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Notes

NOTES

ADMIRALTY—STATUTES IN DEROGATION OF COMMON LAW CONSTRUED STRICTLY—AGENCY—AGENT NOT ENTITLED TO PERSONAL IMMUNITIES OF PRINCIPAL—STEVEDORE COMPANY COULD NOT CLAIM PROTECTION OF LIMITATION OF LIABILITY PROVISION OF CONTRACT WHICH DID NOT EXPRESSLY OPERATE TO ITS BENEFIT.—The instant case,[1] decided by the Supreme Court of the United States on April 20th, 1959, presented issues of extreme importance to the maritime industry and to the stevedoring industry in particular. The issue presented to the court was whether a stevedore, who had negligently caused damage to goods, could, as to the shipper, claim the protection of limitation of liability provisions, which, by their express terms, operated to the benefit of only the carrier and the ship. *Held:* that the stevedore could not avail himself of such protection; either by the terms of the provisions themselves, or by the theory that he was performing the carrier's obligations under the contract, hence was entitled to all the impersonal immunities of his principal.

Petitioner, a contracting stevedore, orally engaged with a common carrier in Baltimore, Maryland, to load certain cargo onto the S. S. Castillo Ampudia. One item of cargo consisted of sixty-two cases of machine goods. These cases were the property of respondents. While in the process of loading the vessel, one crate, containing a nineteen ton press, was negligently handled by petitioner's servants and toppled into the water. The bill of lading contained a limitation of liability provision for the benefit of the carrier.[2] The contract between respondents and carrier was within the purview of the Carriage of Goods by Sea Act, including the limitation of liability provision of said act.[3]

The practical considerations of this issue are considerable. In its brief of Amicus Curiae, the National Association of Stevedores indicated:[4]

> The decision below (for respondents), if allowed to stand, permits steamship companies who do their own stevedoring to limit their liability against claims and suits brought on behalf of cargo interests in accordance with the $500 per package provisions of the Carriage of Goods by Sea Act, while contract stevedores performing the identical service may not. Not only does the decision discriminate against the contract stevedore, but it will result in discrimination against the Association members' customers, those steamship companies whose size or activities do not justify operating their own steve-

[1] Robert C. Herd & Co., Inc. v. Krawill Machinery Corporation et al., 359 U.S. 297, 79 S. Ct. 766, 3 L. Ed. 2d 820 (1959).

[2] Ibid. at 299 (n), 79 S. Ct. 766, 768 (n), 3 L. Ed. 2d 820, (n).

"30. In consideration of a choice of freight rates having been offered to the shipper by the Carrier, it is agreed that in case of loss of, or damage to . . . Goods of an actual value exceeding $500 . . . per package . . . the value of such Goods shall be deemed to be $500 per package . . . and the Carrier's liability, if any, shall be determined on the basis of $500 per package . . . unless the nature of such goods and a value higher than $500 per package . . . shall have been declared in writing by the shipper . . . .

"37. This bill of lading shall have effect subject to the Carriage of Goods by Sea Act of the U.S.A. and the carrier the ship shall be entitled to all the rights and immunities set forth in said Act."

[3] An Act Relating to the Carriage of Goods by Sea, Apr. 16, 1936, c. 229, 49 Stat. 1207, 46 U.S.C. 1300-1315; 1304(5).

"(5) Neither the carrier nor the ship shall in any event be or become liable for any loss or damage to or in connection with the transportation of goods in an amount exceeding $500 per package . . . unless the nature and value of such goods have been declared by the shipper before shipment and inserted in the bill of lading."

[4] Brief of Amicus Curiae, The National Association of Stevedores, Filed in Support of Petitioner, pages 3-4.

doring departments and who must, because of the small margin of profit in the stevedoring business, be called upon to share the cost of this increased risk . . . .

On the other hand, the American Institute of Marine Underwriters filed a brief of Amicus Curiae in which it said:[5]

As an important feature of the business of the members of the Institute is the writing of insurance on cargo transported to and from this country by sea, the extent of a stevedore's liability for damage to such shipments is of vital interest to them . . . .

A decision which held that a stevedore, negligent in discharge of his obligations thereby causing damage to or loss of cargo, could avail himself of the limitation of liability provision in the bill of lading first appeared in 1952 in *A. M. Collins & Co., v. Panama R. Co.*,[6] where the stevedore negligently caused damage to a freezer unit while discharging a vessel. In holding that the stevedore was liable to the shipper in the amount of $500.00, the court applied the Restatement of the Law of Agency rule that: "An agent who is acting in pursuance of his authority has such immunities of the principal as are not personal to the principal."[7] The *Collins* case stated the theory, that the stevedore performs those services formerly performed by the ship's crew, which the carrier has undertaken to perform, and that the parties to the bill of lading must have been cognizant that the carrier would employ a stevedore for such services. Consequently, the stevedore is entitled to the immunities the carrier would have enjoyed had he performed the same services. The United States Circuit Court of Appeals for the Fifth Circuit in reaching this decision said:[8]

The controlling feature of the case is not, . . . who are the formal parties of the bill of lading. What is controlling are the terms, purpose and effect of the bill of lading as applied to the facts . . . . The stevedore . . . was an agent selected by the carrier to carry out the carrier's obligation . . . as required by its contract with the shipper. The negligent injury and damage arose in the course of this very performance of the carrier's obligation . . . . That the carrier would engage such services must have been contemplated by the parties . . . . A stevedore so unloading, in every practical sense, does so by virtue of the bill of lading and, though not strictly speaking a party thereto, is, while liable as an agent for its own negligence, at the same time entitled to claim the limitation of liability provided by the bill of lading to the furtherance of the terms of which its operations are directed . . . .

The theory propounded in *Collins* had been reached prior to 1952 and has received some favorable treatment both in Federal and State courts since that time. In the case of *Employers Fire Ins. Co. v. United Parcel Service of Cincinnati, Inc.*,[9] an action was brought by the insurer of a fur coat against the defendant, whose servant had been negligent in transporting said coat to a storage company for the owner. The court held that as the liability of the storage company was limited to $100.00, the liability of defendant as agent of the storage company was also limited to $100.00. The court said:[10]

Had the principal acted in person in carrying this coat and had been sued for the damage done, no matter what the form of action, its liability would have been limited

[5] Brief of the American Institute of Marine Underwriters, as Amicus Curiae, page 3.

[6] A. M. Collins & Co. v. Panama R. Co., 197 F.2d 893 (5th Cir. 1952); cert. den. 344 U.S. 875, 73 S. Ct. 168, 97 L. Ed. 677 (1952).

[7] Restatement of the Law, Agency, § 347 (1933).

[8] See note 6 supra at 896.

[9] Employers Fire Ins. Co. v. United Parcel Service of Cincinnati, Inc., 99 N.E.2d 794 (1950); in accord, Berger v. 34th Street Garage, Inc., 3 N.Y.2d 701, 148 N.E.2d 883 (1958); Schoeffer v. United Parcel Service of N.Y., 277 App. Div. 569, 101 N.Y.S.2d 451 (1st Dept. 1950).

[10] Ibid. at 799.

to $100.00. When it engaged the defendant to get the coat for it, it clothed the defendant with all the authority and rights which it, the principal, had against the owner, including the right to have liability limited to $100.00 . . . .

In *United States v. The South Star et al.,*[11] the government sued a carrier for damage to certain goods and the carrier impleaded the stevedore. The court affirmed a judgment which held that, since the charter party between the carrier and the United States incorporated the Carriage of Goods by Sea Act and its provision respecting a one year statute of limitations as to suits for damage to or loss of goods (46 U.S. Code, Section 1313-6), the filing of suit by plaintiff more than one year after delivery was untimely, hence both defendant and the stevedore were held to benefit from this provision. In expressing its view, the court said:[12]

(J)udge Leibell held that the limitation provisions . . . enured also to . . . the stevedore, to whom the performance of such duty had been delegated. We agree with this view, which is in accord with the holding of the Fifth Circuit, in *A. M. Collins & Co. v. Panama R. Co.* . . .

In *Ford Motor Company v. Jarka Corporation,*[13] a carrier contracted to transport component parts of Ford trucks for plaintiff. The carrier engaged defendant to load the vessel. The bill of lading between carrier and plaintiff contained an express limitation of liability of $500.00 per package or customary freight unit. The defendant negligently caused a case to fall, causing damage of $2800.00. The court found for the plaintiff for the sum of $500.00 as limited by the bill of lading. The *Collins* case was accepted by the court as existing law:[14]

In the light of the clear decisional and controlling law, I am satisfied that a cargo owner who enters into a contract of carriage with a carrier impliedly authorizes the carrier to employ on his behalf all such necessary and usual servants and agents (and this includes independent contractors) as may be required to perform the contract of carriage, . . . By virtue of this implied authority . . . the independent contractor . . . is entitled to the same protection and immunities as would extend to the principal, if an action were brought against such principal, . . .

In *Autobuses Modernos, S.A. v. The Federal Mariner,*[15] the action was by an assignee on a contract for the purchase of passenger buses for damage to one bus occurring while the bus was being loaded onto the ship. The ship's crew had improperly rigged the ship's gear and defendant stevedore's servants, with knowledge of the defect in the rigging, operated said gear, causing damage to the bus. The court held, following the *Collins* case, that defendant stevedore, whose negligence was jointly shared by the carrier, was entitled to the benefit of a $500.00 limitation of liability given to the carrier in the bill of lading. In *National Federation of Coffee Growers of Colombia v. Isbrandtsen Company, Inc.,*[16] plaintiff brought an action to recover damages to a shipment of coffee which defendant, as an agent of the carrier, had unloaded and stored. While defendant was in possession of the shipment, it was damaged. The court held that defendant was entitled to the protection of the one year statute of limitations in the

[11] United States v. The South Star et al., 210 F.2d 44 (2d Cir. 1954); in accord, L. W. & P. Armstrong v. The Mormacmar, 196 F.2d 752 (2d Cir. 1952).

[12] Ibid. at 45.

[13] Ford Motor Company v. Jarka Corp., 1954 A.M.C. 1095 (Mun. Ct., 1st, N.Y.C. N.Y.).

[14] Ibid. at 1100-1.

[15] Autobuses Modernos, S.A. v. The Federal Mariner, 125 F. Supp. 780 (ED Pa. 1954).

[16] National Federation of Coffee Growers of Colombia v. Isbrandtsen Company, Inc., 1957 A.M.C. 1571 (S. Ct. N.Y.).

Carriage of Goods by Sea Act[17] in stating that the provisions of the bill of lading extended to the stevedore because defendant performed certain of those maritime services the carrier was obligated to perform.

In the instant case, respondents brought an action in the United States District Court for the District of Maryland for damages sustained as a consequence of petitioner's negligence in the discharge of its obligations. Petitioner denied the allegations of negligence. As a separate defense, petitioner asserted that even if it had been negligent, its liability was governed by the limitation of liability provisions of the Carriage of Goods by Sea Act and the bill of lading, both heretofore mentioned. The trial court found that petitioner had been negligent and that the limitation of liability provisions of the Carriage of Goods by Sea Act and the bill of lading did not extend to the stevedore.[18] The case went on appeal to the United States Circuit Court of Appeals for the Fourth Circuit, which unanimously affirmed the judgment of the trial court in favor of respondents.[19] The court expressly refused to follow the decision in *Collins*. In disapproving the decision in *Collins,* the court said:[20]

> (J)udge Holmes' dissent in *Collins* reasons that a stevedore is subject to the ordinary liability for its negligence; that immunity (or limitation of liability) is the exception and not the rule; that the right of the carrier to limit its liability for negligence to an amount not exceeding $500.00 being in derogation of the common law, should be strictly construed, and may not be availed of by one who is not a party to the bill of lading . . . . With the highest respect to the majority opinion in *Collins,* Judge Holmes' reasoning commends itself to us more . . . .

Because of the conflict in decisions, the Supreme Court of the United States granted certiorari.[21]

The theory of the Fourth Circuit in the instant case had been unquestioned law prior to *Collins*. The Supreme Court had enunciated the principle that statutes in derogation of the common law were to be construed strictly; that the inroad on the common law was to be bounded by the express words of the statute.[22] In *Texas and Pacific Railway Company v. Abilene Cotton Oil Company,*[23] the Supreme Court, with reference to statutes in derogation of the common law, said:[24]

> (W)e must be guided by the principle that . . . a statute will not be construed as taking away a common law right existing at the date of its enactment, unless that result is imperatively required; . . .

In *Reid v. American Express Company et al.,*[25] an automobile valued at $3900.00 was shipped from London to New York. The bill of lading contained a provision limiting the liability of the carrier to $100.00. Due to the negligent discharge of the automobile by the stevedore, damage was caused of $2700.00. The stevedore was held to be primarily and totally liable for the damages. The decision was based on the theory that a tortfeasor is independently liable for his acts of negligence. True, the stevedore here did not

17 See note 2 supra, 1303(6).
18 155 F. Supp. 296 (D. Md. 1957).
19 265 F.2d 946 (4th Cir. 1958).
20 Ibid at 949-50.
21 358 U.S. 812, 79 S. Ct. 61, 3 L. Ed. 2d 56 (1959).
22 Shaw v. Railroad Co., 101 U.S. 557, 25 L. Ed. 892 (1879).
23 Texas and Pacific Railway Company v. Abilene Cotton Oil Company, 204 U.S. 426, 27 S. Ct. 350, 51 L. Ed. 553 (1907).
24 Ibid. at 437, 27 S. Ct. 350, 354, 51 L. Ed. 553, 557.
25 Reid v. American Express Company et al., 241 U.S. 544, 36 S. Ct. 712, 60 L. Ed. 1156 (1916).

claim the protection of the limitation of liability clause in the bill of lading, but the case, as stated by the Supreme Court in the case at bar:[26]

> (I)s some basis for respondent's argument that the members of the Bar understood that case to hold that the stevedore was not so entitled, for that principle does not appear to have been challenged in any reported American opinion during the 36 years between the decision of the *Reid* case in 1916 and the decision of the *Collins* case in 1952.

The case of *Sloan Shipyards Corp. v. United States Shipping Board Emergency Fleet Corporation*[27] held that an agent of the United States did not enjoy the same immunity from suit as did the United States. *Parker v. Bissonette*[28] evolved where the plaintiff was travelling on a railroad on a free ticket containing a no-liability clause. While being transported from one station to another by defendant pursuant to a contract between the railroad and defendant, plaintiff was injured. Held: the defendant was not protected by the liability clause of plaintiff's free ticket. "We do not think that it follows that the defendant is entitled, merely because he is a servant, to the benefits conferred upon the master by the contract . . . ."[29]

The case of *Brady v. Roosevelt Steamship Co., Inc.,*[30] came about when petitioner brought an action to recover damages for the benefit of herself and her children, as administrator of her deceased husband's estate. Deceased, a customs inspector, died as a result of injuries incurred when a ladder he was climbing collapsed beneath him. The ladder was located on a vessel belonging to the United States, operated for it by respondent under a contractual arrangement. Trial court found for plaintiff-petitioner; reversed by the Court of Appeals. The Supreme Court reversed the Court of Appeals and remanded the case. Speaking to the subject of the principal-agent relationship, the court said:[31]

> Moreover, if petitioner had a cause of action against respondent, it is difficult to see how she could be deprived of it by reason of a contract between respondent and the Commission . . . . The rights of principal and agent inter se are not the measure of the rights of third persons against either of them for their torts . . . .

and again:[32] "The liability of an agent for his own negligence has been long imbedded in the law." Also, ". . . if Congress had intended to make such an inroad on the rights of claimants it would have said so in unambiguous terms . . . ."[33]

In *Publicker Industries, Inc. v. American-Hawaiian S.S. Co.,*[34] a vessel was in the course of undocking. Because of insufficient power, the two tugs, in maneuvering the vessel, cause it to strike and damage an adjacent pier. The court found the captains of the tugs negligent and observed:[35]

26 See note 1 supra at 304 (n), 79 S. Ct. 770 (n).

27 Sloan Shipyards Corp. v. United States Shipping Board Emergency Fleet Corporation, 258 U.S. 549, 42 S. Ct. 386, 66 L. Ed. 762 (1922).

28 Parker v. Bissonette, 26 S.E.2d 497 (S. Ct. S. Car. 1943); But cf. Wilder v. Pennsylvania R. Co., 245 N.Y. 36, 156 N.E. 88.

29 Ibid. at 500.

30 Brady v. Roosevelt Steamship Co., Inc., 317 U.S. 575, 63 S. Ct. 425, 87 L. Ed. 471 (1943), rehearing denied 318 U.S. 799, 63 S. Ct. 659, 87 L. Ed. 1163 (1943); in accord, Quinn v. Southgate Nelson Corp., 121 F.2d 190 (2d Cir. 1941); cert. den. 314 U.S. 682, 62 S. Ct. 184, 86 L. Ed. 545 (1941).

31 Ibid at 583, 63 S. Ct. 425, 429, 87 L. Ed. 471, 478.

32 Ibid at 580-1, 63 S. Ct. 425, 428, 87 L. Ed. 471, 476.

33 Ibid at 581, 63 S. Ct. 425, 428-9, 87 L. Ed. 471, 477.

34 Publicker Industries, Inc. v. American-Hawaiian S.S. Co., 78 F. Supp. 223 (E.D. Pa. 1948).

35 Ibid. at 226.

There appears to be authority for holding that where a tug captain in charge of the docking or undocking of a vessel is negligent in the performance of that duty . . . , he is liable in damages, notwithstanding . . . the existence of contracts or other elements affecting the relationship or liability of the owners and operators . . . as between themselves . . . .

The case of *Pierre v. Eastern Air Lines, Inc.*,[36] held that the pilot of the aircraft on which plaintiff was injured was not entitled to the protection of the limitation of liability provisions of the Warsaw Convention[37] to which protection the airline was entitled. The case of *International Milling Co. v. S.S. Perseus*[38] involved an action by a shipper of grain cargo to recover for damages caused by water when the vessel sprung a leak. The master of the vessel was among those sued. The master attempted to use the *Collins* case as a basis of his defense, but the court refused to follow the majority of the court in *Collins:*[39]

Admittedly, the master is not exempted by express terms. . . . Construing the statute in connection with previous common law liability, the principle is also well established that the statute must be strictly construed . . . . The court concludes that it was the intention of the act in question, . . . to have immunity from liability remain personal to the carrier and the ship . . . .

In the case at bar, the United States Supreme Court unanimously affirmed the judgment of the trial court in favor of respondents.[40] The court examined petitioner's contentions in order. With respect to the Carriage of Goods by Sea Act, the court followed the rule of strict construction and held that neither the language nor the ascertainable intent could be held to extend the provision concerning limitation of liability to other than the carrier and the ship. The court said:[41]

It must be assumed that Congress knew that generally agents are liable for all damages caused by their negligence. Yet Congress, while limiting the amount of liability of "the carrier (and) the ship," did not even refer to stevedores or agents of a carrier . . . .

The limitation of liability provisions of the bill of lading referred only to the carrier, subject to the Carriage of Goods by Sea Act:[42]

There is, thus, nothing in those provisions to indicate that the contracting parties intended to limit the liability of stevedores or other agents of the carrier for damages caused by their negligence. If such had been a purpose of the contracting parties, it must be presumed that they would in some way have expressed it in the contract . . . .

The court overruled the theory of the *Collins* case in concluding that the weight of authority was against such extension of immunity to the agent of the carrier.

It would seem that the crux of the problem is the validity of the *Collins* case's theory that the limitation of liability provision was an impersonal immunity extended to the carrier and, through him, to the stevedore. It has been noted that, previous to *Collins,* all immunities of agents had been granted by statute; that *Collins* was the first to construct a contractual vesting of immunity.[43] The Supreme Court in the instant case was guided by the common law principle that an agent is liable for the damages caused by his torts; that this liability can only be reduced by express agreement among the parties to a contract or by statute. Another guiding principle was the rule of construc-

36 Pierre v. Eastern Air Lines, Inc., 152 F. Supp. 486 (D. N.J. 1957).
37 49 Stat. No. 3019, Art. 22(1).
38 International Milling Co. v. S.S. Perseus, 1958 A.M.C. 526 (E.D. Mich.).
39 Ibid at 530.
40 See note 1 supra.
41 Ibid. at 302, 79 S. Ct. 769.
42 Ibid. at 302, 79 S. Ct. 766.

tion that statutes in derogation of the common law are to be strictly construed. Hence the court found that the immunities granted to the carrier and the ship were personal in nature. *Collins* based its theory on section 347 of the Restatement of the Law of Agency: "An agent who is acting in pursuance of his authority has such immunities of the principal as are not personal to the principal."[44] The interpretation given to this section by the court in the *Collins* case is erroneous. In the Restatement of the Law, Second, Agency (1958), section 347 has been amended to read:[45]

"Immunities and Standard of Care of Principal"

(1) An agent does not have the immunities of his principal although acting at the direction of the principal.
(2) Where, because of his relation to a third person, a master owes no duty, or a diminished duty, of care, a servant in the performance of his master's work owes no greater duty, unless there has been reliance by the master or by a third person upon a greater undertaking by the servant."

Thus, such immunities are impersonal as are given by the law to each and every person acting under the law in a certain fashion; conforming to a standard of care defined and imposed by the law. The right of the master to be negligent with respect to trespassers is also the right of his servant. An impersonal immunity of the carrier is that he is not, unless bound to do so by contract, obliged to give more than a certain standard of care to the performance of his obligation. This immunity is also that of his agents or of independent contractors he employs. The immunities granted by contract or statute in derogation of the common law, apply only to those expressly designated by said contract or statute; hence, are personal in nature.

W. D. O'H., JR.

EVIDENCE—THE FEDERAL RULE AND NEW YORK RULE TRACED AS TO ADMISSIBILITY OF ILLEGALLY OBTAINED AND WIRE-TAPPED EVIDENCE IN FEDERAL AND STATE COURTS.— The Court of Appeals of the State of New York recently affirmed the principle[1] that evidence obtained by wire tapping pursuant to New York statutes is admissible in a prosecution; and the state policy of admitting such evidence[2] does not contravene federal law.[3]

The defendant had been tried and convicted upon three charges of bookmaking in violation of the Penal Code[4] in the Court of Special Sessions of the Village of Tarrytown. The defendant appealed to the County Court of Westchester assigning

43 66 Harvard Law Review 530, 531 (1953).
44 See note 7 supra.
45 Restatement of the Law, Second, Agency, § 347 (1958).

1 People v. Variano, 5 N.Y.2d 391, 157 N.E.2d 857 (1959).
2 Section 813a, N.Y. Code of Criminal Procedure provides:
"An ex parte order for eavesdropping . . . may be issued by any Justice of the Supreme Court or Judge of a County Court or of the Court of General Sessions of the County of New York upon oath or affirmation of a district attorney, or of the attorney general, or of an officer above the rank of Sergeant of any police department of the state or of any political subdivision thereof, that there is reasonable ground to believe that evidence of crime may be thus obtained. . . ."
3 The Federal Communications Act, U.S.C. Title 47, Section 605 provides . . . "No person not being authorized by the sender shall intercept any communications and divulge or publish the existence, contents, substance, purport, effect, or meaning of such intercepted communications to any person. . . ."
4 N.Y. Penal Law, § 986.

as error the Tarrytown's Court admitting, over the defendants' objection, a transcript of a recording of a wire-tapped conversation in evidence.

The County Court of Westchester reversed the decision, holding that the wire-tapped conversation should not have been admitted, and in support of the reversal cited *People v. Dinan*[5] and *Benanti v. United States.*[6]

The Court of Appeals, on direct appeal from the Westchester County Court, held that the County Court erred in basing its reversal on the *Benanti Case,* and said:

> "Assuming for argument only that the wire-taps were illegally obtained, it would not be grounds for reversal that illegally obtained evidence was introduced at the trial under New York State policy.[7]
> A state policy of admitting evidence having probative force, even though obtained illegally does not contravene federal law."[8]

It is well settled in New York that evidence, although obtained illegally, is none-theless admissible. This rule of evidence was expounded in *People v. Defore* and *People v. Richters Jewelers.*[9] Even if property is seized in violation of law, this does not affect its admissibility.[10]

The *Defore Case,* decided by the New York Court of Appeals in 1926, involved a police officer who arrested the defendant on a charge of stealing an overcoat. The crime, if committed, was petit larceny since the value of the coat was under $50.[11] The defendant, when taken in custody, was in the hallway of a boarding house. The officer after making the arrest entered the defendant's room and searched it. The officer found a black jack in a bag. The defendant was acquitted of larceny, but was indicted as a second offender for possession of the weapon.[12] Before trial, the defendant moved to suppress the evidence obtained by search without a warrant; however, the motion was denied. Over the defendant's objections, the illegally seized evidence was admitted at the trial and the defendant was convicted.

On appeal, the Court of Appeals found the arrest was unlawful since the crime was a misdemeanor and was not committed in the officer's presence. Consequently, if the arrest was unlawful, there could be no legal search incident thereto.

However, the Court of Appeals held that although the evidence of criminality was obtained by an act of trespass, it was nonetheless admissible in evidence although the officer might have been resisted, sued for damages, or prosecuted for oppression under the penal law.[13]

The *Richters Jewelers Case* also supports the rule that evidence, although illegally obtained, is nonetheless admissible in New York. In this case, an inspector of weights and measures saw a ring in the defendant's store window with a tag advertising it as an "1 ct. perfect diamond—platinum" selling for $265. Suspecting that the defendant was guilty of misleading advertising, the inspector, over the defendant's objection, seized the ring and tag in order to check the diamond at the laboratory. Further

[5] People v. Dinan, 15 Misc. 2d 211, 172 N.Y.S.2d 496 (County Court of West. 1958). Rev. 7 A.D.2d 119, 181 N.Y.S.2d 122 (2d Dep't 1958).

[6] Benanti v. United States, 355 U.S. 96, 78 S.Ct. 155, 2 L.Ed. 2d 126 (1957).

[7] People v. Richters Jewelers, 291 N.Y. 161, 51 N.E.2d 690 (1943); People v. Defore, 242 N.Y. 13, 150 N.E. 585 (1926), aff'd, 270 U.S. 657, 46 S.Ct. 353, 70 L.Ed. 784 (1926).

[8] Schwartz v. Texas, 344 U.S. 199, 73 S.Ct. 232, 97 L.Ed. 231 (1952).

[9] See note 7, supra.

[10] Ibid.

[11] N.Y. Penal Law, §§ 1296, 1298.

[12] N.Y. Penal Law, § 1897.

[13] N.Y. Penal Law, §§ 1846, 1847.

analysis verified his suspicion. The Court of Appeals held that although the property was seized illegally, it was nonetheless admissible as evidence.

Added to this broader policy of admitting illegally obtained evidence, New York by statute has specifically made wire tapping permissible under certain circumstances.[14] It would appear, therefore, that the New York law is clear and unequivocal as to the admissibility of evidence procured by wire tapping. This policy and the law, however, have been under attack since the New York State policy is in direct opposition to the provisions and policy underlying the Federal Communications Act.[15]

Prior to *Benanti v. United States,*[16] the courts of New York in several decisions[17] consistently upheld the admissibility of wire-tapped evidence. This was so even in those cases where the legality of the court order authorizing the wire tap was in question.[18] In 1952, the position of the New York rule admitting wire-tapped evidence was strengthened by the decision of the United States Supreme Court in *Schwartz v. Texas.*[19]

In the *Schwartz Case* the defendant had been convicted of a crime in a Texas state court after the admission of a telephone conversation between the defendant and an accomplice as evidence. On appeal, the United States Supreme Court held that the federal prohibition against intercepting and divulging the contents of telephone communications did not render evidence obtained in violation thereof inadmissible in a *state* criminal trial. The court said:

"We hold that Section 605[20] (Federal Communications Act) applies *only* to the exclusion in *federal* court proceedings of evidence obtained and sought to be divulged in violation thereof; it does not exclude such evidence in state court proceedings." (Italics supplied.)

The prevailing rule in the federal courts is the direct opposite to that of New York State. In *Nardone v. United States*[21] it was settled by the United States Supreme Court that evidence obtained by federal agents through wire-tapping was in violation of the Federal Communications Act and such evidence was inadmissible in a criminal prosecution in a federal court. In the *Nardone Case,* the defendant was convicted on separate counts of the smuggling of alcohol, possession and concealment of alcohol, and conspiracy to smuggle and conceal alcohol. The conviction was obtained after federal agents were permitted to testify to the substance of certain telephone conversations they intercepted between the defendant and others. The defendant appealed and the Supreme Court held that admitting such testimony was error.

The *Benanti Decision,*[22] decided by the United States Supreme Court in 1957 served to clarify and enlarge the rule laid down in the *Nardone Case.* In the *Benanti Decision* a slightly different problem was posed. New York State authorities, and not federal agents, had tapped the defendant's telephone pursuant to a court order

[14] See note 2, supra.
[15] See note 3, supra.
[16] See note 6, supra.
[17] In re Davis 252 App. Div. 591, 299 N.Y. Supp. 632 (1st Dep't 1931), Harlem Check Cashing Corp. v. Bell, 296 N.Y. 15, 68 N.E.2d 854 (1946), People v. Stemmer, 298 N.Y. 728, 83 N.E.2d 141 (1948).
[18] People v. Feld, 305 N.Y. 322, 113 N.E.2d 440 (1953).
[19] See note 8, supra.
[20] See note 3, supra.
[21] Nardone v. United States, 302 U.S. 379, 58 S.Ct. 275, 82 L.Ed. 314 (1937); 308 U.S. 338, 60 S.Ct. 266, 84 L.Ed. 307 (1939).
[22] See note 6, supra.

obtained under New York statutes.[23] With the aid of this wire tap, the defendant was apprehended for the illegal possession and transportation of distilled spirits. Government witnesses disclosed at the trial that information leading to discovery of the distilled spirits was obtained by the wire-tap made by the New York State authorities. The testimony was admitted and the defendant was convicted. The conviction was affirmed by the Circuit Court of Appeals[24] but was reversed by the Supreme Court of the United States.[25] The government argued that no violation of Section 605 (Federal Communications Act) occurred because the wire-tap was placed by state agents acting in accordance with state law and urged further that Congress had not exercised the power of forbidding wire-taps by the states. The Supreme Court rejected this argument and said ". . . we read the Federal Communications Act and Section 605 in particular, to the contrary. It is a comprehensive scheme for regulating interstate communications." The court pointed out further in the *Benanti Case* that the *Nardone Decision* settled the proposition that Section 605 created a prohibition against any person violating the integrity of a system of telephonic communication and said "we hold . . . that evidence obtained by any means forbidden by Section 605, *whether by state or federal agents,* is *inadmissible in a federal court.*" (Italics added.)

Apparently, the *Benanti Decision,* although not expressly overruling the *Schwartz Case,* did, because of its strong language, raise some doubt as to the continued validity of the New York rule. Consequently in 1958, in *People v. Dinan,*[26] the County Court of Westchester dismissed an indictment by the Westchester County Grand Jury against the defendant for bookmaking after an investigation of the minutes disclosed that wire-tap evidence had been admitted to obtain the indictment and rested their opinion on the *Benanti Decision.* Although the *Benanti Decision* was not squarely on all fours with the *Dinan Case* in that the former was concerned with the admissibility of wire-tap evidence obtained by state authorities in a federal court and the latter with the admissibility of wire-tap evidence in a state court, the language of the United States Supreme Court raised some doubt as to whether the *Schwartz Case,*[27] which supported the New York decision, was still valid law.

The *Dinan Case* was appealed by the People; however, before a decision was made by the Appellate Division, the *Variano Case*[28] was presented to the Westchester County Court and the same result was reached as in the *Dinan Case.*

The *Dinan Case* was reversed by the Appellate Division in December 1958, holding that the *Schwartz Case* and the New York decisions in accord with that case were not affected by the *Benanti Decision.*

The Appellate Division, in reversing the Westchester County Court in the *Dinan Case,* indicated that although the *Schwartz Case* pointed out that the very introduction of wire-tap evidence would itself violate Section 605 (Federal Communications Act), the Court of Appeals in *People v. Saperstein*[29] said:

"The rule of this state that the evidence (wire-tap) is admissible is not affected by the circumstance that requiring a witness to testify as to wire-taps might force him to a criminal violation of the Federal Communications Act."

[23] See note 2, supra.
[24] United States v. Benanti, 244 F.2d 389 (2d Circuit 1957).
[25] See note 6, supra.
[26] See note 5, supra.
[27] See note 8, supra.
[28] See note 1, supra.
[29] People v. Saperstein, 2 N.Y.2d 210, 140 N.E.2d 252 (1957).

The Appellate Division further observed in the *Dinan Case* that:

"It must not be forgotten that the Court of Appeals in formulating the rule did so with the realization that the very introduction of evidence of this kind would itself constitute the commission of a crime—one with the ostensible sanction of the trial court. . . . Under the circumstances the rule should be followed."

In April 1959, the *Variano Case,* was reversed by the Court of Appeals. It may be observed that the highest court of Pennsylvania which followed the New York rule reached the same result[30] after the *Benanti Decision* as did the New York Courts in the *Dinan Case* and *Variano Case;* however, the rule admitting wire-tap evidence in Pennsylvania was subsequently changed by statute.[31]

From the foregoing decisions it may be concluded that Section 605 of the Federal Communications Act which forbids unauthorized interception and divulgence of telephone communications applies to *all* persons and *any* evidence obtained in violation thereof will be inadmissible in a prosecution in a federal court. In the states which authorize wire-tapping and permit its admissibility in state prosecutions, the United States Supreme Court considers these acts a violation of Section 605 of the Federal Communications Act, however; the Court refuses to overturn a state rule admitting such evidence. Therefore, it is left to the states whether evidence obtained in violation of Section 605 is admissible in a state prosecution. The law in New York on this subject is clear—wire-tap evidence obtained pursuant to New York statutes is admissible in state prosecutions. C. Y.

PRACTICE AND PROCEDURE—ATTORNEYS—REGULATION OF CONTINGENT FEES—APPELLATE DIVISION OF SUPREME COURT, FIRST JUDICIAL DEPARTMENT, HAS POWER TO ADOPT RULE 4 OF SPECIAL RULES OF THAT COURT RELATING TO CONTINGENT FEES IN CLAIMS AND ACTIONS FOR PERSONAL INJURY AND WRONGFUL DEATH.—In a recent decision[1] based upon a highly controversial point of law, the Court of Appeals by a 5-2 decision reversed the judgment of the Appellate Division of the Supreme Court, 3rd Department. The issue pertinent thereto sought the determination of the following question: Did the Appellate Division of the 1st Department have the power to adopt Rule 4 of the Special Rules of that court insofar as it provides that contingent fees equal to or less than the percentages fixed by it are "fair and reasonable," whereas those in excess "shall constitute the exaction of unreasonable and unconscionable compensation."[2]

Rule 4, which requires attorneys to supply information considered a prerequisite to the forming of conclusions pertaining to the value of the professional services rendered by them in negligence and wrongful death cases was held to be invalid by the Third Department upon two grounds: (1) that it is inconsistent with section 474 of the Judiciary Law providing that compensation of an attorney is governed by agreement, express or implied, and (2) that the Appellate Division lacks power of discipline over attorney's regarding excessive fees, except in extraordinary cases and or when professional services have been completed.[3] Plaintiff's here-in question neither the good nor evil of the rule, nor its responsiveness or lack of same with regard to the ethical and moral standards of the community, but rather they challenge the Appellate

30 People v. Voci, 393 Pa. 404, 138 A.2d 232 (1958).
31 15 P.S. § 2443.

1 Gair v. Peck, 6 N.Y.2d 97; — N.E.2d — (1959).
2 Id. at 123.
3 Id. at 104.

Division's *power* to adopt it. It is alleged that Rule 4, having been enacted by the Judiciary, essentially alters the substantive law which determines through Constitutional powers, relationships between attorneys and clients, and as thus manifested, it conflicts with Section 474 of the Judiciary Law, *supra,* insofar as said section dictates that the compensation of an attorney is governed by agreement, express or implied.[4]

Historically, this discrepancy can be traced most directly to the adoption of the Field Code[5] and statutes accruing therefrom to form the basis of 474 of the Judiciary Law. At that time, the courts, while not outlawing contingent fee contracts, as such, did exercise supervision over them. In 1846, what now constitutes Section 474 was formulated, providing that the compensation for services rendered by an attorney to his client, was to be decided and governed by agreement between them, as heretofore stated, and as such was to be subject to no restraints by law.[6] This view was upheld by the Judicial Committee of the Assembly, which thwarted an attempt made by the New York State Bar Association to amend the law so as to enable the courts to pass upon the question of reasonableness of contingent fee contracts.[7] The said Judicial Committee rejected the proposed amendment for the singular reason that it would promote a usurpation of power not given the courts by the Constitution, and that in fact, such a usurpation of power would be an invasion of an attorney's right to contract with his client, thereby violating a basic Constitutional guarantee.

In 1938, a committee of the Association of the Bar recognized that any and all authority and/or change which was to govern the question as presented herein, must come from new legislation. As stated in its reports, the following was said:

"There is little practical scope left for the argument that the courts retain any power in this field apart from fraud and over-reaching. . . . However that may be, the lines of judicial and legislative doctrine are too firm by this time to sustain the hope of successful modification by the judiciary alone. There is definite and unquestioned need for a new deposit of authority in our courts, and this deposit of authority must come from new legislation."[8]

Five years later, in 1943, the question was again examined by the same Association. And again, it was determined that although restraints upon unconscionable or unreasonable fees were necessitated, Section 474 of the Judicial Law did *not* allow the courts to exercise those restraints. Remedial legislation was again suggested. . . .

"We can only point the way in the hope that the legislature, where many of our professional brethren labor, may also recognize the evil and give to the courts the power to apply some remedy."[9]

Thus, it is urged by plaintiffs herein that although there may well be a recognized need for restraint, and although it has been recommended that control of such fees be specifically vested in the courts, this has *not* in fact been done. The Legislature has continually rejected such proposals[10] and as such has taken no action upon it. Plaintiffs therefore question the right of the courts to ignore history and statute, and

[4] Id. at 105.

[5] Code of Procedure, Laws of New York 71st Session L. 1848, ch. 379, p. 487 Van Benthuysan Albany (1848).

[6] Laws of New York 99th Session L. 1876, ch. 448, sec. 66, p. 13. Van Benthuysan Albany 1876.

[7] 31 N.Y.S. Bar Assn. Rep. 105-106, 136.

[8] Annual Reports of Assoc. of Bar of City of N.Y. Pp. 295-296 (1938).

[9] Assoc. of Bar of City of N.Y. Reports. Vol. 80, No. 649 (1943).

[10] 31 N.Y.S. Bar Assn. Rep. 121.

impose their interpretation and will upon an issue which is not constitutionally theirs to determine. As is stated in *McKinney's Consolidated Laws of New York:*

"The Constitution of this state vests the legislative power in the Senate and Assembly (N.Y. Const., Art. 111, Sec. 1) and that the courts may not divest or usurp this power has been announced so frequently and in such varying language as to defy complete repetition. Thus it is said that courts may not make, change, amend or repeal a statute, since their function is to interpret, declare and enforce the law; not to make it. No matter what disastrous consequences may result from following the expressed intent of the Legislature, the Judiciary cannot avoid its duty."[11]

In *People v. Friedman,*[12] the court stated that: "A plea that a statute imposes inconvenience or hardship upon a litigant should be addressed to the Legislature; we may not usurp its functions by legislating judicially." And, in *Matter of Fink v. Cole,*[13] the question of usurpation of power by a court was expressed in the following language: "Nothing is more certain than that beneficent aims, however great or well directed, can never serve in lieu of Constitutional power."

Plaintiffs therefore conclude that the Appellate Division had no right to enact a rule which completely contravened a legislative declaration. It is their contention that not only is a presumption of guilt of unconscionable conduct on the part of an attorney raised, but further, his constitutional guarantee to contract with a client is, for all practical purposes, obfuscated.

The Appellate Division, 1st Department, has declared that Rule 4, *sub judice,* is an essential determinative force for the laying of a proper foundation for disciplinary action against possibly unworthy practices. It is asserted by them, in complete contradiction to plaintiffs' contention, that the courts have had, and continue to have, the power to enact rules which speak of effecting discipline and control over contingent fees. In *People ex rel. Karlin v. Culkin,*[14] it was said that:

"The supreme court shall have power and control over attorneys and counselors-at-law."[15]

Again, looking to history, it is seen that precedent establishing this point was first expressed in the Constitution of 1777, Section 27,[16] wherein was stated that: "all attorneys, solicitors, and counselors at law hereafter to be appointed be appointed by the court and licensed by the first judge of the court in which they shall respectively plead or practice; and be regulated by the rules and orders of the said court." As construed by the Appellate Division, this provision spoke decidedly in favor of giving the courts explicit jurisdiction over attorneys who were and are still deemed to be its officers, subject to its rules and code of procedure. Therefore, if in conjunction therewith, a court saw fit to determine fees to be charged by an attorney in connection with work done by him for his client, such regulation would not be considered a derogation of constitutional privileges in as much as an attorney was primarily duty bound to obey the covenants and practices of a court with the power to exercise such jurisdiction.

Justice Cardozo summarized these provisions in the *Karlin* case, *supra,* as follows: "With this background of precedent there is little room for doubt as to the scope and

11 McKinney's Consolidated Laws of New York, Statutes, Sec. 73, p. 110.

12 People v. Friedman, 302 N.Y. 75; 96 N.E.2d 184 (1950).

13 Matter of Fink v. Cole, 302 N.Y. 216; 97 N.E.2d 873 (1951).

14 People ex rel. Karlin v. Culkin, 248 N.Y. 465; 162 N.E. 487 (1928).

15 Judiciary Law Sec. 90, sub. 2 at 107.

16 1 Lincoln's Constitutional History of N.Y. 179 § 27. Lawyer's Coop. Publ. Co. Rochester, N.Y. (1906).

effect of the provision in the Constitution of 1777 that attorneys might be regulated by rules and orders of the courts. The provision was declaratory of a jurisdiction that would have been implied, if not expressed. The next Constitution, that of 1821, was silent as to the whole subject, containing no reference either to regulation or to the appointment. Promptly, to avoid misapprehension, the Legislature passed a statute, the act of April 17, 1823 (L. 1823, ch. 182, sec. 19) which continued in the same words the provision formally contained in the Constitution of 1771. There was a revision of the statutes in 1827 (Act of Dec. 2, 1827) in which the provision was omitted, but the courts continued to act upon the theory that the power of regulation was either inherent or implied. The question does not now concern us whether the power may be withdrawn or modified by statute (Matter of Cooper, 22 N.Y. 67, 68). Instead of being withdrawn, it has been explicitly confirmed. In 1912, by an amendment of section 88 of the Judiciary Law (L. 1912, ch. 253) the jurisdiction was removed from the realm of implication. The earlier statutes were restored through a renewed declaration that lawyers are subject to the control and power of the court. We are back to the law as it existed in 1777."[17]

Thus, we are brought to the situation as it now stands before us. On the one hand, it is urged by plaintiffs that the effect of Rule 4, if so adopted, is in complete derogation of Section 474 of the Judiciary Law, and is therefore void. It is thereby submitted that no attorney may or should be subjected to discipline for exercising his statutory right to enter into and contract with his client, that latter person being presumed to be adult and of sound mind; that a limitation and/or regulation sought to be imposed thereupon by the Appellate Division is unconstitutional[18] in that it deprives plaintiffs of liberty and property without due process of law.[19]

On the other hand, it is appellants' contention that Rule 4 is an exercise, express and inherent, of the broad power of the court over the professional conduct of attorneys within its jurisdiction. It is not intended that Rule 4 fix legal fees, but merely that it regulate excessive and unconscionable rates of compensation.[20] In *Matter of Friedman*,[21] where a contract for 50% of a recovery in an accident case was held not to be fraudulent per se in all instances, the court added:

"But the recovery may be such that what was in the first instance a fair contract becomes unfair in its enforcement . . . the recovery may be such that the lawyer's retention of it would be unjustified and would expose him to the reproach of oppression and over-reaching. He is an officer of the court, and is judged as such, and technical contractual rights must yield to his duty as such officer."

The determination of the issue presented herein, viz., Did the Appellate Division of the 1st Department have the power to adopt Rule 4 of the Special Rules of that court, insofar as it provides that contingent fees equal to or less than the percentages fixed by it are "fair and reasonable," whereas those in excess "shall constitute the exaction of unreasonable and unconscionable compensation," was answered in the affirmative by this court, reversing the decision of the Appellate Division, 3rd Department. Upon the question of the usurpation of constitutional powers, it is to go further to the United States Supreme Court. P. S. B.

17 See note 14, supra.
18 Matter of Knapp, 85 N.Y. 284; 59 H.P. 367 (1881); Matter of Fitzsimmons, 174 N.Y. 15; 66 N.E. 554 (1903); Greenberg v. Remick & Co., 230 N.Y. 70; 129 N.E. 213 (1920).
19 Gregonis v. Philadelphia & Reading Coal & Iron Co., 235 N.Y. 152; 139 N.E. 221 (1923); Fisher-Hanson v. Bklyn. Hgts. R.R. Co., 173 N.Y. 492; 66 N.E. 395 (1903).
20 See supra note 18, Matter of Fitzsimmons.
21 Matter of Friedman, 136 App. Div. 750, 121 S. 426 (2nd Dept. 1910).

TAXES—DISTRIBUTION IN CASH BY A CORPORATION TO ITS CONTROLLING STOCKHOLDER OUT OF THE PROCEEDS OF A REFINANCED MORTGAGE TREATED AS A RETURN OF CAPITAL TO THE EXTENT IT EXCEEDED THE PROFITS AND EARNINGS OF THE CORPORATION.—When called upon to review a determination made after a hearing under Section 374 of the Tax Law[1] in the Matter of State Income Taxes of one Leonard Marx, the New York Court of Appeals reversed the decision of the Appellate Division and the determination made by the State Tax Commission and found that a distribution made by a corporation, not out of profits or earnings but rather out of unrealized appreciation in the value of its real property, was a return of capital to a stockholder receiving such a distribution.[2]

In March 1942, Larchmont Apartments, Inc. purchased an apartment house from the Federal Housing Administrator for $1,745,000.00 consisting of $63,000.00 in cash and a mortgage of $1,682,000.00 given to the Federal Housing Administrator. Detailed restrictions were provided as to the regulation and supervision of the corporation by the F.H.A. These restrictions, relating to rents, capital structure, payment of dividends, maintenance of reserves, and debt limitations, were to be enforced while the F.H.A. mortgage remained outstanding.

Marx, the petitioner, became the president of Larchmont Apartments, Inc. in 1943 and in August of 1943 he and a group of associates acquired all of the common stock of the corporation. Marx had personally purchased 4/9 of a share of Larchmont stock in 1945 and 556 1/9 shares in 1950.

In July 1950 a new mortgage loan of $2,000,000.00 was obtained by Larchmont from the Provident Mutual Life Insurance Company of Philadelphia. The net proceeds of this transaction, after payment in full of the existing F.H.A. mortgage and other incidental expenses, amounted to $824,810.60.

The Board of Directors of Larchmont on July 27, 1950 unanimously voted to authorize the corporation to make a distribution equal to $700.00 per share to the stockholders of record on July 28, 1950. This distribution was made during the calendar year 1950 and Mr. Marx received $389,588.89. On his Federal and State Income Tax Returns for 1950 Mr. Marx reported $41,296.42 as a dividend and subject to normal income tax, since this 10.60018% of his distribution was equal to his share of the earnings and profits of Larchmont. From the remaining $348,292.47 he subtracted the cost of his shares, $346,117.85, and reported the balance of $2,174.62 as a capital gain and subject to the income tax on capital gains. (This latter amount was not made a part of this controversy since the petitioner, due to the relative insignificance of the tax ($68.50), conceded for the purpose of the appeal that this sum was subject to be taxed as ordinary income.)

At issue is the question of the taxability of the $346,117.85 that the petitioner contends is a return of capital, and as such, not subject to income tax. The state, on the other hand, is attempting to subject this amount to tax as ordinary income. The Federal government accepted the determination of the petitioner and construed the $346,117.85 as a return of capital bringing the basis of the stock to zero.

To fully comprehend the aforementioned problem, portions of the salient New York State statutes are given below to acquaint the reader with the statutory law governing this subject:

Article 16 of the New York State Tax Law:

Section 350 Definitions:[3] For the purpose of this article and unless otherwise required by the context:

[1] N.Y Tax Law, Article 16 § 374.
[2] Marx v. Bragalini, 6 N.Y.2d. —.
[3] See note 1, supra, § 350.

(8) The word *Dividend* means any distribution made by a corporation out of its earnings or profits to its shareholders.

Section 359:[4] Gross Income defined: The term *gross income*

(1) Includes gains, profits, and income derived from salaries, wages, or compensation for personal service of whatever kind and in whatever form paid, or from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit or gains or profits and income derived from any source whatever.

Section 354:[5] Exchange of Property. Upon the sale or exchange of property the entire amount of the gain or loss, determined under Section three hundred and fifty-three of this article, shall be recognized, except as hereinafter provided in this section.

(9)d. In the case of a qualified electing shareholder

i. There shall be recognized and taxed as a dividend so much of the gain as is not in excess of his rateable share of the earnings and profits of the corporation.

ii. There shall be recognized and taxed as capital gain so much of the remainder of the gain as is not in excess of the amount by which the value of that portion of the assets received by him, which consists of money or of stock or of securities acquired by the corporation after August fifteenth, nineteen hundred fifty exceeds his rateable share of such earnings and profits.

The Attorney General of the State of New York arguing in favor of the position taken by the State Tax Commission, contended that the corporate distribution received by the petitioner constituted ordinary income within the meaning of the statutory definition of gross income. He stated that the petitioner seeks "exemption" from normal tax by seeking to be taxed at the more favorable capital gain rates and cited *People ex rel. Savings Bank of New London v. Coleman*[6] as authority for the principle that one seeking exemption must be able to point out some statute clearly giving such an exemption. If the petitioner was seeking "exemption" from some tax this case would be pertinent. However the petitioner is not seeking to "exempt" any of his income from taxation but rather contends that he had no "income" to exempt, since the amount in question was merely a return of his original investment.

The respondent further alleged that since there is no statute declaring the distribution here in question to be a capital gain, it must therefore be considered ordinary income. A requirement of a capital gain[7] is a "sale or exchange" and since no "sale or exchange" took place there could be no capital gain, hence the distribution had to be ordinary income. In answer to the contention the petitioner pointed out that merely because there is no statute subjecting this type of a distribution to capital gains treatment is not reason enough to subject it to ordinary income treatment. A statute must be cited subjecting the distribution to ordinary income taxes before it will be taxable as ordinary income. The New York Tax Law[8] construes "gross income" to include "dividends." but "dividends" are defined as a distribution out of "earnings or profits." Since this distribution was only partially out of "earnings or profits" it is only partially a "dividend." Section 359[9] further states that "gross income" does not include every receipt but must be a receipt that is in the nature of income. Merely receiving a return of one's investment is not in the nature of income.

[4] See note 1, supra, § 359.
[5] See note 1, supra, § 354.
[6] 135 N. Y. 231, 31 N.E. 1022 (1892).
[7] See note 3, supra.
[8] See note 4, supra.
[9] Ibid.

In disregarding the decision of the Federal Commissioner of Internal Revenue, to allow the petitioner to offset his cost against the distribution, the respondent cited *Matter of Appleby v. Bates*;[10] to wit: where New York tax policy differs from that of the United States, the State is not bound by the Federal tax treatment of property. In *People ex rel. Mosbacher v. Graves*[11] however, the court said,

"While, of course, Federal decisions are not binding, they are highly persuasive, especially where the statutes are identical, the decisions uniform and the reasoning logical. Uniformity of construction between Federal and State taxing statutes is highly desirable and entitled to great weight in determining an open question. It is apparent that this State statute was copied verbatim from the Federal thus indicating a strong legislative intent for uniformity in interpretation (*Matter of Weiden*)."[12]

Respondent further alleged that it is well established that where corporate property exceeds the value of the stock specified in its charter the excess is surplus and is to be regarded as surplus profits.[13] In *Randall v. Baily*[14] however the court was called upon to construe Section 58 of the New York Stock Corporation Law[15] which states:

"No stock corporation shall declare or pay any dividend which shall impair its capital, nor while its capital is impaired, nor shall any such corporation declare or pay any dividend or make any distribution of assets to any of its stockholders whether upon a reduction of the number or par value of its shares or of its capital unless the value of its assets remaining after the payment of such dividend, or after such distribution of assets, as the case may be, shall be at least equal to the aggregate amount of its debts and liabilities, including capital."

For the purposes of this statute unrealized appreciation in value of fixed assets was considered in determining whether a corporate surplus existed. The above decision made no mention of the taxability of a distribution out of such surplus, however, as it was not called upon to do so. The purpose of section 58[16] is to benefit creditors by keeping the assets of a corporation unimpaired and sufficient for the payment of corporate debts. For such a purpose the value of corporate property should be considered before deciding whether a distribution to the stockholders would endanger the relative position of corporate creditors. In *Williams v. Wester Union Telegraph*[17] it was held that where corporate property exceeds that limited in its articles of incorporation the excess is surplus which may be distributed to the stockholders. Here again the court was not called upon to rule on the tax consequences of such a distribution. By allowing a corporation to make a distribution out of surplus provided by unrealized appreciation the courts merely ruled that such a distribution did not impair capital and hence did not violate the Stock Corporation Law.[18]

Randall v. Bailey[19] and *People ex rel. Wedgewood Realty Co. v. Lynch*,[20] the leading cases in construing section 58 of the Stock Corporation Law[21] and section 182

10 278 App. Div. 12, 103 N.Y.S.2d 317, appeal den. 278 App. Div. 985, 105 N.Y.S.2d 1007 (1951).
11 254 App. Div. 438, 440, 5 N.Y.S.2d 553, 555 (1938).
12 263 N.Y. 107, 188 N.E. 270 (1933).
13 Randall v. Bailey, 288 N.Y. 280, 43 N.E.2d 43 (1942).
14 Ibid.
15 N.Y. Stock Corp. Law, § 58.
16 Ibid.
17 93 N.Y. 162, 61 H.P. 216 (1883).
18 See note 15, supra.
19 See note 13, supra.
20 262 N.Y. 202, 186 N.E. 673 (1933) motion to amend den. 262 N.Y. 644.
21 See note 15, supra.

of the Tax Law,[22] respectively, did not involve the question of the taxability of distributions to stockholders. In the *Wedgewood* case[23] the court decided that all distributions to stockholders from a corporation would be considered as "dividends" in determining the New York State Franchise Tax to be assessed against the corporation. The Franchise Tax is imposed on the corporation and is measured by the net value of its stock. In determining the value of such stock the amount of distributions to the stockholders has to be considered. Thus a "dividend" under sec. 182[24] includes all distributions to the stockholders which would help establish the value of the stock. A distribution from any source would help establish the value of the stock and the court declared that one out of unrealized appreciation would be no exception. The basic concept underlying sec. 182 of the New York Tax Law[25] is that of valuation, while the concept underlying Article 16 of the New York Tax Law, is realization. In determining the value of the stock of a corporation the court in the *Wedgewood* case,[26] correctly took into consideration distributions out of unrealized appreciation but the court made no mention as to whether or not such a distribution would be taxable to one receiving it. The concept of valuation does not enter the personal income tax picture, but rather the concept of realization takes over. In the *Wedgewood* case[27] as in the *Randall* case[28] the question of personal income taxes was not touched upon.

The value of the real estate held by Larchmont had increased to a minimum of $2,500,000.00, the amount the state claimed it was worth, as proven by the mortgage executed with the Provident Life Insurance Company of Pennsylvania. A Pennsylvania statute provides as to life insurance companies:

"No mortgage or trust deed loan shall at the date of investment exceed two-thirds (2/3) of the value of the real property securing the loan."[29]

Presuming that the Provident Life Insurance Company complied with the laws of Pennsylvania the value of the real estate would be at least $3,000,000.00.

New York State, through its Tax Commission, contended that in reliance on this increase in value and with the funds secured by negotiating a new mortgage based on this increased value, the corporation made a distribution to its stockholders and charged such distribution to its surplus, thereby arriving at a deficit surplus since the account had not been increased to reflect the appreciation in value of the real estate; that such distribution did not reduce the liability of the corporation on its common stock and did not constitute a return of capital to its stockholders, nor did it impair the corporation's capital; that such distribution was made without restrictions and that the stockholders assumed no liability, either directly or indirectly, to repay the new mortgage, and as such was a taxable dividend to the stockholders.

The petitioner claimed that the distribution represented a return of capital to the extent it exceeded the "earnings and profits" of the corporation and that amount did not exceed the total cost basis of his stock. Appreciation in value of real property not consummated by a sale of that property does not increase the "earnings and profits" of a corporation for the purpose of determining the taxability of any subsequent

22 N.Y. Tax Law, § 182.
23 See note 20, supra.
24 See note 22, supra.
25 Ibid.
26 See note 20, supra.
27 Ibid.
28 See note 13, supra.
29 Purdon's Penna. Stat. Anno.; Title 40, § 504 G.

distributions by the corporation. Article 66 of the rules of the State Tax Commission in respect to distributions other than out of earnings states,

"In general any distribution made by a corporation other than out of the earnings or profits is to be regarded as a return to the stockholder of part of the capital represented by his share of stock, and upon a subsequent sale of such stock, his profit will be the excess of the selling price over the basic value, as defined in Article 491, after applying against such basic value the amount of any such capital distribution. Liquidating dividends received in complete or partial liquidation of a corporation are treated as proceeds of a sale or exchange under sec. 350 subdivision 15."[30]

Hence a distribution not out of "earnings or profits" is a return of capital to the extent it does not exceed the basis of the stockholders capital.

The Federal government treats such a distribution as a return of capital and since the State Tax Laws were modeled after the Federal Law the State should treat a like distribution in a like manner. *People ex rel. Clark v. Gilchrist.*[31] The New York State Tax Law defines dividends just as they are defined in the Federal code, to wit, out of "earnings or profits." Since the State Legislature followed so closely the Federal definition of "dividends" it follows that the Legislature intended to invoke the same meaning the Federal government had. A congressional declaration will suffice to illustrate the Congress' thinking on this subject.

"Under court decisions an addition to surplus through reappraisement of assets is not made out of earnings and profits and therefore the distribution of an amount so added to surplus would not be a taxable dividend since not made out of earnings and profits."[32]

The Federal Internal Revenue Bureau regards a distribution from a source other than "earnings and profits" as a return of capital and since the State attempted to follow the Federal definition of dividends, it's but one more step to the Federal conclusion on distributions out of unrealized appreciation of assets. Article 66 of the rules of the State Tax Commission takes that step and conforms with the Federal thinking on the subject. The case of *Commissioner v. Gross,*[33] in accordance with the congressional declaration given above declared that reappraisement of assets does not result in an increase in "earnings and profits." This case dealt with the distribution of the excess of mortgage receipts over the actual cost of construction of real property and distributions to stockholders due to increased mortgages placed on appreciated land. These distributions, as in the instant case,[34] exceeded the accumulated "earnings and profits" of the distributing corporations. Circuit Judge Lumbard posed the question:[35]

"Thus the question here is the familiar one whether a distribution made out of unrealized appreciation in the value of the corporation's assets is taxable as ordinary income."

The court held such distribution should be treated as a return of the stockholders investment thereby reducing the basis of his stock. It seems well settled that unrealized appreciation does not increase "earnings and profits." Judge Lumbard in the *Gross* case[36] further stated:

30 Article 66 of the Rules of the State Tax Commission.
31 243 N.Y. 173, 276 N.Y.S. 357 (1926).
32 H. Rept, No. 767 on Revenue Bill of 1918, 65th Cong.
33 236 F. 2d 612 (2d Cir. 1952).
34 See note 2, supra.
35 See note 33, supra at p. 616.
36 Id. at p. 618.

"And we have held that the mortgaging of property for an amount in excess of its basis does not result in a realization of income even when the mortgagor is not personally liable to repay the loan *Woodsam Associates, Inc. v. Commissioner of Internal Revenue*."[37]

When one borrows money and pledges his real property as security for that loan, he acquires an asset, the cash he borrowed, and a liability, the amount of the mortgage loan. There is no sale or exchange and hence, no profit or loss is incurred by such a transaction. This is true for corporations as well as individuals since a corporation is considered an entity under the law. If then a corporation made a loan, secured by a mortgage on its real prpoerty, in excess of the cost of that real property no "earnings or profits" would result from that transaction since the liability incurred would still be equal to the asset acquired.

In the context of an income tax statute the term "earnings and profits" refers only to realized gain. "So long as property is in the hands of its owner any increase in value is an increase of the capital; it is derived or realized as income only when the property is disposed of. It is the deriving of the income, not the increase in value, that is made subject to the tax."[38] This suggests that realization is a basic concept of the New York State Tax Law.

In construing a statute it is well settled that when the same words are used in more than one place in the statute they must be given the same meaning.[39] So it is with the term "earnings and profits" as used in Article 16.[40] Only two sections of this Article use the term "earnings or profits." One of these is sec. 350(8)[41] the construction of which is at issue here, and the other is sec. 354(9)(d)(i)[42] dealing with the taxing of gains to corporate stockholders on liquidations. The purpose of sec. 354(9)[43] was to give relief to stockholders of a corporation which has substantially appreciated assets and small "earnings or profits." It enabled stockholders of such corporations to be taxed, if they so elected, at ordinary income rates on the amount that the corporation could have distributed as taxable dividends, out of "earnings or profits." The remainder of the gain, from the appreciation of the corporation's assets, is taxed in a different way than the distribution which is out of "earnings or profits." If the legislature meant the term "earnings or profits" to include unrealized appreciation in the value of corporate real property, there would have been no need for sec. 354(9)(d)(ii)[44] since the entire distribution would have been out of earnings or profits" and therefore taxable at ordinary income rates. The logical assumption is, therefore, that unrealized appreciation is not part of "earnings or profits." Giving the term "earnings or profits" the same meaning in sec. 350(8)[45] it cannot be construed as including unrealized appreciation. There is nothing in the New York Tax Law to suggest the legislature intended one meaning in one section and another meaning in a different section of the same law.

Courts of sister states, with like Tax Laws, have had the same problem as is here before the court, and it is interesting to note their decisions. The courts of these states

37 198 F. 2d 357 (2d Cir. 1952).

38 People ex rel Brewster v. Wendell, 196 App. Div. 613, 617, 188 N.Y.S. 510, 514 (1921).

39 Mangam v. The City of Brooklyn 98 N.Y. 585, 50 Am. R., 705 (1885).

40 N.Y. Tax Law, Article 16.

41 See note 3, supra.

42 See note 5, supra.

43 Ibid.

44 Ibid.

45 See note 3, supra.

have consistently held that a distribution out of unrealized appreciation in the value of corporate assets is not out of "earnings or profits" and hence not taxable as a dividend. In construing a Wisconsin statute[46] that follows the federal definition of dividings, to wit, out of "earnings or profits," the court said in *State ex rel. Hansen v. Carey:*[47]

"Now why did the Legislature define the term "dividends"? Because there were two kinds of dividends well known to it, namely, dividends issued out of profits, and dividends issued upon the increased value of corporate assets . . ."

The court held that the latter type, e.g., out of increased value of corporate assets, was not a taxable dividend. A Massachusetts statute provided that distributions out of "accumulated profits" were subject to income tax.[48] In *Sears v. Commissioner of Corporations and Taxation*[49] a distribution by a corporation of its assets, in kind, to its stockholders was held to be a return of capital reducing the basis of the outstanding stock and as such, non-taxable. The court said, in referring to the assets:[50]

"All that happened to them was that they increased in market value. Never during the existence of the corporation was the increased value turned into 'profits' by sale or otherwise."

In defining the word "profit" the court went on to say[51] "It does not include mere appreciation in market value."

In the Kentucky case of *Collins v. Kentucky Tax Commission,*[52] with the facts akin to those of the *Sears* case,[53] the court found the distribution taxable and gave the Kentucky definition of a dividend as "any distribution made by a corporation out of its current earnings or profits or out of its accumulated earnings or profits. It includes such portion of the assets of a corporation distributed at the time of dissolution as is in effect a distribution of earnings or profits."[54] The court reasoned that the phrase "in effect" used in the statute brought a distribution out of unrealized appreciation into the taxable category. "It may be conceded that so long as the whiskey was held by the corporation, with no markup on its books, the increased value of the whiskey was not taxable as earnings or profits of the corporation."[55] This latter statement seems to infer that a distribution out of unrealized appreciation, in Kentucky, would not be taxable unless a bookkeeping entry had been made by the corporation writing up the asset to its increased value and increasing the surplus by a like amount. As no such entry was ever made by Larchmont Apartments, Inc., it is apparently safe to assume that the distribution here in question would have been non-taxable if made in Kentucky. The reasoning of the Kentucky court is open to question in that the mere making of a bookkeeping entry would render an otherwise non-taxable distribution taxable.

The Federal government and sister states, with similar tax statutes, have construed the term "earnings or profits" not to include unrealized appreciation in asset values.

46 West's Wisconsin Statutes Annotated, Vol. 11, sec. 71.316, page 459.
47 191 Wis. 153, 153, 210 N.W. 420, 420 (1926).
48 General Laws (Ter. Ed. C 62 § 1).
49 322 Mass. 446, 78 N.E. 2d 89 (1948).
50 Id. at p. 450, 78 N.E. 2d at p. 92.
51 Ibid.
52 —— Ky. ——, 261 S.W. 2d 303 (Ky 1953).
53 See note 49, supra.
54 See note 52, supra at p. 304.
55 Id. at p. 306.

Since the New York Tax Law is also based on the Federal Law, the above decisions should have been given due weight in deciding the same question in New York.

Distributions not out of "earnings or profits" should be considered return of capital and thereby reduce the basis of the stock in the hands of the stockholder. Any excess of distribution over the basis of the stock should be considered a long or short term capital gain depending upon the length of time the stock was held. Article 66 of the Rules of the State Tax Commission makes this quite clear. No gain is recognized until the shareholder first reduces his basis to zero.[56] Any amount received in excess of the basis of the stock should be treated as a capital gain on the theory that such a distribution is treated as a "sale" to the corporation of a portion, or all of the stockholders interest. The term "sale or exchange" as used in sec. 350(15)(f) of the Tax Law[57] includes "complete or partial liquidation of a corporation whereby a stockholder receives liquidating dividends." The fact that a stockholder does or does not turn in any stock certificates to the corporation should have no effect on this section. So long as the distribution takes the effect of a pro-rata redemption from all of the stockholders the fact that there has or has not been a turn in of stock certificates would have no effect on the individuals proportionate interest in the corporation assets. If one has ten shares of stock with a book value of five dollars or five shares of stock with a book value of ten dollars, his interest still amounts to fifty dollars. Where a distribution is not out of "earnings or profits" and is made pro-rata, it should be treated as a redemption of stock whether or not there is a turn in of stock certificates to the corporation.

An economic example best illustrates the logical reasons for finding the distribution a return of capital. Had the entire distribution, $389,588.89, been treated as ordinary income the basis of Marx's stock would have remained $346,117.85, his cost. The value of his shares would have been only $282,112.00 after the distribution (assuming the property was worth $2,500,000.00). If then the corporation had been liquidated one day after the distribution, Marx would have incurred a capital loss of $64,005.85, the difference between the basis of his stock and the value of his share of the corporate assets upon distribution. There would have been a depreciation of his capital investment while the corporate assets underlying this investment appreciated substantially. He would have been compelled to report his share of the capital appreciation as normal income and then allowed a capital loss deduction of $64,005.85 on liquidation. The legislature did not intend to tax capital appreciation as normal income as evidenced by the special treatment given the sale of capital assets.

The Court of Appeals in the instant case[58] held that a distribution, in cash, by a corporation to its controlling stockholder out of the proceeds of a refinanced mortgage was to be treated as a return of capital to the extent it exceeded the "earnings or profits" of the corporation making such distribution. Thus the question of whether a distribution out of unrealized appreciation constituted ordinary income was determined in the negative. Judge Fuld stated the issue to be,

"whether unrealized appreciation in value of a corporation's assets or the borrowing of money by the corporation, secured in part by such appreciation increases its earnings and profits."[59]

Since there was no sale and hence no realization, there was, of necessity, no profit or loss to the corporation. In order to obtain a profit on a corporate asset, that asset

[56] See note 1, supra § 353.
[57] See note 3, supra.
[58] See note 2, supra.
[59] Ibid.

must be disposed of.[60] In support of the court's decision that unrealized appreciation in asset values was not subject to income taxes, the court stated:

"That the legislature of this State deliberately and intentionally adopted this fundamental concept is established by the fact that, when it enacted the New York Personal Income Tax Law in 1919 (L. 1919 ch 627) it modeled it after the Federal Revenue Act of 1918."[61]

The definitions of "dividends" used in the State and Federal Tax Laws are similar in every respect and clearly state that a distribution must be out of "earnings or profits" to be taxable as a dividend.

The fact that the corporation was able to, and did in fact, borrow money due to the appreciation in the value of its real property had no effect on its "earnings or profits." Although money is received by a corporation if the corporation retains the ownership of the assets, which are the cause of this receipt, and an equivalent liability is incurred, there is no increase of the corporation's "earnings or profits."[62] The surplus of Larchmont was not effected by the loan since there was a corresponding increase in the assets, cash received, and the liabilities; the increased mortgage loan.

The policy of New York is to follow the Federal construction of similar tax provisions whenever possible.[63] The court in the instant case leaned quite heavily on the Federal ruling and went so far as to state that "no persuasive reason has been advanced for adopting a different meaning of the term for New York State income tax purposes than has been adopted and consistently applied from the beginning in the construction of the Federal statute."[64]

The Court of Appeals decision conformed with the Federal opinion in that the distribution was first treated as a return of capital, thereby lowering the basis of the stock in the hands of the petitioner to zero, and the remainder treated as a taxable receipt. F. H. G.

[60] See note 38, supra.
[61] See note 2, supra.
[62] See note 33, supra.
[63] Matter of Rogers 296 N.Y. 676, 70 N.E. 2d 170 (1946). Matter of Russell 294 N.Y. 99, 60 N.E. 2d 823 (1945).
[64] See note 2, supra.