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Territorial Fairness: A Due Process Standard for Quasi In Rem Jurisdiction

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CASES NOTED

TERRITORIAL FAIRNESS: A DUE PROCESS STANDARD FOR QUASI IN REM JURISDICTION

A Kansas resident filed a complaint against an Illinois drug company in a Mississippi court alleging that she had suffered a stroke as a result of using the defendant's inadequately tested birth control pills which she had purchased in Kansas. The defendant was incorporated in Delaware, had its principal place of business in Illinois, and owned no tangible property in Mississippi. The defendant did maintain three full-time employees in Mississippi and sold several hundred thousand dollars worth of its products annually to companies in that state. The plaintiff attempted to establish jurisdiction by attachment[1] of debts owed to the defendant by companies doing business in Mississippi. The defendant removed the action[2] to the federal district court where the complaint was dismissed for lack of jurisdiction. On appeal, the United States Court of Appeals for the Fifth Circuit *held*, reversed and remanded: Mississippi law provides that where a nonresident plaintiff attaches debts owed to a foreign corporate defendant, the court has quasi in rem jurisdiction to adjudicate a tort claim arising outside of the state; there is no violation of due process in the exercise of such jurisdiction where the defendant has sufficient contact with the forum state so that the maintenance of the action will not be unfair. *Steele v. Searle & Co.*, 483 F.2d 339 (5th Cir. 1973).

For the purpose of determining jurisdiction, actions are characterized as in personam, in rem, or quasi in rem.[3] In personam jurisdiction is the power of the court to impose a personal liability upon the defendant.[4] In rem jurisdiction is the power of the court to determine the interests of all persons in specific property.[5] Quasi in rem jurisdiction is the power of the court to determine the interests of particular persons in specific property.[6] Quasi in rem actions are of two types: (1) actions which arise from disputes concerning the rights of the parties to the property over which the court has taken jurisdiction, and (2) actions to determine a claim unrelated to the property, which is used as a device for obtaining jurisdiction and as a fund for execution.[7] In *Steele* the court was confronted with the latter type.

Prior to *Steele*, different due process tests were applied depending

1. The attachment action was brought pursuant to MISS. CODE ANN. §§ 1437, 5346 (1942), and MISS. CODE ANN. § 5309—230 (Supp. 1972), on the ground that the defendant was doing business in Mississippi. The dismissal of the in personam action was not appealed.
2. The action was removed pursuant to 28 U.S.C. § 1441 (1970).
3. RESTATEMENT (SECOND) OF CONFLICTS, Introductory Note, at 102-04 (1971).
4. *Id.*
5. *Id.*
6. *Id.*
7. *Id.*

upon whether the action was in personam or in rem. The basis upon which state court jurisdiction could be predicated, within the limitations of fourteenth amendment due process, was first outlined in 1877 in *Pennoyer v. Neff*.[8] The Supreme Court indicated that in rem jurisdiction was based on the physical presence of property within the forum state, and that in personam jurisdiction was based either upon the consent of the defendant, or upon service of process on the defendant while present within the forum state. These bases, along with notice and opportunity to defend, satisfied the requirements of due process with respect to the exercise of the various types of state court jurisdiction.[9]

Since *Pennoyer*, the due process restrictions on a state's exercise of in personam jurisdiction have been relaxed. In addition to presence and consent, it has been held that a state court may validly exercise in personam jurisdiction on the basis of domicil;[10] appearance;[11] perpetration of a tort within the state;[12] commission of an act outside the state which causes legally actionable effects within the state;[13] and the act of doing business in the state.[14] In *International Shoe Co. v. Washington*,[15] the Court stated the rule of due process with respect to in personam jurisdiction:

> [D]ue process requires only that in order to subject a defendant to a judgment *in personam*, if he be not present within the territory of the forum, he have certain minimum contacts with it such that the maintenance of the suit does not offend "traditional notions of fair play and substantial justice."[16]

This "minimum contacts" test, as developed by subsequent case law,[17] is the due process standard which is presently applicable to in personam jurisdiction over corporations as well as individuals.[18]

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8. 95 U.S. 714 (1877) [hereinafter referred to as *Pennoyer*].

9. *Id.*

10. Milliken v. Meyer, 311 U.S. 457 (1940).

11. Adam v. Saenger, 303 U.S. 59 (1938) (appearance of plaintiff); York v. Texas, 137 U.S. 15 (1890) (appearance of defendant).

12. Hess v. Pawloski, 274 U.S. 352 (1927).

13. *See* McGee v. International Life Ins. Co., 355 U.S. 220 (1957); *cf.* Hanson v. Denckla, 357 U.S. 235 (1958).

14. *E.g.*, International Harvester Co. v. Kentucky, 234 U.S. 579 (1914).

15. 326 U.S. 310 (1945).

16. *Id.* at 316.

17. *See generally* Travelers Health Ass'n v. Virginia, 339 U.S. 643 (1950) (solicitation of new members by nonprofit organization satisfies "minimum contacts"); Perkins v. Benguet Consol. Mining Co., 342 U.S. 437 (1952) (where defendant's activities constitute substantial contacts with the forum state, the cause of action need not arise out of those activities); McGee v. International Life Ins. Co., 335 U.S. 220 (1957) (renewal of a single life insurance policy and collection of premiums satisfies "minimum contacts" test); Hanson v. Denckla, 357 U.S. 235 (1958) (administration of an out of state trust, remittance of income to the beneficiary in the forum state, and execution of powers of appointment by the beneficiary do not satisfy "minimum contacts" test with respect to the trustee).

18. Prior to the "minimum contacts" test the Court had justified the exercise of state court jurisdiction over foreign corporations under theories of presence, doing business, and consent. *See* McGee v. International Life Ins. Co., 355 U.S. 220, 222 (1957).

The permissible bases of quasi in rem jurisdiction were expanded by the Supreme Court in *Harris v. Balk*[19] to encompass a state's territorial power over intangible as well as tangible property located within the forum state.[20] In *Harris*, the Court stated that where a state statute authorizes attachment of a debt, service of process upon the garnishee found in the forum state confers quasi in rem jurisdiction upon the court, provided the garnishee could be sued by his creditor in that state.[21] This principle has been held to apply also where the garnishee is a corporation doing business in the forum state.[22] Thus, prior to *Steele*, there had developed a territorial test of due process for in rem jurisdiction and a "minimum contacts" test of due process for in personam jurisdiction.

The application of different standards of due process depending upon whether an action was characterized as in personam or in rem was declared by the United States Supreme Court in *Mullane v. Central Hanover Bank & Trust Co.*[23] to be an unnecessary constitutional inconsistency. The Court rejected the distinctions between in rem, quasi in rem, and in personam jurisdiction for the purposes of satisfying due process, stating that

> the requirements of the Fourteenth Amendment to the Federal Constitution do not depend upon a classification for which the standards are so elusive and confused generally and which, being primarily for state courts to define, may and do vary from state to state.[24]

The Court proceeded to determine the jurisdictional issue on general principles of due process.

The *Mullane* approach to the due process issue concerning state court jurisdiction was adopted and expanded by the Supreme Court of California in *Atkinson v. Superior Court*.[25] In that case, the court applied the "minimum contacts" test of due process in holding that it had validly obtained quasi in rem jurisdiction to adjudicate the rights of the parties to a trust fund located in another state. This idea that the "minimum contacts" test is relevant to determine whether due process

19. 198 U.S. 215 (1905) [hereinafter referred to as *Harris*].

20. The courts have experienced considerable difficulty in determining the physical territorial location, or *situs*, of intangible property, a necessarily fictional concept. Incongruities and unfair limitations resulting from arbitrary and conflicting rules fixing the location of intangible property have led a number of writers to call for eliminating the *situs* concept and replacing it with a fairness standard. *E.g.*, Traynor, *Is This Conflict Really Necessary?* 37 TEXAS L. REV. 657 (1959) [hereinafter cited as Traynor]. See note 27 *infra*. In *Harris*, however, the Court held that the *situs* of a debt is the location of the debtor. Harris v. Balk, 198 U.S. 215 (1905).

21. *Id.* at 222.

22. Louisville & N.R.R. v. Deer, 200 U.S. 176 (1906).

23. 339 U.S. 306 (1950) [hereinafter referred to as *Mullane*].

24. *Id.* at 312.

25. 49 Cal. 2d 338, 316 P.2d 960 (1957), *appeal dismissed and cert. denied sub nom.*, Columbia Broadcasting Sys., Inc. v. Atkinson, 357 U.S. 569 (1958).

permits the exercise of quasi in rem jurisdiction and that the distinction between in rem and in personam "has no bearing on the fairness"[26] of exercising such jurisdiction has gained widespread support among scholars and commentators.[27]

Shortly after *Atkinson* was decided, however, the United States Supreme Court reiterated the territorial standard of due process and relied on the in rem—quasi in rem—in personam distinctions in determining the constitutionality of state court jurisdiction in *Hanson v. Denckla*.[28] The Court held, on facts similar to those of *Atkinson*, that despite numerous contacts between the forum state and the parties, there could be no quasi in rem jurisdiction over a trust fund located in another state.

The significance of the territorial standard of due process was reaffirmed in *Minichiello v. Rosenberg*,[29] where the court held, in reliance on *Harris*, that a New York court had validly obtained quasi in rem jurisdiction over a nonresident defendant in order to litigate a tort claim arising outside of the state, by attachment of a "debt," the obligation of the defendant's liability insurer. In *Minichiello*, however, it was pointed out that the holding applied only to actions brought by residents of the forum state.[30] It was specifically determined that a quasi in rem action based on a foreign claim could not be maintained by a nonresident plaintiff against a nonresident defendant in *Farrell v. Piedmont Aviation, Inc.*[31] In that case, the Court of Appeals for the Second Circuit indicated that to permit a nonresident to maintain such an action would raise "exceedingly serious" constitutional doubts.[32]

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26. *Id.* at 346, 316 P.2d at 965.

27. *See, e.g.*, RESTATEMENT (SECOND) OF CONFLICTS §§ 65, 68, comment *c* (1971); Seidelson, *Seider v. Roth, et seq.: The Urge Toward Reason and the Irrational Ratio Decidendi*, 39 GEO. WASH. L. REV. 42 (1970); Traynor, *supra* note 20; von Mehren & Trautman, *Jurisdiction to Adjudicate*, 79 HARV. L. REV. 1121 (1966); *Developments in the Law—State Court Jurisdiction*, 73 HARV. L. REV. 909 (1960) [hereinafter cited as *State Court Jurisdiction*]; Comment, *Garnishment of Intangibles: Contingent Obligations and the Interstate Corporation*, 67 COLUM. L. REV. 550 (1967); Comment, *Long-Arm and Quasi in Rem Jurisdiction and the Fundamental Test of Fairness*, 69 MICH. L. REV. 300 (1970); Comment, *Adjudication of Personal Rights by Proceedings Quasi in Rem*, 10 STAN. L. REV. 750 (1958); Note, 46 CALIF. L. REV. 637 (1958); Note, 43 ST. JOHN'S L. REV. 58 (1968). This position was most emphatically advanced by Justice Traynor:

> It is time we had done with mechanical distinctions between in rem and in personam, high time now in a mobile society where property increasingly becomes intangible and the fictional res becomes stranger and stranger. Insofar as courts remain given to asking "Res, res—who's got the res?," they cripple their evaluation of the real factors that should determine jurisdiction. They cannot evaluate the real factors squarely until they give up the ghost of the res.

Traynor, *supra note* 20, at 663.

28. 357 U.S. 235 (1958) [hereinafter referred to as *Hanson*].

29. 410 F.2d 106 (2d Cir. 1968), *cert. denied*, 396 U.S. 844 (1969) [hereinafter referred to as *Minichiello*].

30. *Id.* at 110 n.6. *Id.* at 119 (concurring opinion).

31. 411 F.2d 812 (2d Cir. 1969) [hereinafter referred to as *Farrell*].

32. *Id.* at 817. While the court decided the issue on the basis of state public policy and, therefore, did not reach the federal constitutional issue, it characterized the above quoted dicta as "understatement."

In resolving the *Steele* case, the Fifth Circuit was faced with an apparent dilemma as to the proper due process standard applicable to the exercise of quasi in rem jurisdiction by a state court. On the one hand, the court was bound by the authority of *Harris* as reinforced by *Hanson* and *Minichiello*. On the other hand, it could not ignore the compelling reasoning of *Mullane* that fair play and substantial justice do not depend on whether an action may be labelled in personam or quasi in rem. In resolving this conflict the court purported to apply both the territorial and the minimum contacts due process tests. In finding that both had been satisfied it avoided any definitive rejection of either standard.

Clearly, the territorial requirements of *Harris* and *Hanson* had been satisfied; there had been service of process upon the garnishees doing business[33] in the forum state, and the garnishees could have been sued by their creditor in that state. Yet the court went on to disapprove the harsh rule of *Harris*, stating:

> [W]ere we faced today with a case like the Harris v. Balk of old, in which a defendant's debtor wanders across a border line and thereby subjects the defendant to the process of a strange and distant state, the tendency to call a halt would be strong.[34]

Since the principles of state territorial power, outlined in *Pennoyer* and reaffirmed in *Harris* and *Hanson*, could not be disregarded, they were considered in applying the "minimum contacts" test. Thus, the court stated that the presence of the defendant's debtor within the forum state provides "a crucial point of contact [that] goes far toward providing the essential 'minimum' necessary for the constitutional assumption of jurisdiction."[35] Once this was established, the further contacts necessary to fulfill the "minimum" required were easily found to exist in that the defendant maintained employees within the state and shipped several hundred thousand dollars worth of merchandise into the state annually.

If the court had merely wished to adhere to the old rule of *Harris*, it would not have been necessary to extend the opinion beyond a measurement of the facts against that standard. By questioning *Harris* and proceeding to measure the facts against a "minimum contacts" test based on principles of fairness as well as territoriality, the court developed a new due process standard applicable to quasi in rem jurisdiction. That test requires not only the presence of intangible property in the forum state, but also some additional contact between the defendant and that forum such that the maintenance of the suit will not be unfair.

In applying the tests of due process, the *Steele* court noted that to allow a nonresident plaintiff to sue a nonresident defendant on a foreign

33. See note 22 *supra* and accompanying text.
34. 483 F.2d at 349.
35. *Id.* at 348.

claim was constitutionally permissible. In light of *Minichiello* and *Farrell*, which indicated that maintenance of such an action by a nonresident would be constitutionally impermissible, the decision in the instant case is questionable.

In *Steele*, the court treated the United States Supreme Court decision in *Ownbey v. Morgan*[36] as authority preventing disallowance of an action on the basis of nonresidence of the plaintiff. The court quoted the following language from *Ownbey*:

> [I]t is clear that, by virtue of the "privileges and immunities" clause of section 2 of article 4 of the Constitution, each state is at liberty, if not under duty, to accord the same privilege of protection to creditors who are citizens of other states that it accords to its own citizens.[37]

Although a state may not discriminate on the basis of citizenship as to who may have access to its courts, it may discriminate on the basis of residence.[38] Therefore, if it were found that, because of a plaintiff's nonresidence, a quasi in rem action against a foreign corporation based upon a foreign claim would violate due process as indicated in *Minichiello* and *Farrell*, the action could be disallowed on due process grounds, and the privileges and immunities clause of the Constitution would not prevent such disallowance.

In addition to possible conflict with the views of the Second Circuit,[39] there also remain unresolved issues concerning the *situs* of intangible property,[40] the availability of a limited appearance,[41] and the applicable

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36. 256 U.S. 94 (1921).

37. 483 F.2d at 346, *quoting* Ownbey v. Morgan, 256 U.S. 94, 109 (1921).

38. While it has been held that in distribution of a debtor's assets a state may not discriminate against nonresident creditors by giving resident creditors priority, Blake v. McClung, 172 U.S. 239 (1898), it is settled that a state may validly employ a distinction of privileges according to residence where the distinction is supported by rational considerations. Douglas v. New Haven R.R., 279 U.S. 377 (1929). Thus, a state licensing statute granting licenses only to resident insurance salesmen is valid, La Tourette v. McMaster, 248 U.S. 465 (1919), and under the doctrine of *forum non conveniens* a state court may validly refuse to take jurisdiction of a case brought against a foreign corporation by a nonresident, even though it can not refuse such an action brought by a resident. Douglas v. New Haven R.R., *supra*. It is submitted that since the "privileges and immunities" clause of the Constitution does not prevent exclusion of nonresidents under the doctrine of *forum non conveniens*, a fortiori, it should not prevent exclusion of nonresidents under the fourteenth amendment.

39. *See* Minichiello v. Rosenberg, 410 F.2d 106 (2d Cir. 1968), *cert. denied*, 396 U.S. 844 (1969); Farrell v. Piedmont Aviation, Inc., 411 F.2d 812 (2d Cir. 1969).

40. See note 20 *supra*.

41. In *Steele*, the court dismissed the issue of notice and opportunity to appear and to be heard in a footnote. 483 F.2d at 341 n.4. Under the Mississippi attachment statute, however, if the defendant defends on the merits, he is subject to a personal judgment for the balance of the plaintiff's claim not realized by the sale of the attached property. John E. Hall Comm'n Co. v. Foote, 90 Miss. 422, 43 So. 676 (1907). This procedure, which conditions the due process right to be heard upon the surrender of the right of immunity from in personam jurisdiction in a foreign tribunal, is highly questionable on constitutional grounds. *See State Court Jurisdiction, supra* note 27, at 953-55. In *Steele*, however, since the value

substantive law and statute of limitations.[42] Nevertheless, the *Steele* case reflects an ingenious solution to the problem presented by inconsistent standards of due process applicable to the exercise of state court jurisdiction. By adding a fairness requirement to the territorial requirements of *Harris* and *Hanson*, the court utilized apparently conflicting precedents to synthesize a new rule of due process. Without abandoning basic principles of state territorial sovereignty, this new rule for quasi in rem jurisdiction marks a significant step toward a standard which truly reflects considerations of substantial justice and fair play.

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PRIVATE ANNUITIES: CLOSED TRANSACTIONS?

Decedent and his wife transferred appreciated stock in two closely held corporations to their children and respective spouses who in exchange, promised to make monthly annuity payments to decedent and his wife for their joint lives. As security for the payments, the stock was placed in escrow and a cognovit note was executed which provided for judgment against the children in case of non-payment. Payments were received in 1968 and 1969 pursuant to the annuity agreement. The annuitants treated these payments as a return of their investment and paid no federal income tax on them. The Commissioner of Internal Revenue determined deficiencies in the annuitants' federal income taxes for 1968 and 1969, treating the annuity payments received as prescribed by Revenue Ruling 69-74.[1] Applying the provisions of Revenue Ruling 69-74, the Commissioner found that decedent and his wife realized an immediate capital gain on the transfer of the property and as the annuity payments were received they were required to recognize that gain on a

of the attached debt far exceeded the plaintiff's claim, there was no need to decide that question.

42. *See* 483 F.2d at 349 n.26. The instant case was instituted in Mississippi in order to take advantage of a longer statute of limitations. *Id.*

1. 1969-1 CUM. BULL. 43 [hereinafter referred to as Revenue Ruling 69-74] in pertinent parts provides as follows:

> (1) The gain realized on the transaction is determined by comparing the transferor's basis in the property with the present value of the annuity . . . .
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> . . . .
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> (3) The gain should be reported ratably over the period of years measured by the annuitant's life expectancy and only from that portion of the annual proceeds which is includable in gross income by virtue of the application of section 72 of the 1954 Code . . . .
>
> (4) The investment in the contract for purposes of section 72 of the 1954 Code is the transferor's basis in the property transferred . . . .
>
> After the capital gain . . . has been fully reported, subsequent amounts received (after applying the exclusion ratio) are to be reported as ordinary income.