined them with other shares purchased from third parties to obtain control of the corporation. The shares were issued in good faith; the receipts were used to pay creditors so the corporation could continue in business.

In the present case, the proposed issuance of nonvoting stock would cause the minority stockholders to lose the benefits of a stock exchange: improved share marketability, increased use of the stock as collateral, published securities prices, and publicity of corporate affairs. The corporation would also suffer from the issuance, since listing provides goodwill, aids future financing and the sale of securities by stock warrants, promotes stability through broader public ownership, and facilitates mergers and acquisitions through stock payments.

Hoyt's desire not to relinquish control apparently forced the directors to recommend the nonvoting stock in the face of its overwhelming disad-

194 Mass. 518, 80 N.E. 450 (1907).

325 Mass. 343, 90 N.E.2d 541 (1950). In Kahn v. Schiff, 105 F. Supp. 973, 978 (S.D. Ohio 1952), the court enjoined the creation of a new class of voting stock because "the issuance of stock is for the express purpose of retaining in power the persons who authorize the issue, and who are therefore distinctly benefited to the disadvantage of another and substantial part of the stockholders . . . ."

Floor v. Johnson, 114 Utah 313, 199 P.2d 547 (1948); Luther v. C. J. Luther Co., 118 Wis. 112, 94 N.W. 69 (1903); see Rohrlich, Suits in Equity by Minority Stockholders as a Means of Corporate Control, 81 U. Pa. L. Rev. 692, 702-05 (1933).

253 N.Y. 274, 170 N.E. 917 (1930); accord, Runswick v. Floor, 116 Utah 91, 208 P.2d 948 (1949).

Moreover, listed stocks sell for higher prices in proportion to their earnings than unlisted stocks. Guthmann & Dougall, Corporate Financial Policy 331 (3d ed. 1955); Leffler & Farwell, The Stock Market 129 (3d ed. 1963); see Brief for Complainants, pp. 10-17, instant case.

Only listed stocks may be pledged as collateral with a member broker of the NYSE.


When there has been no breach of fiduciary duty, a court will not let the rules of the NYSE govern the operations of the corporation. If the state gives corporations the right to engage in certain activities and the majority of the directors have not abused this right, minority stockholders cannot base their cause of action on the NYSE rules. Gaynor v. Buckley, 318 F.2d 432 (9th Cir. 1963).


The present case presents no danger of a court’s substituting its judgment for that of the directors on corporate policy because the sole reason for the nonvoting characteristic was revealed in the proxy statement and Hoyt admitted that the stock was disadvantageous. A different case might have been presented if the directors had determined independently that Hoyt’s experience and expertise made his control a valuable asset—more valuable than NYSE listing or other advantages of voting stock. Faced with such an independent judgment by the directors, few courts would weigh anew the advantages and disadvantages of a proposed cause of action. Since Hoyt apparently insisted on the plan for his benefit, however, the present court properly held that the majority shareholder’s interest in maintaining control did not justify the detriment to the corporation and the minority.

The present court also held that both Hoyt and the corporation were estopped from carrying out the proposed plan by their promise in the prospectus to apply for NYSE listing. The court needlessly deserted the

28 Adams and several other directors of Carter would have preferred to have the new common stock voting rather than non-voting, in order to avoid delisting by the N.Y.S.E. They tried, unsuccessfully, to convince Hoyt that he could retain effective working control of Carter with less than 51% of the voting stock. ... Hoyt has been and is unwilling to relinquish any part of his control of over 50% of Carter’s voting stock. Whatever reasons there were for the recommendation of Carter’s Board of Directors to the shareholders of the creation of additional Common Stock, Hoyt’s position in respect of retention of his majority control was the only reason for the recommendation that the new Common Stock be non-voting.


29 The proxy statement admitted that the proposed plan will continue control in the Hoyt family “which they are unwilling to relinquish or reduce.” Instant case, Finding of Fact No. 27.

30 See Brief for Complainants, p. 6, instant case. The stipulation also discloses that Carter was not able to interest the Milano Company in a merger because the latter wanted a tax-free exchange which required voting stock. See Int. Rev. Code of 1954, § 368.

31 It has been argued that stockholder approval nullifies any action against directors for a breach of fiduciary duty. Thurmond v. Paragon Colliery Co., 82 W. Va. 49, 95 S.E. 816 (1918); cf. Haldeman v. Haldeman, 176 Ky. 635, 197 S.W. 376 (1917) (dictum). The argument was rejected in Seagrave Corp. v. Mount, 212 F.2d 389 (6th Cir. 1954), the court noting that the influence of the majority in soliciting proxies and persuading voters, when added to control’s initial block of stock, prevented a valid ratification. In the present case, even though the stockholders were truthfully advised of all relevant matters, approval of the amendment was a foregone conclusion. Not only did Hoyt and his family vote their 51.38 percent of the shares in favor of the amendment, see instant case, Finding of Fact No. 33, but so did other substantial stockholders who were under Hoyt’s control or close to him, see instant case, Finding of Fact No. 31, detailing the votes of the directors and the original selling shareholders. Even without a large block of stock, the ability to solicit proxies (management control) usually enables those in power to emerge victorious from stockholders’ meetings. See Berle, Modern Functions of the Corporate System, 62 Colum. L. Rev. 433, 438-39 (1962). Stockholder approval of the plan even if the votes of the majority shareholder were not counted may still not insure a valid ratification. Kahn v. Schiff, 105 F. Supp. 973 (S.D. Ohio 1952) (dictum).

That all statutory, charter, and by-law provisions have been observed does not insure that the fiduciary’s duty was not breached. Lebold v. Inland Steel Co., 125 F.2d 369 (7th Cir. 1941), cert. denied, 316 U.S. 675 (1942); Kavanaugh v. Kavanaugh Knitting Co., 226 N.Y. 185, 123 N.E. 148 (1919).
CASE COMMENTS

traditional contract analysis in favor of promissory estoppel. A statement in a prospectus becomes part of the corporation's offer to sell its stock and the purchase of that stock supplies the consideration to render promises in that prospectus enforceable. The court may have resorted to promissory estoppel on the theory that privity of contract was absent—the shares were not sold directly by the corporation to the public, but title to the shares was placed in underwriters who then resold them. Viewed realistically, however, there is one large transaction between the corporation and the public, with the underwriter acting as insurer of the distribution. So viewed, the requisite privity between the corporation and the public seems present. Recent cases have held that when a vendor makes direct appeals or statements to the ultimate purchaser through advertising, he may be liable for a breach of express warranty even if there is a complete absence of privity. This exception to the privity rule—if privity did not exist in the present case—would have bound the corporation to its promise.

The promise to remain listed was inferred from the prospectus. The court found that a statement of intent to apply for listing made in a prospectus carries the strong implication to the financial world that the listing is certain of being effected and maintained unless adequate reasons for a subsequent delistment appear. This conclusion seems fully war-

32 In his discussion of promissory estoppel, Corbin asks, "First, was the action in reliance actually bargained for by the promisor and given by the promisee in exchange for the promise? If the answer to this is yes, we have a case of true consideration . . . ." 1A CORBIN, CONTRACTS § 205, at 246 (2d ed. 1963). The corporation did bargain for the purchase of the stock and its promise to apply for listing was a material inducement to the complainant's purchase. See instant case, Findings of Fact Nos. 34-35.

33 The court may have been motivated by the somewhat restrictive Maryland privity doctrines. See, e.g., Vaccarino v. Cozzubo, 181 Md. 614, 31 A.2d 316 (1943) (refused to relax privity requirements even in the case of unwholesome food).

34 In certain cases the underwriters may never have title to the securities. An underwriting group may simply market the securities for the corporation and guarantee the sale of the entire issue; the underwriters are then working for the corporation and receive commissions for their work. Other underwriting agreements, like that in the present case, call for the purchase of the securities by the underwriters with a subsequent resale to the public. See BALLANTINE, CORPORATIONS § 197 (rev. ed. 1946); 2 DEWING, FINANCIAL POLICY OF CORPORATIONS 1082-95 (5th ed. 1953). No matter what the form of the syndicate, the essential characteristic of the underwriting device remains the same—the placing of the risk of security disposal on the underwriter.


36 Corporations have long been bound to warranties made in the sale of their stock. See Cornish v. Friedman, 94 Ark. 282, 126 S.W. 1079 (1910); 12A FLETCHER, CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS §§ 5615-16 (1957).

37 There might be more of a problem concerning the effect of implied promises if the promissory estoppel analysis is used. The defendants argued that the promise upon which a promisee relies when seeking relief through promissory estoppel must be an express promise. Although this conclusion seems unwarranted in view of the trend in contract law not to distinguish between express and implied promises, RESTATEMENT, CONTRACTS § 2 (1932), a court which is hesitant about the use of promissory estoppel might make this distinction. Courts which have considered the question have held that the doctrine does apply to implied promises. Claverie v. American Cas. Co., 76 F.2d 570 (4th Cir. 1935); Ziegler v. Ryan, 66 S.D. 491, 285 N.W. 875 (1939).
ranted. The court properly recognized, however, that listing on the NYSE may not always be an asset. Adverse credit influence in periods of recession, increased danger of stock manipulation, excessive interest in the company's position in the stock market on the part of the company's managers, and harmful disclosures in reports submitted to the exchange may all result from the listing of the corporation's stock. Cognizant of these considerations, the present court said that Carter could voluntarily delist if "that action was necessary to achieve a proper corporate purpose."  

CRIMINAL PROCEDURE—ADMISSIONS DURING STATE DETENTION WITHOUT ARRAIGNMENT HELD ADMISSIBLE IN A FEDERAL TRIAL

Defendant was arrested for vagrancy by Oklahoma City Police on July 15, 1962, and detained without arraignment. In the course of an interrogation at the police station, he implied that he had committed federal crimes. The next day, a federal investigator making a "routine check" at the police station was informed of defendant's statements. His questioning of defendant elicited admissions indicating violations of the federal Transportation of Firearms Act and the Internal Revenue Code. On July 17, the city police released defendant to the federal officers, who formally arraigned him. At trial, defendant's incriminating statements were admitted over the objection that there was an unnecessary delay before he was taken to a United States Commissioner. The Court of Appeals for

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38 The University of Pennsylvania Law Review sent eighteen letters to a random sample of members of the NYSE to determine whether, according to the known usage and practice in the financial world, the promise to apply for listing constituted a promise to remain listed in the absence of a valid corporate purpose for delisting. Without dissent, the eleven replies indicated that the court had made the proper interpretation of the promise in the present case.

39 Guthmann & Dougall, op. cit. supra note 23, at 332-35. Leffler and Farwell doubt, however, that there is any serious risk of manipulation today. They contend that the corners and pools which marked the old market are not present on today's exchanges. Instead of being a mechanism for manipulation, the exchanges have become central in the fair determination of prices. Leffler & Farwell, op. cit. supra note 23, at 75-76.

While the reports required by the NYSE are usually considered to be helpful to shareholders, they may also force the corporation to reveal information useful to competitors. It is expected, however, that Congress will eventually subject unlisted corporations to the same disclosure rules as listed ones. The imposition of such a requirement is likely to encourage additional corporations to seek listing. See Forbes, March 1, 1964, p. 26.

40 Instant case at 8; 151 The Daily Record (Baltimore), Sept. 23, 1963, p. 2, col. 3, 6.

1 Under Oklahoma law "the defendant must, in all cases, be taken before the magistrate without unnecessary delay." Okla. Stat. Ann. tit. 22, § 181 (1937); see Petition of Dare, 370 P.2d 846, 855 (Okla. Crim. App. 1962) (confessions not inadmissible merely because made prior to delayed arraignment; duress must be shown).


the Tenth Circuit affirmed defendant's conviction. *Hollingsworth v. United States*, 321 F.2d 342 (10th Cir. 1963).

The Federal Rules of Criminal Procedure require that arrested suspects be taken without "unnecessary delay" to a hearing before a Commissioner, who will insure that there is probable cause for the arrest and inform the suspect of his rights to remain silent, retain counsel, and have a preliminary examination.\(^4\) Under the *Mallory*\(^5\) rule, incriminating statements obtained in federal detentions after an "unnecessary delay"\(^6\) are inadmissible in federal trials.

In *Anderson v. United States*,\(^7\) Tennessee Valley Authority power lines were dynamited.\(^8\) On his own initiative, the local sheriff arrested defendants and held them without arraignment for two to six days. During this period, questioning by both the sheriff and federal officers elicited confessions which were subsequently admitted in defendants' federal trials. The Supreme Court, observing that the detention was illegal whether measured by state or federal standards, held the confessions inadmissible because obtained through a "working arrangement" between state and federal officers.\(^9\)

The term "working arrangement" was not explicitly defined in *Anderson*, but the facts of the case support the definition offered by Judge Waterman, dissenting in *United States v. Coppola*: "such cooperation between federal and local police as permitted the former to interrogate the latter's prisoners during their detention by the latter."\(^10\) In *Coppola*, the Federal Bureau of Investigation informed state police that defendant had committed a state crime. State officials arrested the defendant and detained him for twenty-nine hours before arraignment. During this time he was interrogated by federal officials and confessed to a federal crime. In a per curiam order, with Mr. Justice Douglas dissenting, the Supreme Court

\(^4\) FED. R. CRIM. P. 5.

\(^5\) McNabb v. United States, 318 U.S. 332 (1943), was the first case to hold that a confession during an illegal detention must be excluded from a federal trial. In *McNabb* the federal agents did not comply with Act of June 18, 1934, ch. 595, 48 Stat. 1008, which required arraignment "immediately" after arrest. In 1946 FED. R. CRIM. P. 5(a) was passed, requiring that a suspect arrested be taken without "unnecessary delay" before a United States Commissioner. See also FED. R. CRIM. P. 40(b). Thereafter, Mallory v. United States, 354 U.S. 449 (1957), reaffirmed the *McNabb* exclusionary rule.

\(^6\) Compare Jones v. United States, 307 F.2d 397 (D.C. Cir. 1962) (four hour delay unnecessary), with Trilling v. United States, 260 F.2d 677 (D.C. Cir. 1958) (5-to-4 decision) (three hours not unnecessary). United States v. Mitchell, 322 U.S. 65 (1944), held that an illegal detention following a valid confession does not render the confession inadmissible. Thus the time relevant for the *Mallory* rule is the time between the apprehension and the confession, not apprehension and arraignment, if the confession precedes arraignment. See generally Hogan & Snee, *The McNabb-Mallory Rule: Its Rise, Rationale and Rescue*, 47 GEO. L.J. 1, 17-20 (1958).

\(^7\) 318 U.S. 350 (1943).

\(^8\) This act was a federal offense, 52 Stat. 198 (1938), as amended, 18 U.S.C. § 1361 (1958), and a state offense, TENN. CODE ANN. § 39-4533 (1955).

\(^9\) 318 U.S. at 356.

affirmed the lower court's decision that the defendant's confession was admissible at his trial in a federal court. Thus, in *Coppola* the Supreme Court apparently reconsidered the implications of *Anderson* and approved *sub silentio* the definition of "working arrangement" that had won general acceptance in the federal courts: a situation in which "state officials are acting for, and under the direction of, federal agents under circumstances which fairly warrant the conclusion that the custody is federal in substance." 11 *Coppola* clearly governs the illegal detention issue in the present case.

As a result of the *Coppola* gloss on *Anderson*, if state officers arrest and detain a suspect on their own initiative, any voluntary admission made during interrogations by state or federal officers before arraignment may be used in a subsequent federal trial. The courts reason that statements made to state officers are admissible because *Mallory* does not apply to them. 12 Moreover, statements made to federal officers are admissible because the federal officers are not responsible for delay before arraignment so long as the state officers independently detain the suspect for their own purposes. 13 *Mallory* apparently only applies when an agency relationship can be established between the federal and state officers in either the arrest or the length of detention.

*Elkins v. United States,* 14 decided one year before *Coppola*, eliminated a similar "silver platter" doctrine in the search and seizure area by holding that evidence seized by a state officer would be inadmissible in a federal trial if the seizure were unreasonable by federal standards. *Elkins* was designed to deter federal and state officers from cooperating to undermine the rule of *Weeks v. United States,* 15 which excludes from the federal courts all evidence unconstitutionally seized by federal officers. *Elkins* is distinguishable from *Coppola* and the present case because in the *Elkins* situation state officers were violating the federal constitution whereas in the latter they are at most violating a state law. 17 Even though the requirement of arraignment without "unnecessary delay" helps prevent


12 See, e.g., Swift v. United States, 314 F.2d 860 (10th Cir. 1963).


15 232 U.S. 383 (1914).


17 The state law was being violated in *Coppola*, see United States v. Coppola, 281 F.2d 340, 341 n.1 (2d Cir. 1960) (dictum), *aff'd per curiam*, 365 U.S. 762 (1961), and in the present case, see note 1 *supra.*
coerced confessions and arrests without probable cause, neither this requirement nor the Mallory exclusionary rule has heretofore been regarded as constitutionally required. Therefore, evidence acquired in state detentions illegal by federal standards is not obtained unconstitutionally.

The Anderson-Coppola rule does not effectively prevent cooperation between state and federal officers to circumvent Mallory. A "working arrangement" is difficult to prove, especially since officers who intentionally try to circumvent a federal rule might also perjure themselves. Federal officers need not actually initiate an arrest to circumvent Mallory. Close cooperation might easily keep state officers informed about federal suspects, and individuals wanted by both authorities could be arrested by state officers. Informed of the arrest, federal officers could rely on the state officers to interrogate thoroughly, then make a "routine check," study the interrogation of the suspect, and, if necessary, either request additional interrogation by state officers or interrogate the suspect themselves. Because of the difficulties in proving secret or unspoken agreements between state and federal officers, even the broad construction of Anderson's "working arrangement" could not prevent state and federal cooperation to circumvent Mallory, since federal officers could avoid personally interrogating the suspect, but instead advise state officers about the line of questioning they wish pursued. The defendant might never know federal officers were involved.

Cases decided subsequent to Coppola indicate that the "silver platter" doctrine in the illegal detentions area should be discarded entirely. In the thirty-five months since Coppola there are eight reported cases in which admissions concerning federal crimes were made by prisoners in state de-

\[18\] The rule deters the practice of trying to coerce confessions during long delays behind closed doors by making such confessions inadmissible. In addition, the rule eliminates the difficult problem of litigating what goes on behind the closed doors. See Culombe v. Connecticut, 367 U.S. 568, 573-74 (1961) (opinion of Frankfurter, J.); Ashcroft v. Tennessee, 322 U.S. 143, 152-53 (1944) (dictum).

\[19\] Mallory reduces the number of illegal arrests because an officer is less likely to arrest an offender without probable cause when shortly after the arrest he is required to bring the offender before a magistrate and show probable cause there. See Hogan & Snee, supra note 6, at 22-23.


\[21\] Evidence obtained in these detentions will not contaminate the federal courts to the same extent as evidence unreasonably seized by state officers. While the undesirability of contaminating a federal court was emphasized by Justices Holmes and Brandeis, see Olmstead v. United States, 277 U.S. 438, 485 (1928) (Brandeis, J., dissenting); id. at 470 (Holmes, J., dissenting), the main purpose of an exclusionary rule should not be to keep tainted material out of the courts but to deter improper police conduct, see Mapp v. Ohio, 367 U.S. 643, 648 (1961) (dictum); Elkins v. United States, 364 U.S. 206, 217 (1960) (dictum); Blakey, The Rule of Announcement and Unlawful Entry: Miller v. United States and Ker v. California, 112 U. PA. L. Rev. 499, 552 (1964).


\[23\] The present case may be an example. See instant case at 345.


\[25\] See text accompanying note 10 supra.
attention before any arraignment. For example, in *Sullivan v. United States*, defendant was arrested by state officers who apparently suspected him of a state crime. After confessing to a federal crime during a state detention of uncertain length, defendant entered a guilty plea to the federal offense. The court held that the *Anderson* rule invalidated neither the guilty plea nor the confession upon which it was based. In *Swift v. United States*, state officers arrested defendant after they had reason to know he had committed a federal offense. Defendant was apparently detained in state custody for a period "unnecessary" under the federal standards, but his statements made during that period were admitted against him. In *Evans v. United States*, defendant's statements, made after a period in state custody which was "unnecessary" under the Federal Rules, were admitted against him even though state officers had arrested defendant at the express request of the Federal Bureau of Investigation.

Although the *Anderson-Coppola* rule aids federal law enforcement, *Mallory* assumes that prolonged detentions prior to arraignment are not necessary in federal law enforcement. Since the *Mallory* rule is designed to protect individual rights, it is appropriate for the federal courts to preserve the integrity of that decision. *Killough v. United States*, in which the District of Columbia Circuit held that a confession obtained in violation of *Mallory* and reaffirmed after arraignment but before defendant has consulted with counsel must be excluded from a federal trial,

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26 Evans v. United States, 325 F.2d 596 (8th Cir. 1963); Hutchins v. United States, 322 F.2d 649 (10th Cir. 1963) (per curiam); instant case; Sullivan v. United States, 315 F.2d 304 (10th Cir. 1963); Swift v. United States, 314 F.2d 860 (10th Cir. 1963); Davidson v. United States, 312 F.2d 163 (8th Cir. 1963); Hayes v. United States, 296 F.2d 657 (8th Cir. 1961), cert. denied, 369 U.S. 867 (1962); Reed v. United States, 291 F.2d 856 (4th Cir. 1961). See also Jones v. United States, No. 17688, D.C. Cir., Feb. 6, 1964 (statements given in federal detention immediately following a state detention but before any arraignment); United States v. Long, 323 F.2d 468 (6th Cir. 1963); Cram v. United States, 316 F.2d 542 (10th Cir. 1963); United States v. Sailer, 309 F.2d 541 (6th Cir. 1962), cert. denied, 374 U.S. 835 (1963); United States v. Connell, 213 F. Supp. 741 (D. Mass. 1963) (statements given after state arraignment, but while in state custody and before federal arraignment).

27 315 F.2d 304 (10th Cir. 1963).

28 Id. at 305. But cf. Reed v. United States, 291 F.2d 856 (4th Cir. 1961).

29 314 F.2d 860 (10th Cir. 1963).

30 Accord, Davidson v. United States, 312 F.2d 163 (8th Cir. 1963); see Hayes v. United States, 296 F.2d 657 (8th Cir. 1961) (same except unclear whether or not the state detention was illegal by federal standards). But see Reed v. United States, 291 F.2d 856 (4th Cir. 1961) (statement made to federal officer during state detention may violate *Anderson*; guilty plea invalidated because not voluntary).

31 325 F.2d 598 (8th Cir. 1963).

32 See instant case at 352.

33 No part of the criminal law of any state or of the federal government provides for a period of questioning of a suspect by police officers after his arrest. See Hogan & Snee, supra note 6, at 23-24. However, Uniform Arrest Acr § 2 provides for a two hour "detention" period preceding a technical arrest. The constitutionality of the provision has not yet been tested.


35 315 F.2d 241 (D.C. Cir. 1962).

36 The federal officer admitted that he was trying to circumvent *Mallory*. See id. at 242.
closed one avenue by which Mallory can be circumvented.37 A rule which excludes from federal courts admissions obtained in state detentions which would violate federal standards appears necessary to block off a much wider avenue.

**FEDERAL COURTS—CONVEYANCE TO NONRESIDENT RELATIVE PRIOR TO LAND CONDEMNATION PROCEEDINGS GAINS FEDERAL DIVERSITY JURISDICTION DESPITE ASSIGNEE’S PROMISE TO PAY LITIGATION PROCEEDS TO ASSIGNORS**

A family-owned Alabama corporation transferred land to its several shareholders as tenants in common. All but one of the shareholders resided in Alabama. The share of the property received by each shareholder was in proportion to his ownership in the corporation. About three months later, the city council passed a resolution to condemn part of the land transferred. However, three days before the city instituted suit in a state court,1 the resident defendants assigned for one dollar consideration their interest in the land to the nonresident defendant for the express purpose of creating diversity jurisdiction. The defendants agreed that the assignee would divide the entire condemnation award among the resident defendants according to their former interest in the property. After the nonresident defendant removed the case to a federal district court by alleging diversity jurisdiction,2 the city moved for remand3 to the state court by alleging that the jurisdiction had been collusively obtained.4 The district court assumed jurisdiction, however, holding that one dollar consideration was sufficient to support the transfer of the land under Alabama law and that the motive for the assignment was irrelevant to federal diversity jurisdiction.5 City of Eufaula v. Pappas, 213 F. Supp. 749 (M.D. Ala. 1963).

37 Cf. Reed v. United States, 291 F.2d 856 (4th Cir. 1961).

1 Brief for Plaintiff, p. 2, instant case.
3 28 U.S.C. § 1447(c) (1958) requires that a federal court to which a suit has been removed must remand the suit to the state court if at any time before final judgment it appears that the suit was not removable under 28 U.S.C. § 1441 (1958).
5 The city raised another objection to diversity jurisdiction. It alleged that easements and an undefined portion of the condemned land, which were owned by other residents, were inseparable from the interests of the defendants and would preclude removal based on diversity jurisdiction. The judge, however, ruled that the cause of action stated against the removing defendant was "separate and distinct" from those stated against the other interests. Instant case at 752. The test applied by the judge is no longer in effect. The present removal statute requires a finding that the cause of action stated against the removing party be "separate and independent" from those stated against the nonremovable interests. 28 U.S.C. § 1441 (c) (1958), American Fire & Cas. Co. v. Finn, 341 U.S. 6 (1951). See generally 1A Moore, Federal Practice ¶¶ 0.162, 0.163 (2d ed. 1961).
Had the transfer among the defendants not occurred, none of them would have had any basis for obtaining diversity jurisdiction. Since diversity jurisdiction requires complete diversity of citizenship between all defendants and all plaintiffs, the resident defendants could not have removed the case to a federal court. The nonresident defendant alone could not have removed for two reasons. The value of her interest in the land was probably insufficient to meet the minimum value in controversy necessary to invoke diversity jurisdiction. In addition, section 1441(c) of the Judicial Code authorizes removal of cases involving more than one defendant from state courts only if the plaintiff's cause of action against the removing defendant would be removable if sued upon alone and if it is "separate and independent" from the cause of action against other defendants with nonremovable interests. Since the nonresident defendant owned an undivided interest in the land, and other undivided interests were owned by residents, removal would be precluded.

Section 1359 prohibits federal courts from assuming diversity jurisdiction when "any party, by assignment or otherwise, has been improperly or collusively made or joined to invoke the jurisdiction of such court." Since the nonresident defendant owned an interest in the land before the transfer, the words "made or joined" do not literally apply to the present case. The transfer did not "join" the nonresident as a party since she already was one; she was "made" a party only to the extent that the transfer enabled her to seek federal removal jurisdiction based on diversity of citizenship.

In analogous cases concerning transfers by resident parties to nonresidents who did not previously own an interest in the transferred property, courts have developed certain criteria to determine the effect of the transfer on jurisdiction. Section 1359 has been construed to deny jurisdiction when the resident retained a significant interest in the outcome of the

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6 The party invoking federal diversity jurisdiction must allege, and if challenged must prove, the existence of diversity jurisdiction. E.g., McNutt v. General Motors Acceptance Corp., 298 U.S. 178 (1936); Bradbury v. Dennis, 310 F.2d 73 (10th Cir. 1962), cert. denied, 372 U.S. 928 (1963); Steinberg v. Toro, 95 F. Supp. 791 (D.P.R. 1951).


8 Three months before the present action, the 100 acres, which included the condemned land, was valued at $60,000 for the purposes of the state transfer tax. An eight-acre portion of the condemned tract, included in the condemnation order, was optioned to another party for $16,000. Brief for Plaintiff, p. 2. These figures indicate that the nonresident's one-twelfth interest in the 35.9 acres condemned probably was not worth the $10,000 required for diversity. See 28 U.S.C. §§ 1332, 1441 (1958).


10 See, e.g., Bellaire v. Baltimore & O.R.R., 146 U.S. 117 (1892); Torrence v. Shed, 144 U.S. 527 (1892); Rosen v. Rozan, 179 F. Supp. 829 (D. Mont. 1960). Although the first two cases were decided before 28 U.S.C. § 1441(c) was enacted, their authority is unimpaired because § 1441(c) reduced the scope of removal jurisdiction. See American Fire & Cas. Co. v. Finn, supra note 9.

litigation. Evidence of control over the property by the assignor after its assignment is a strong indication that he has retained such a significant interest. Not only did the present assignors retain a significant interest in the outcome of the litigation, but some testimony, as well as the family relationship between the assignors and assignee, indicates that the assignee may not have been free to dispose of the property or otherwise treat it as her own rather than defend the suit.

Despite these factors, the present court assumed jurisdiction in part because nominal consideration supported the transfer to the nonresident.

Thus, if the legal title in bonds is assigned to a nonresident for the purpose of collection by suit in a federal court and equitable title is retained by the assignor, jurisdiction will be denied when the assignee attempts to sue the resident debtor in a federal court. E.g., Woodside v. Beckham, 216 U.S. 117 (1910); Waite v. Santa Cruz, 184 U.S. 302 (1902); Bernards Township v. Stebbins, 109 U.S. 341 (1883); Birkins v. Seaboard Serv., 96 F. Supp. 245 (D.N.J. 1950); see Barney v. Baltimore City, supra.

If the purchase price of the property depends on the outcome of the anticipated litigation, jurisdiction will also be denied. Cf. Little v. Giles, 118 U.S. 596, 603-07 (1886); Farmington v. Pillsbury, supra. The same result obtains when the assignee promises to reconvey the property after the owners' rights have been established in a federal court. See Miller & Lux, Inc. v. East Side Canal & Irr. Co., 211 U.S. 293 (1908); Lehig Mining & Mfg. Co. v. Kelly, supra; Barney v. Baltimore City, supra.

Jurisdiction has also been denied when the legal relationship between the parties permitted the assignor to acquire the benefits of the litigation without payment of consideration, although the terms of the assignment indicated that full legal and equitable title passed to the assignee. This situation occurs when a resident corporation assigns property to a nonresident subsidiary for the purpose of creating diversity jurisdiction. Compare Miller & Lux, Inc. v. East Side Canal & Irr. Co., supra, with Black & White Taxicab & Transfer Co. v. Brown & Yellow Taxicab & Transfer Co., 276 U.S. 518 (1928) (assumed jurisdiction because the parent had dissolved), and Bradbury v. Dennis, 310 F.2d 73 (10th Cir. 1962), cert. denied, 372 U.S. 928 (1963) (transfer to sole stockholder).

Diversity jurisdiction will also be denied when the evidence shows that the asserted assignment was a sham or when the assignee never intended to pay the stated consideration or take title to the property. E.g., Southern Realty Inv. Co. v. Walker, 211 U.S. 603 (1909); Lake County Comm'r's v. Dudley, 173 U.S. 243 (1899); Steinberg v. Toro, supra.


14 On direct examination of Gregory Pappas, one of the resident assignors, the following testimony indicates that the residents may not have yielded all control over the property with the transfer:

Q. Is she [nonresident assignee] free to convey the property now if she wanted to?
A. No.
Q. Well, I mean is the record title in—-is the title to the property in her?
A. Yes, sir.

Record, p. 4.

15 The court held that, under Alabama law, the recitation of $1.00 nominal consideration is sufficient to transfer the legal as well as the equitable title to the property.
Although the absence of valuable consideration has never been a sufficient ground for denial of diversity jurisdiction, its presence tends to establish a bona fide transfer and divestment of interest and control in the property by the resident assignor. Its absence in the present case, however, adds to the apparent collusion shown by the agreement to distribute the litigation proceeds.

The present court also cited *Cross v. Allen,* in which a resident partnership conveyed land to a nonresident partner so that suit could be brought in a federal court. Upholding diversity jurisdiction, the Supreme Court emphasized that the motive behind the transfer was unimportant because the resident partnership had received full consideration for the land and had relinquished its interest in the property. Since both these factors are absent in the present case, it seems apparent that *Cross v. Allen* is not authority for upholding jurisdiction; on the contrary, it suggests that jurisdiction should have been denied. Moreover, other courts have suggested that motive is a relevant consideration when the transferor retains a significant interest in the property.

The present holding also renders ineffective section 1441(c) by permitting the resident defendant to assign his interest to the nonresident defendant, thus allowing the nonresident defendant to remove to a federal court a claim not "separate and independent" from that against the resident.

Crosby v. Baldwin County, 227 Ala. 122, 148 So. 814 (1933); Stewart v. Stewart, 171 Ala. 485, 54 So. 604 (1911). The grantor cannot recover the land even if the stated consideration was never paid provided there is neither fraud nor duress. Wilfe v. Waller, 261 Ala. 436, 74 So. 2d 451 (1954); Stewart v. Stewart, supra.

Diversity jurisdiction was upheld when a resident assigned his interest in bonds issued by his state to a resident of another state as a gift so that the assignee could use the federal courts to establish the validity of the assigned bonds, as well as similar bonds held by the assignor. South Dakota v. North Carolina, 192 U.S. 286 (1904); see Peterson v. Sucro, 93 F.2d 878 (4th Cir. 1938); Woodside v. Ciceroni, 93 Fed. 1 (9th Cir. 1899); Benedict v. Seiberling, 17 F.2d 841 (N.D. Ohio 1927).

See Barney v. Baltimore City, 73 U.S. (6 Wall.) 280 (1867); Bradbury v. Dennis, 310 F.2d 73 (10th Cir. 1962), cert. denied, 372 U.S. 928 (1963); Board of Educ. v. James, 49 F.2d 91 (10th Cir. 1931); O'Neill v. Wolcott Mining Co., 174 F.2d 527 (8th Cir. 1909); Hartmann Coal Mining Co. v. Hoke, 157 F. Supp. 313 (E.D. Pa. 1957).

141 U.S. 528 (1891).


The present court quoted the following passage from *Cross v. Allen, 141 U.S. 528, 533 (1891):*

The transfer of the notes and mortgages having been made for a valuable consideration, and the pecuniary interest of the transferrer in the subject matter of the transfer having thereby terminated, it makes no difference that by such transaction the transferee acquired the advantage of suing in the Federal Court. This suit, so far as the record shows, is for the sole and exclusive benefit of the complainant [nonresident].

Instant case at 751. (Emphasis added.)

See Black & White Taxicab & Transfer Co. v. Brown & Yellow Taxicab & Transfer Co., 276 U.S. 518 (1928) (dictum); Bradbury v. Dennis, 310 F.2d 73 (10th Cir. 1962) (dictum), cert. denied, 372 U.S. 928 (1963); Tower Realty Co. v. City of Detroit, 185 F.2d 590 (6th Cir. 1950).
CASE COMMENTS

1964]

defendant. It thus seems clear that section 1359 should deny jurisdiction in the present case even though the transferee owned an interest in the property prior to the transfer.

The statutory history of section 1359 indicates that this fact should not affect the outcome. The section arose out of the 1948 revision of the Judicial Code to replace two preexisting statutes. One, the assignee clause, provided that:

No district court shall have cognizance of any suit (except upon foreign bills of exchange) to recover upon any promissory note or other chose in action in favor of any assignee, or of any subsequent holder if such instrument be payable to bearer and be not made by any corporation, unless such suit might have been prosecuted in such court to recover on said note or other chose in action if no assignment had been made.

This clause was designed to prevent the manufacture of diversity jurisdiction by assignment. The courts, however, interpreted the phrase "promissory note or other chose in action" as not applicable to obligations implied in law, assignments by operation of law, and assignments of real property interests as in the present case; the statute itself is explicitly inapplicable to corporate bearer paper and foreign bills of exchange. These exceptions, which weakened the prophylactic effect of the section, and its inclusion of bona fide purchasers for value of nonexcepted obligations, induced the revisers to drop the assignee clause and replace it with section 1359. Thus, the history behind the revised section suggests that it was designed to expand the exclusionary effect of the assignee clause to cover assignments to which it was previously inapplicable, such as land transfers, which do not involve a bona fide purchaser for value. Significantly, there is no bona fide purchaser for value in the present case.

The other statute previously governing denial of jurisdiction was section 80 of the 1940 Judicial Code which required district courts to deny jurisdiction of "such suit [which] does not really and substantially involve a dispute or controversy properly within the jurisdiction of said district court, or . . . [if] the parties to said suit have been improperly or collusively made or joined, either as plaintiffs or defendants, for the purpose of creating a case cognizable or removable under this chapter . . . ."

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22 See note 9 supra and accompanying text.
26 Ibid.
28 Act of May 3, 1911, ch. 231, §37, 36 Stat. 1098.
The revisers decided to eliminate the first part of section 80, involving dismissal of cases not properly within the court's jurisdiction, as unnecessary because "any court will dismiss a case not within its jurisdiction . . . ." 29 They also decided that the second part of section 80 dealing with assignments was sufficient to preclude jurisdiction when "the assignment is improperly or collusively made to invoke [federal] jurisdiction." 30 Therefore, they reenacted the second part of section 80 in substantially the same language and did not reenact any other portions of the other two sections dealing with the denial of diversity jurisdiction.

This history indicates that section 1359 should defeat jurisdiction in the present case. The court could have held that, although the nonresident had previously been a party, she was "improperly or collusively made" the sole party by the transfer for the express purpose of enabling her to seek removal of the case to federal court. This construction is supported by the statutory history.

In the alternative, the court could have taken the revisers literally and dismissed the suit as not really and substantially involving a dispute or controversy properly within the jurisdiction of a federal court since the suit was, in reality, that of the resident parties who will receive payments directly based on an award made in a federal court.

TAXATION—COMMISSIONER REFUSES TO REVOKE DIOTUM DENYING DEDUCTION FOR CHARITABLE REMAINDERS WHENEVER PAYMENT OF MUTUAL FUND CAPITAL GAIN DISTRIBUTIONS TO LIFE TENANT IS POSSIBLE

When a trust provides for income to a noncharitable life tenant and remainder to charity, the value of the remainder at the time of the trust's inception is generally deductible for federal income, estate, and gift tax purposes. 1 Revenue Ruling 60-385 2 held that the deduction would be allowed when the instrument creating such a trust provides "that the corpus may be invested in stock of regulated investment companies, and that [capital gain] dividends [therefrom] . . . be treated as corpus . . . ." Reversing his previous position, 3 however, the Commissioner stated in dictum that "if the trust instrument provides that [capital gain] dividends

29 H.R. REP. No. 308, at A125.
30 Id. at A126.

2 1960-2 CUM. BULL. 77 [hereinafter referred to as present ruling].
3 Rev. Rul. 55-620, 1955-2 CUM. BULL. 56, held that "the present worth of the remainder interest . . . . is deductible . . . . irrespective of whether the [capital gain] dividends . . . . are distributed as income . . . . or added to the corpus . . . . ."
shall (or, in the trustee's discretion, may) be treated as income or if the instrument could be so construed."

On behalf of the Corporate Fiduciaries Association of Philadelphia, counsel requested revocation of the ruling, contending that mutual fund capital gain distributions are clearly income and that payment of them to the life tenant does not render the value of the remainder uncertain.

The Commissioner conceded that the nature of capital gain dividends was doubtful, but denied the request, stating that revocation "would have to be based on a clear finding that . . . [they] are income and not principal." Private Letter Ruling From Internal Revenue Service to Kenneth W. Gemmill, Oct. 25, 1963.

The Regulations provide that a deduction for a charitable remainder may be taken only insofar as the charitable interest is "presently ascertainable." Litigation concerning this requirement has been confined largely to cases in which the trust instrument provided that corpus might, under certain circumstances, be invaded for the benefit of the life tenant. Since, in such cases, the instrument itself evidences an intent, or at least a willingness, that the charitable interest be diminished or defeated, the burden of overcoming this evidence properly has been placed on the taxpayer. Unless the possibility of invasion "is so remote as to be negligible," the charitable deduction will be denied or reduced by the extent to which the power to invade may be exercised. However, a prompt and irrevocable disclaimer by the beneficiary of a power to invade will preserve at least

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4 Present ruling (dictum).
5 Memorandum on Behalf of Corporate Fiduciaries Association of Philadelphia From Kenneth W. Gemmill & George Craven to Internal Revenue Service, January 25, 1963, on file in the Biddle Law Library [hereinafter referred to as memorandum].
6 On file in the Biddle Law Library [hereinafter referred to as letter].
7 (a) Remainders and similar interests. If a trust is created . . . for both a charitable and a private purpose, deduction may be taken of the value of the charitable beneficial interest, only insofar as that interest is presently ascertainable, and hence severable from the noncharitable interest. The present value of a remainder . . . is to be determined in accordance with the rules stated in §20.2031-7. Treas. Reg. §20.2055-2(a) (1958) (estate tax). The Gift Tax Regulations contain a similar provision. Treas. Reg. §25-2522(a)-2(a) (1958). The Income Tax Regulations merely provide that a "remainder interest shall be valued according to the tables [of §20.2031-7] . . . ." Treas. Reg. §1.170-1(d) (1958).
9 Even a remote possibility that the corpus can be invaded without limitation has destroyed the deduction. Henslee v. Union Planters Nat'l Bank & Trust Co., 335 U.S. 595 (1949). The standard has been criticized as being too severe. See Merchants Nat'l Bank v. Commissioner, supra note 8, at 263 (Douglas, J., dissenting); Henslee v. Union Planters Nat'l Bank, supra at 600 (Frankfurter, J., dissenting).
11 Ibid.
the estate tax deduction. The present ruling attaches to the mere possibility of payment of mutual fund capital gain dividends to the life tenant the identical consequences that flow from an unlimited power to invade the corpus.

Assuming arguendo that such payments constitute a diversion of the trust corpus, delineation of the proper scope of the present ruling presents a serious problem. It clearly applies to trusts requiring or expressly permitting investment in mutual fund shares, and does not apply when the instrument excludes mutual funds as permissible investments. But when the instrument makes no reference to mutual funds, the trust would seem to be one in which "the corpus may be invested in stock of regulated investment companies," unless the applicable state law excludes them from the list of permissible trust investments. Thus, except in the relatively few states requiring addition of mutual fund capital gain dividends to corpus, the charitable deduction would be denied. This seems a harsh penalty for the mere omission of provisions which might appear irrelevant to the draftsman when mutual fund investments were not contemplated. On the other hand, if the ruling is not applied to trusts in which mutual funds are unmentioned, the charitable deduction could be obtained despite the fact that capital gain distributions from subsequently acquired mutual fund shares might be paid to the life tenant. The trustee's agreement either to refrain from purchasing mutual fund shares or to allocate capital gain distributions to corpus, or the life tenant's disclaimer of any interest in such distributions, would operate as a "complete termination of a power to consume." Therefore, the Commissioner could achieve uniform results without undue harshness by applying the ruling only to trusts contemplating mutual fund investments and, in other cases, by requiring such an agreement or disclaimer as a condition of deductibility.


Although the present ruling was prospective in effect, applying only to trusts taking effect after January 1, 1961, it necessitates review of all wills of living testators creating trusts with charitable remainders. Memorandum, p. 3.

BOGERT, TRUSTS § 105, at 280 (4th ed. 1963) [hereinafter cited as BOGERT], notes a recent tendency to include mutual funds in statutory lists as valid trust investments.


The Commissioner shows concern for uniformity when he says, "since State rules differ, we have the difficult task of deciding what are the demands made on us in administering the tax law with uniformity, and to what extent we can justify allowing equal deductions for unequal rights." Letter, p. 3.

The Commissioner suggests the "possible publication of a clarifying ruling at some future date, which may also cover areas to which Revenue Ruling 60-385 is not to be applied." Letter, p. 4. (Emphasis added.)
The basic question remains as to whether a trust which holds or contemplates holding mutual fund shares and requires allocation of capital gain dividends to the life tenant should, within the framework of the Regulations, be denied a deduction. The Commissioner did not rule that such dividends clearly were capital, but based disallowance of the deduction on the proposition that they are not clearly income. The search for a clear definition is inevitably doomed to failure. State courts which have considered the question have almost uniformly required that mutual fund capital gain dividends be paid to the income beneficiary; a few statutes and the revised *Uniform Principal and Income Act* provide that they be added to corpus. These decisions and statutes, however, decide only to whom the distributions shall be paid in the absence of contrary directions. When expressed, the settlor's intent controls. As a practical matter, the intent of the settlor of a charitable remainder trust is, in most cases, to provide the life tenant, usually himself or a member of his family, with the maximum income consistent with obtaining a tax deduction for the contribution or bequest. To implement that intent, he would undoubtedly choose, or desire that the trustee choose, investments offering a generous return in preference to those which sacrifice current income for maximum

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20 The case in which the instrument requires allocation to the life tenant is obviously the strongest. The instrument may direct the trustee to use his discretion, or it may say nothing, in which event the trustee may be permitted or required to allocate such dividends to the life tenant under the governing state law. The case in which the settlor leaves the trustee no alternative may be distinguishable. See note 55 infra and accompanying text.

21 For a lively debate on the subject by two authorities in the field of trust law see Shattuck, *Capital Gain Distributions—Principal or Income?*, 88 Trusts & Estates 160 (1949); Young, *A Dissent on Capital Gain Distributions*, 88 Trusts & Estates 292 (1949); Shattuck, *Further Comment on Capital Gain Distributions*, 88 Trusts & Estates 420 (1949); Young, *More About Capital Gains*, 88 Trusts & Estates 467 (1949). Shattuck takes the position that a mutual fund share represents an undivided interest in a pool of assets and that the gain retains the character it would have if the stockholder owned the underlying asset himself. Young maintains that it is a share in a corporation devoted to buying and selling securities at a profit and that the distribution is merely passing the profit on to the shareholder. Basically, all arguments proceed from one of these two assumptions.


23 See statutes cited note 16 supra.

24 Revised Uniform Principal and Income Act § 6(c) [hereinafter cited as Uniform Act].

25 Uniform Act § 2(a)(1); Boget § 109; 3 Scott, Trusts § 236.15 (2d ed. 1956).

26 While it might be assumed that the settlor intended increased benefits for the charity, it would be unrealistic to imply an intention to benefit the Government. Thus, if the income were greater than the anticipated needs of the life tenant, additional charitable contributions could be made out of that income and additional tax deductions realized therefrom.
safety or the opportunity for capital enhancement. A reasonable discretion in the choice of investments has not heretofore been equated with a permission to invade the corpus.

Mutual fund shareholders generally may elect to accept capital gain distributions in either cash or additional fund shares. In the subjective view of the investor, an election to take cash is not a decision to deplete his capital, but rather a choice of an investment offering an ample current return in preference to one affording more modest income and planned capital enhancement. It is not significantly different from selecting a corporate stock yielding five percent rather than the stock of another corporation, yielding less than three percent, with a policy of financing growth through planned reinvestment of earnings. While the immediate and

27 For an excellent summary of current views on trust investments see Jennett, Changing Concepts of Trust Investments, 94 TRUSTS & ESTATES 843 (1955).

28 A charitable remainder has been held to be presently ascertainable and, hence, deductible even when the trust investments could be chosen by the life tenant who presumably would exercise his power to maximize current income, the court implying a duty to protect the integrity of the principal. "Nothing . . . discloses an uncertainty except the possibility that the securities could not survive . . . the exercise . . . [of the life tenant's] reasonable discretion in changing investments. Such a possibility of disappearance of the corpus is too remote to defeat the deduction." Estate of Smith v. Commissioner, 46 B.T.A. 337, 343 (1942), rev'd on other grounds sub nom. Worcester County Trust Co. v. Commissioner, 134 F.2d 578 (1st Cir. 1943).

It is doubtful that the Commissioner would acquiesce in such a decision today. The Regulations deny deduction of a charitable income interest when the trust assets consist of stock in a corporation the fiscal policies of which are controlled by private remaindermen. Treas. Reg. §§20.2055-2(b), 25.2522(a)-2(b) (1958). By analogy, it would seem reasonable to deny deduction of a charitable remainder interest when the trust held stock in a corporation controlled by the private income beneficiary. An extension of this rationale would indicate that unfettered control of investment policy by the life tenant is inconsistent with his fiduciary responsibility to the remainderman.

29 The great popularity of mutual fund shares—assets increased from $2.5 billion in 1941 to $29 billion in 1961, 27 SEC ANN. REP. (1960-1961)—is generally attributed to the advantages of diversification and professional management. Another significant appeal is the flexible distribution arrangement which enables an investor to "tailor" his fund investment to his personal objectives. A typical fund offers three options: (1) all distributions in cash, (2) income dividends in cash and capital gain distributions in stock, and (3) all distributions in stock. Wellington Fund, Prospectus, April 1, 1963 (Supp. Oct. 21, 1963), p. 2.

30 "[I]nvestors in such trusts count on [capital gain] distributions as income . . . . Recent statistics show that . . . [income] distributions . . . are about 2.8% . . . [and] capital gain distributions . . . about 2.3%, so that to procure for the investor a satisfactory yield both distributions would have to be regarded as income." Bogert §115, at 306.

31 normally, the investor's choice would be between the shares of different corporations. Occasionally, corporate dividend policy may provide a similar flexibility. For example, Georgia Pacific Corp., whose shares now sell for about $55, pays a quarterly dividend of $3? in cash and 1% in stock. A stockholder who sells the stock dividends as he receives them has a 6% investment; one who retains them has a 2% investment with greater growth potential.
temporary effect of the present ruling may be to collect additional tax from
unwary or ill-advised taxpayers or their estates, its ultimate effect, by
requiring the addition of capital gain dividends to corpus as a condition of
deductibility, will be the elimination of mutual fund shares from charitable
remainder trust portfolios and the substitution of other high-yielding
securities the distributions from which will be unambiguously defined as
income. Since the price of common stocks frequently reflects expectations
of capital enhancement, the probable tendency will be toward bonds and
preferred stocks with little or no chance for capital growth. In an infla-
tionary environment this will result in the erosion of the purchasing power
of the charitable interest, even if the dollar value is maintained.

It would be unrealistic to permit deduction of charitable remainders
whenever the trust instrument does not expressly authorize invasion of the
corpus; some allocations of trust receipts, such as payment of the total
proceeds of an annuity contract to the life tenant, obviously constitute a
de facto depletion of the principal. The problem is to distinguish the
trust which contemplates only reasonable investment discretion consistent
with its legitimate purpose from that which is designed to defeat or diminish
the charitable interest or, "by reason of all the conditions and circum-
stances," is likely to have that effect. The Commissioner's definitional
test that all distributions to the life tenant be "clearly income" has three
serious drawbacks. It imposes an impossible burden of proof on the tax-
payer—it implies, for example, that a deduction for a charitable income
interest in a trust requiring allocation of mutual fund capital gain dividends
to corpus would be disallowed on the grounds that such dividends were not
"clearly capital." Also, it unduly restricts investment flexibility—a logical
extension of its rationale would reach stock dividends, subscription rights,
and other corporate distributions which have ambivalent characteristics,
thus effectively excluding from charitable remainder trust portfolios shares
in corporations which regularly make such distributions in lieu of cash
dividends. Finally, it fails to reach other common allocations which result

\[32\text{Insofar as the ruling results in allocation of capital gain dividends to corpus}
when they might otherwise have been paid to the life tenant its effect will be to
reduce income tax revenues.}\]

33 See Bogert §105, at 280. "If . . . capital gains distributions . . . are to
be allocated to the capital . . . there would seem to be . . . a violation of the
duty of impartiality by the trustee . . . since he is taking a sub-normal income for
the purpose of securing additions to the capital . . . ." Since the promulgation
of the present ruling, it is the practice for draftsmen, as a matter of convenience, to
exclude mutual funds as permissible trust investments or to provide that capital gain
dividends shall be credited to principal. Interview With George Craven, Esq., in

34 See statistics tabulated in note 52 infra.

35 Other examples of "wasting property" are copyright and patent rights, claims
for renewal commissions, or a landlord's interest in a favorable lease. See Uniform
Act §11; Bogert §122.


37 Proper allocation or apportionment of such distributions has frequently been
the subject of litigation and comment. See Uniform Act §6; Bogert §§115-17; 112

38 See note 31 infra. Another unusual example is Citizens Utilities Corp. which
has two classes of common stock, class A paying only stock dividends and class B
paying the equivalent amount in cash.

\[34\text{See statistics tabulated in note 52 infra.}\]

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for renewal commissions, or a landlord’s interest in a favorable lease. See Uniform
Act §11; Bogert §122.}\]

\[36\text{Treas. Reg. §§20.2055-2(b), 25.2522(a)-2(b) (1958).}\]

\[37\text{Proper allocation or apportionment of such distributions has frequently been
the subject of litigation and comment. See Uniform Act §6; Bogert §§115-17; 112
U. Pa. L. Rev. 290 (1963) (particularly regarding stock dividends).}\]

\[38\text{See note 31 infra. Another unusual example is Citizens Utilities Corp. which
has two classes of common stock, class A paying only stock dividends and class B
paying the equivalent amount in cash.}\]
in capital depletion—rents from depreciable real estate, \(^{30}\) interest from bonds purchased at a premium, \(^{40}\) and corporate cash dividends in excess of current earnings \(^{41}\) are all items which are customarily regarded as "clearly income"; yet a trust invested entirely in such assets and requiring allocation of all receipts to the life tenant would evidence an unmistakable intent to afford him with an above-average income at the expense of the corpus. \(^{42}\) A deduction for the remainder interest in such a trust would seem properly denied or reduced since the actual subject matter of the deduction is the property that the charity will ultimately receive. \(^{43}\)

A more meaningful approach would avoid a seemingly futile attempt to categorize the distributions and, instead, analyze the character of the assets which the instrument contemplates will remain in the trust after the distributions have been made. Then, assuming future price stability, a determination should be made as to whether it is reasonably probable that the value of these assets will be diminished by the time the remainderman takes. \(^{44}\) The suggested standard of reasonable probability, although different from the "remote possibility" standard applied when the trust instrument expressly provides for invasion of corpus, \(^{45}\) is already embodied in the Regulations through the use of the valuation tables. \(^{46}\) The validity of these tables as a device to determine the present value of a future interest

\(^{30}\) Uniform Act § 3(a)(1) defines rent as income, but § 13(a)(2) suggests that depreciation be deducted. "[B]y the weight of authority a trustee is not allowed or required to follow this procedure." Bogert § 114, at 300.

\(^{40}\) Uniform Act § 7(a) does not require amortization of bond premiums. The rationale that premiums and discounts would "wash out" is inapplicable when the trust assets consist only of bonds inventoried at higher than redemption value or when the trustee is directed to purchase only bonds selling at a premium. See Bogert § 113.

\(^{41}\) Uniform Act § 6(d) seems to indicate that all cash dividends are income unless designated as liquidating dividends pursuant to § 6(b)(3).

\(^{42}\) In another ruling dealing with allocation of receipts in a charitable remainder trust, the Commissioner has held that no deduction will be allowed for "a remainder in subsurface [mineral] rights . . . where there is no provision for withholding and adding to corpus such reserves for depletion . . . as are adequate, according to accepted accounting and engineering principles, to maintain the corpus intact . . . ." Rev. Rul. 60-162, 1960-1 Cum. Bull. 376. The crucial factor distinguishing that ruling from the present ruling is that, in the case of depletable natural resources, well-established principles require apportionment in order to preserve the integrity of the remainder interest. Uniform Act § 9 suggests apportionment. See Bogert § 122.

\(^{43}\) The Regulations make no reference to the character of the distributions but require only that the value of the remainder be ascertainable. See Treas. Reg. § 20.2055-2(a) (1958), quoted in note 7 supra.

\(^{44}\) It is not suggested that such a determination is free from difficulty; but some reasonable assumptions can be made. For example, property subject to physical depreciation or depletion, in the absence of appreciation in real estate values, would clearly be worth less. Compare Rev. Rul. 60-162, 1960-1 Cum. Bull. 376. Bonds should approach their face value as maturity nears; shares of common stock, in the absence of special information about particular corporations, would have to be assumed to retain their current market value. In a mutual fund, where the value is directly related to the value of the underlying assets, the character of those assets should be examined.

\(^{45}\) See notes 8-11 supra and accompanying text.

rests on three probabilities—the life expectancy of the income cestui, a constant interest rate (now three and one-half percent), and the constant value of a trust corpus consisting of either "money or property." There is certainly more than a remote possibility that the income beneficiary will outlive his expectancy, that interest rates will rise, or that the trust property, whether it be stocks, bonds, or real estate, will decline in value.

Judged by this standard it is doubtful that the present ruling should be retained. It is improbable, in a period of known price stability, that independent mutual fund managements whose compensation is based on a percentage of total fund assets would, contrary to their own interest, realize capital gains, distribute them to shareholders, and thus deplete the asset value of the shares. It would be far more likely that they would either avoid realizing gains or seek to realize offsetting losses thus maintaining their compensation base and, consequently, the intact value of the shareholders' investment. Past experience has shown that the net asset value of mutual fund shares, the property that would remain in the trust corpus, compares favorably with the value of other available investment media. It

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47 Probability at the time the trust takes effect governs even if subsequent events establish certainty. Ithaca Trust Co. v. United States, 279 U.S. 151, 155 (1929). Despite differences in the actuarially determined life expectancy of men and women, the valuation tables do not distinguish on the basis of the sex of the life tenant.


51 Since the market price of shares in open-end funds is determined solely by their net asset value, a distribution necessarily reduces the market value. The market price of shares in closed-end funds must, for the purposes of this analysis, be assumed to vary directly with the value of the fund's underlying assets.

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<th>Year</th>
<th>Mutual Funds</th>
<th>Indust. Stocks</th>
<th>Utility Stocks</th>
<th>Rail Stocks</th>
<th>Corp. Bonds</th>
<th>U.S. Bonds</th>
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In all indices, 1954 = 100. Mutual Fund index represents the weighted average of the year-end net asset values of Wellington Fund, Affiliated Fund, and Massachusetts Investors Trust. Stock indices are the Dow Jones year-end values. Bond indices are closing Standard & Poor's indices for high grade bonds and U.S. Government long term bonds.

Despite the fact that all three mutual funds involved distributed realized capital gains to their stockholders in every year during this period, the overall performance throughout the period was exceeded only by the utility and industrial stocks. In only one year was the mutual fund index lower than its 1954 value, while the rail stock index was below 100 in four subsequent years and neither bond index ever attained its initial level. The mutual fund index suffered a year-to-year decline only three times while the rail stock index declined in five years and both bond indices during six. Performance correlates quite closely with the industrial stock index with the total appreciation being about half in percentage.
is possible that a given mutual fund management might adopt a planned program of asset depletion by realizing gains, distributing them to shareholders, and retaining only depreciated investments in the fund. The shares in such a fund would become an inappropriate trust investment; but this is equally true of the shares of any corporation which embarked on a program of asset disposal and distribution of dividends in excess of current operating earnings. Unless the trust instrument otherwise provided, there would be an implied duty for the trustee either to dispose of such shares or to apportion the dividends between the life tenant and the remainderman. It would be entirely reasonable for the Commissioner to require an express statement of this duty in every charitable remainder trust as a condition of deductibility, but it is difficult to justify his present position which implies that such a statement is unnecessary when the trust may not hold mutual fund shares and inadequate when it may.

Both the present ruling and Revenue Ruling 60-162 indicate the Commissioner's concern that a charitable remainder trust may be used as a vehicle to obtain tax deductions while indirectly defeating the charitable interest, thereby circumventing Congress' purpose to tax private income, bequests, and gifts. If comprehensive standards to prevent such abuse are required, however, they should not restrict reasonable investment discretion, nor discriminate among available investment media. Furthermore, unless the instrument, the identity of the trustee, or other "conditions or circumstances" suggest a reasonable probability that the value of the assets in the corpus will be reduced, there should be a presumption that the trust will be administered in accordance with established fiduciary principles to protect the separate interest of the charitable remainderman. The adoption of unreasonable or overly restrictive standards may have the effect of frustrating Congress' equally manifest purpose to encourage, through the medium of tax deductions, charitable gifts and bequests.


54 The Commissioner points out, to support his position, that mutual fund capital gain "distributions may be and frequently are paid during a decline in portfolio values, and are not limited by the amount of the decline . . . ." Letter, p. 3. In an ordinary corporation, prudent management may preclude dividend payments in excess of current earnings, except as a temporary measure; but there are no reasons why they could not make such payments.

55 See Bogert §§ 108, 122. Insofar as a trust instrument which requires investment in mutual fund shares and allocation of all distributions to income may be construed to relieve the trustee of this duty, the present ruling is correct. See note 20 supra.

