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the appointment of a nonresident representative. If it is found that he has no "real and substantial" interest in the controversy, the action must be dismissed. Thus, an action may be extensively litigated resulting in expense and loss of time to the parties without a determination on the merits of the case.

The acceptance of *McSparran* in other circuits is difficult to predict. Since *McSparran* supports the general trend toward reducing diversity jurisdiction, it may be followed by other circuits. A practical consideration is the present congestion of the federal courts.<sup>38</sup> Since a large portion of actions in federal courts are diversity actions,<sup>39</sup> congestion would be reduced by following *McSparran*.

Dan M. Cain

### Medical Malpractice: "Locality" Rule Abandoned in Massachusetts

During the delivery of her baby, Brune was administered a spinal anesthetic by Belinkoff, a specialist in anesthesiology practicing in New Bedford, Massachusetts. A partial paralysis developed in her left side. Brune sued Belinkoff for malpractice, contending that he had negligently given her an overdose of the anesthetic pontocaine. Belinkoff had administered eight milligrams of pontocaine<sup>1</sup> to Brune, and medical evidence<sup>2</sup> demonstrated that good medical practice required a dosage of five milligrams or less. However, there was also evidence that the larger dosage was customary in New Bedford for a vaginal delivery.<sup>3</sup>

The trial court refused to give Brune's requested charge that, as a specialist, Belinkoff owed her the duty to have and use the care and skill commonly possessed and used by similar specialists in like circumstances. Instead the trial court charged the jury that the defendant's conduct need only equal the standard of professional care and skill possessed by others in the New Bedford community, even though this standard might be fifty per cent inferior to the Boston standard.<sup>4</sup>

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<sup>38</sup> See 1966 DIRECTOR OF THE ADMINISTRATIVE OFFICE OF THE UNITED STATES COURTS, ANN. REP.

<sup>39</sup> *Id.* at 170. In the fiscal year of 1966, of 70,906 civil cases commenced in district courts, 20,245 were based on diversity.

<sup>1</sup> Eight milligrams of pontocaine in one cubic centimeter of ten per cent solution of glucose.

<sup>2</sup> Eight physicians, apparently local doctors, testified as to the standard of care in New Bedford. The standard of care in other areas was proved through the use of medical textbooks. In the oral argument of the case, plaintiff's counsel questioned the court's refusal to allow testimony of experts from without the community while admitting textbooks whose authors were not from the same community.

<sup>3</sup> New Bedford obstetricians applied suprafundi pressure (pressure applied to the uterus) during delivery which required a higher level of anesthesia.

<sup>4</sup> The complete charge given by the trial court on the standard of care issue was: The defendant "must measure up to the standard of professional care and skill ordinarily possessed by others in his profession in the community, which is New Bedford, and its environs, of course where he practices, having regard to the current state of advance of the profession. If, in a given case, it were determined by a jury that the ability and skill of the physician in New Bedford were fifty

Brune was denied recovery in the trial court. *Held, reversed*: One holding himself out as a medical specialist should be held to the standard of care of the average member of the profession practicing in his specialty, taking into account the general advances in the medical profession and the defendant doctor's accessibility to medical facilities. *Brune v. Belinkoff*, 235 N.E.2d 793 (Mass. 1968).

### I. DEVELOPMENT OF THE "LOCALITY" RULE

It is well settled that a medical doctor owes his patients the duty to possess a minimum standard of skill and care,<sup>5</sup> but the standard by which a doctor's conduct should be judged has long troubled the courts. In the nineteenth century, rigid application of uniform standards to all physicians without regard to special conditions or particular circumstances was considered too harsh<sup>6</sup> because medical facilities differed in the various sections of the country, and poor communications made it difficult for doctors in one part of the country to learn of recent medical developments in another.<sup>7</sup> The country doctor could not be expected to have the equipment, libraries, access to hospitals or the broad-spectrum experience of city doctors.<sup>8</sup> Therefore, courts formulated a rule based on geographic considerations. This maxim, the "locality" rule, provided that a doctor owed his patient the duty to exercise only that degree of skill which would have been exercised by an average doctor in good standing practicing in the *same* locality.<sup>9</sup>

Though the strict locality rule seemingly was based on sound policy, it nevertheless worked a hardship on the plaintiff attempting to prove medical negligence. To do so, the plaintiff had to produce a colleague of the defendant practicing in the *same* community to testify to the local standard of care and defendant's breach of it.<sup>10</sup> No doctor practicing outside of the defendant's community was considered to be sufficiently familiar with local practice to qualify as a witness.<sup>11</sup> Since doctors practicing in the same community are notoriously hesitant to testify against their colleagues,<sup>12</sup> it

percent inferior to that which existed in Boston, a defendant in New Bedford would be required to measure up to the standard of skill and competence and ability that is ordinarily found by physicians in New Bedford."

<sup>5</sup> *Kelly v. Carroll*, 36 Wash. 2d 482, 219 P.2d 79 (1950); see also *Annot.*, 57 A.L.R. 974 (1928). For a discussion of the standard, see *McCoid, The Care Required of Medical Practitioners*, 12 VAND. L. REV. 549 (1958).

<sup>6</sup> 41 AM. JUR. *Physicians and Surgeons* § 84 (1942).

<sup>7</sup> *Smothers v. Hanks*, 34 Iowa 286 (1872); *Tefft v. Wilcox*, 6 Kan. 46 (1870); *Ramsland v. Shaw*, 341 Mass. 56, 61, 166 N.E.2d 894, 901 (1960); *Ernen v. Crofwell*, 272 Mass. 172, 172 N.E. 73 (1930); *Hathorn v. Richmond*, 48 Vt. 557 (1876); *Gates v. Fleischer*, 67 Wis. 504, 30 N.W. 674 (1886).

<sup>8</sup> *Small v. Howard*, 128 Mass. 131 (1880).

<sup>9</sup> *Id.* *Small v. Howard* is generally considered the first case to adopt the "locality" rule. However, the *Small* court did not actually use the words "same community" but used the words "in similar localities with opportunities for no larger experience." The words "same community" were grafted onto *Small* by later decisions. *Goldman, Malpractice Cases in Massachusetts*, 40 MASS. L.Q. 27, 28-29 (1955).

<sup>10</sup> Many courts have held that the only admissible proof in establishing negligence against a doctor is a qualified medical expert. Note, *Overcoming the "Conspiracy of Silence": Statutory and Common Law Innovations*, 45 MINN. L. REV. 1019, 1020 (1961).

<sup>11</sup> *Id.*

<sup>12</sup> *Belli, An Ancient Therapy Still Applied: The Silent Medical Treatment*, 1 VILL. L. REV. 250, 259 (1956). The "conspiracy of silence" which *Belli* discusses exists for several reasons. Most doc-

was often difficult, and sometimes impossible<sup>13</sup> for the plaintiff to produce expert testimony regarding the defendant doctor's alleged negligence.

## II. MODIFICATION OF THE "LOCALITY" RULE

As communications and medical facilities improved, and as courts became increasingly aware of the difficulties of proof created by the strict locality rule, various modifications of the rule were made. The courts expanded the standard of care to include the "same or similar localities," thus including other towns of the same general size and character.<sup>14</sup> Statutes were enacted which permitted out-of-state doctors to testify<sup>15</sup> and which allowed the plaintiff to use medical books as substitutes for expert testimony.<sup>16</sup> Later court decisions further broadened the original rule by expanding the geographical area which constitutes the community,<sup>17</sup> by treating the size and character of the community merely as a factor to be considered rather than as a definite, single standard to be applied,<sup>18</sup> and by emphasizing such considerations as available medical facilities and experience.<sup>19</sup>

Three recent decisions illustrate the quickening judicial trend away from the strict "locality" rule. In *Pederson v. Dumouchel*<sup>20</sup> the Washington supreme court held it reversible error to limit the standard of care solely to that of the same or similar geographical area. In *Douglas v. Busabarger*<sup>21</sup> the same court noted that there is no general rule requiring expert medical testimony as to the standard of care. In the third decision,<sup>22</sup> the Supreme Court of Appeals of West Virginia aptly stated the rationale for abandoning the strict locality rule. Holding that a New York City doctor who was familiar with the standard of medical practice in areas similar to Charleston, West Virginia, was qualified to testify on the standard in Charleston, the court stated: "[T]he doctor in the rural area now

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tors believe that lay jurors are not equipped to cope with the technicalities of the medical profession as presented in malpractice cases (Kantor, *With Justice for All*, 30 TEX. B.J. 23 (1967)), and therefore may find for the plaintiff when in fact no negligence has occurred (Note, *The California Malpractice Controversy*, 9 STAN. L. REV. 731, 734 (1957)). Many doctors dislike the legal cross-examination and feel that they are made to appear ridiculous before the jury. In addition, doctors who do testify sometimes must face the disfavor of the medical association for "unprofessional conduct" (Bernstein v. Alameda Contra Costa County Medical Ass'n, 139 Cal. App. 2d 241, 293 P.2d 862 (1956), where a local doctor was charged with violation of the Principles of Medical Ethics of the American Medical Association. One of the seven charges brought against him alleged that the doctor had rendered a report containing unfavorable remarks about another doctor to a workmen's compensation commission for use by the commission in a pending action), and the possibility of being dropped by their malpractice carriers (Huffman v. Lindquist, 37 Cal. 2d 465, 234 P.2d 34, 46 (1951) (Carter, J., dissenting)).

<sup>13</sup> Agnew v. Parks, 172 Cal. App. 2d 756, 343 P.2d 118 (1959).

<sup>14</sup> E.g., Nation v. Gueffroy, 172 Ore. 673, 142 P.2d 688 (1943).

<sup>15</sup> WIS. STAT. § 147.14(2) (a) (1957).

<sup>16</sup> MASS. GEN. LAWS ch. 233, § 79-C (Supp. 1968).

<sup>17</sup> E.g., Tanner v. Sanders, 247 Ky. 90, 56 S.W.2d 718, 720 (1933); Michael v. Roberts, 91 N.H. 499, 23 A.2d 361 (1941).

<sup>18</sup> E.g., Geraty v. Kaufman, 115 Conn. 563, 162 A. 33 (1932); McGulpin v. Bessmer, 241 Iowa 1119, 43 N.W.2d 121 (1950); Viita v. Dolan, 132 Minn. 128, 135-37, 155 N.W. 1077, 1080-91 (1916).

<sup>19</sup> Tvedt v. Haugen, 70 N.D. 338, 294 N.W. 183 (1940). See also Cavallaro v. Sharp, 84 R.I. 67, 121 A.2d 669 (1956).

<sup>20</sup> 431 P.2d 973 (Wash. 1967).

<sup>21</sup> 438 P.2d 829 (Wash. 1968).

<sup>22</sup> Hundley v. Martinez, 158 S.E.2d 159 (W. Va. 1967).

has available to him most of the same facilities as does the practitioner in the city."<sup>23</sup> In addition, the court observed, ready means of communication now enable the doctor to keep abreast of medical developments and practices regardless of his location.

One authority<sup>24</sup> has said that the current tendency is to abandon any precise formula, making the standard of care merely one of "good medical practice."<sup>25</sup> However, the majority of recent cases apparently still adhere to some form of the "locality" rule. The recent and consistent use of such phrases as "in the same or similar localities,"<sup>26</sup> "in the community,"<sup>27</sup> "in like localities,"<sup>28</sup> or "in the same neighborhood"<sup>29</sup> continue to make the locality an important circumstance in qualifying the standard of care. Texas courts<sup>30</sup> early adopted the "locality" rule, and a 1965 case<sup>31</sup> said that the defendant doctor is required only to exercise that degree of care, skill and diligence as is ordinarily used by members of the profession in "the same general vicinity."<sup>32</sup>

### III. BRUNE V. BELINKOFF

Massachusetts, the first state to adopt the "locality" rule in the case of *Small v. Howard*,<sup>33</sup> now has led the way in repudiating it in *Brune v. Belinkoff*.<sup>34</sup> As applied to the medical profession of today, the rule enunciated in *Small*<sup>35</sup> was found by the *Brune* court to be unsuited to present-day conditions. The court viewed a standard of medical care based solely on geography as no longer valid in view of modern developments in transportation, communication and medical education, all of which tend to promote a certain degree of standardization within the profession. Accordingly, the court determined that the "locality" rule should be abandoned.

*Brune* illustrates the inappropriateness of the "locality" rule today. The defendant practiced only fifty miles from Boston, one of the medical centers of the nation. Nevertheless, the trial court, relying on the ninety-year old case of *Small*,<sup>36</sup> instructed the jury that even "if the skill and ability of New Bedford physicians were 'fifty per cent inferior' "<sup>37</sup> to that of Boston doctors, the defendant still should be judged by New Bedford standards. Although this may have been a correct interpretation of the

<sup>23</sup> *Id.* at 167.

<sup>24</sup> W. PROSSER, *THE LAW OF TORTS* 166-67 (3d ed. 1964).

<sup>25</sup> *Id.* at 167; see also *RESTATEMENT (SECOND) OF TORTS* § 299A (1965).

<sup>26</sup> *Carrigan v. Roman Catholic Bishop*, 104 N.H. 73, 178 A.2d 502 (1962).

<sup>27</sup> *Gore v. United States*, 229 F. Supp. 547 (E.D. Mich. 1964); *Harris v. Campbell*, 409 P.2d 67 (Ariz. Civ. App. 1965); *Goheen v. Graber*, 181 Kan. 107, 309 P.2d 636 (1957).

<sup>28</sup> *Lagerpusch v. Lindley*, 253 Iowa 1304, 115 N.W.2d 207 (1962).

<sup>29</sup> *Foose v. Haymond*, 135 Colo. 275, 310 P.2d 722 (1957); *Snyder v. Pantaleo*, 143 Conn. 290, 122 A.2d 21 (1956).

<sup>30</sup> *Bowles v. Bourdon*, 213 S.W.2d 713 (Tex. Civ. App. 1948), *aff'd*, 219 S.W.2d 779 (1949); *Hess v. Rouse*, 22 S.W.2d 1077 (Tex. Civ. App. 1929); *Dunn v. Styron*, 10 S.W.2d 1018 (Tex. Civ. App. 1928), *error dismissed w.o.j.*

<sup>31</sup> *Levermann v. Cartall*, 393 S.W.2d 931 (Tex. Civ. App. 1965), *error ref. n.r.e.*

<sup>32</sup> *Id.* at 935.

<sup>33</sup> 128 Mass. 131 (1880).

<sup>34</sup> *Brune v. Belinkoff*, 235 N.E.2d 793 (Mass. 1968).

<sup>35</sup> 128 Mass. 131 (1880).

<sup>36</sup> *Id.*

<sup>37</sup> 235 N.E.2d at 798.

"locality" rule, as the Supreme Court of Massachusetts observed, it produced an absurd result.

After disapproving the "locality" rule, the court set forth the new test for determination of the proper standards for both the general practitioner and the specialist. Taking into account the advances in the profession, the general practitioner must exercise the degree of care and skill of the average qualified practitioner. The court said that the medical resources available to the physician may be one of the circumstances considered in determining the skill and care required, thus making some allowance for the type of community in which the physician practices. Similarly, the specialist must measure up to the standard of care and skill of the average member of the profession practicing the specialty, taking into account the advances in the profession and the medical resources available to him.

#### IV. CONCLUSION

The "locality" rule is based on a premise that the standard of medical practice differs throughout the nation. As communications, medical facilities, and medical training improve, this premise continues to lose validity. Several years ago a nation-wide survey indicated that the standard of practice by certified specialists was very similar throughout the United States.<sup>38</sup> This survey is strong evidence that there is no longer any basis for the "locality" rule in the United States.

*Brune* accurately recognizes the impracticality of the rule today and abandons it. Should other jurisdictions follow the lead of Massachusetts, the result will be a new, uniform standard of care which will be required of all doctors. The adoption of such a standard probably would improve the overall quality of medical practice, for it would impose a duty on doctors to inform themselves of medical advances outside of their immediate community. Moreover, the plaintiff in a malpractice case will have an expanded pool of qualified experts from which to choose, for out-of-state doctors will be able to testify. Better informed juries will thus be able to appraise more fairly a doctor's treatment in any negligence action. Thus, the barriers set up by the "conspiracy of silence" can be overcome.

*Lynda K. Zimmerman*

### Oil and Gas Taxation — The Dirge of the Abercrombie Doctrine

Taxpayer, the carried party,<sup>1</sup> and operator, the carrying party, owned working interests in certain properties located in Louisiana. The operator

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<sup>38</sup> Note, *Medical Specialties and the Locality Rule*, 14 STAN. L. REV. 884, 887-88 (1962).

<sup>1</sup> A carried interest arises when the owner of part of the working interest in mineral property agrees to assume the costs of drilling and developing applicable to the share of the other owner(s) of the working interest. The operator, or carrying party, is allowed to recoup the carried party's

contracted<sup>2</sup> to bear the costs and expenses of drilling and developing the properties and to recoup taxpayer's share of such costs from the production, if, as, and when produced, from a specified percentage of taxpayer's working interest.<sup>3</sup> Taxpayer was not personally liable for the advances and the remaining percentage of his working interest was unencumbered. He reported income and claimed depletion allowance, intangible drilling and development costs and depreciation proportionate to both his unencumbered interest and the interest to which operator looked for recoupment. The Commissioner disallowed all intangible drilling and development costs and depreciation deductions and allowed depletion based only on the income from taxpayer's unencumbered interest. In the ensuing refund suit, the trial court found for the taxpayer.<sup>4</sup> *Held, reversed*: In a carried interest transaction, where the carried party has obligated the production from part of his interest to the recoupment of drilling and development costs, the carried party does not have sufficient economic interest in the minerals in place to claim depletion or deductions for intangibles and depreciation. *United States v. Cocks*, 399 F.2d 433 (5th Cir. 1968), *cert. denied*, 394 U.S. 922 (1969).

### I. TAXATION OF THE CARRIED INTEREST

Three types of carried interests are generally recognized.<sup>5</sup> In the *Manahan*<sup>6</sup> type the carried party conveys his entire working interest to the carrying party. The carrying party drills and develops the property and when he has captured sufficient production to recoup his outlays, he reconveys an agreed portion of the working interest to the carried party. During the payout period the carrying party reports all income and claims deductions for depletion, intangible drilling and development costs and depreciation.<sup>7</sup> After payout, depletion is apportioned according to the parties' respective ownership interests.

In the *Herndon*<sup>8</sup>-type transaction the carried party assigns only part of his working interest to the carrying party, and in addition, assigns a production payment out of his retained interest. The carrying party recoups the carried party's share of development costs from the production pay-

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share of such costs from production if, as and when produced. The operator is called the "carrying party" because his capital carries the entire risk. See K. MILLER, OIL AND GAS: FEDERAL INCOME TAXATION § 16-1 (1968).

<sup>2</sup> There were two agreements covering a wide variety of mineral interests on two sets of properties and involving several individuals and corporations. Each of the parties had at least part of the title to some of the leaseholds and interests comprising each set of properties.

<sup>3</sup> After payout the parties were to share income and operating expenses according to their ownership interests. Payout has been defined in proposed Treas. Reg. § 1.612-4(a)(4) as: "The period ending when the gross income attributable to all of the operating mineral interests in the well (or wells) equals all expenditures for drilling and development (tangible and intangible) of such well (or wells) plus the costs of operating such well (or wells) to produce such an amount."

<sup>4</sup> *Cocks v. United States*, 263 F. Supp. 762 (S.D. Tex. 1967).

<sup>5</sup> A fourth type of arrangement, the *Abercrombie* type, is apparently peculiar to the Fifth Circuit (at least as to tax consequences) and is discussed in text accompanying notes 23-34 *infra*.

<sup>6</sup> *Manahan Oil Co.*, 8 T.C. 1159 (1947).

<sup>7</sup> *Id.*; see C. BREEDING & A. BURTON, INCOME TAXATION OF OIL AND GAS PRODUCTION § 8.16 (1961).

<sup>8</sup> *Herndon Drilling Co.*, 6 T.C. 628 (1946).

ment period. During the payout period, the carrying party accounts for all income and deductions.<sup>9</sup>

In the *Burton-Sutton*<sup>10</sup> arrangement the carried party assigns his entire working interest but reserves an overriding royalty for the life of the property. Under this plan, the carrying party accounts for all tax consequences less the income and depletion attributable to the overriding royalty.<sup>11</sup>

Notably, in each of the above arrangements tax benefits and burdens fall to the party holding title to the particular interest in question.<sup>12</sup> In the *Manaban* situation the carrying party holds title to the entire working interest. In *Herndon* he has title to part of the working interest and the production payment. In *Burton-Sutton* he owns the entire working interest less the overriding royalty. A present possessory interest (title) in the particular interest has been characterized as the controlling factor in the taxation of carried interest arrangements.<sup>13</sup>

In contrast to the title theory, the Internal Revenue Service has postulated<sup>14</sup> and the Supreme Court accepted,<sup>15</sup> an "economic interest" concept which has particular importance in the tax treatment of carried interest transactions. The economic interest concept is not susceptible to clear definition. The Internal Revenue Service's view is contained in G.C.M. 22,730 which emphasizes "economic consequences . . . irrespective of conveyancing formalities."<sup>16</sup>

The evolution of the concept began when the lessee of a mine was allowed to claim depletion on the theory that the right to reduce the ore to possession was property within the meaning of the statute.<sup>17</sup> Later, in determining that bonus payments were ordinary income, the Supreme Court held in *Burnet v. Harmel*<sup>18</sup> that "economic consequences" control the taxation of oil and gas transactions. In 1933, the Court seemingly swept away the last vestiges of the local property law test as affixing the depletable interest as it observed in *Palmer v. Bender*<sup>19</sup> that "[t]he language of the statute is broad enough to provide, at least, for every case in which the taxpayer has acquired, by investment, *any* interest in the oil in place, and secures, *by any form of legal relationship*, income derived from the extraction of the oil, to which he must look for a return of his capital."<sup>20</sup> *Com-*

<sup>9</sup> *Id.*; see C. BREEDING & A. BURTON, *supra* note 7, § 8.17. However, the carrying party is required to capitalize the cost attributable to the carried party's interest.

<sup>10</sup> *Burton-Sutton Oil Co. v. Commissioner*, 328 U.S. 25 (1946).

<sup>11</sup> *Id.*

<sup>12</sup> Galvin, G.C.M. 22,730—*Twenty-Five Years Later*, 18TH SOUTHWESTERN LEGAL FOUNDATION INSTITUTE ON OIL AND GAS LAW AND TAX 511, 524 (1967).

<sup>13</sup> *Id.* at 527.

<sup>14</sup> G.C.M. 22,730, 1941-1 CUM. BULL. 214.

<sup>15</sup> *Kirby Petroleum Co. v. Commissioner*, 326 U.S. 599 (1946); *Burnet v. Harmel*, 287 U.S. 103 (1932); *Corliss v. Bowers*, 281 U.S. 376 (1930); *Lynch v. Alworth-Stephens Co.*, 267 U.S. 364 (1925).

<sup>16</sup> G.C.M. 22,730, 1941-1 CUM. BULL. 214.

<sup>17</sup> *Lynch v. Alworth-Stephens Co.*, 267 U.S. 364 (1925); see Int. Rev. Code of 1916, ch. 463, § 12(a), 39 Stat. 767. Deduction shall include a reasonable allowance for "the exhaustion of property." (Now INT. REV. CODE of 1954, § 611: "a reasonable allowance for depletion.")

<sup>18</sup> 287 U.S. 103 (1932).

<sup>19</sup> 287 U.S. 551 (1933).

<sup>20</sup> *Id.* at 557 (emphasis added).



*missioner v. Southwest Exploration*<sup>21</sup> may represent the most extended application of the economic interest concept. In that case the operator owned offshore oil deposits but under California law was required to utilize upland drilling sites. Taxpayer, owner of such upland sites, contributed the sites in return for a net profits interest. The taxpayer was allowed depletion on the net profits on the theory that by its contribution of the sites it acquired an economic interest in the oil in place.

A separate problem related to depletion allowance in carried interest transactions is allocation of deductions for intangible drilling and development costs and depreciation. In the *Manaban, Herndon and Burton-Sutton* arrangements these deductions are allowed the carrying party during pay-out.<sup>22</sup> This is because the carried party bears no part of the expenses but is instead financially passive.

## II. THE FIFTH CIRCUIT AND J.S. ABERCROMBIE

Originally, the Fifth Circuit treated carried interest transactions in a manner consistent with Supreme Court decisions developing the economic interest concept. For example, in *Ortiz Oil Co. v. Commissioner*<sup>23</sup> the circuit court held that the carrying party acquired an economic interest by virtue of the funds advanced in the form of a loan. The carried party therefore should not have reported income or claimed deductions for depletion and interest on that portion of production obligated to repay the advances. Subsequently, in *Commissioner v. Caldwell Oil Corp.*,<sup>24</sup> the same court reached a similar result, stating that "it is now . . . well established that one who has a capital investment in oil in place, or *who has an economic interest in oil to be extracted*, . . . is, for income tax purposes, treated as the owner and entitled to depletion."

In *Commissioner v. J.S. Abercrombie Co.*<sup>25</sup> the Fifth Circuit abandoned this approach. In that case the carrying party was the assignee of a working interest out of which the carried party had retained a one-sixteenth interest. The carrying party was to recoup his advances from the net proceeds of the entire working interest. The carried party was not personally liable for the advances and during the taxable year in question there were no net profits. The court ruled that the gross income from the one-sixteenth interest was taxable to the carried party upon the "fundamental principle that income is taxable to the owner of the property producing the same, and that an assignment in anticipation of such income is ineffective to avoid taxation thereof to the real owner."<sup>26</sup> The court analyzed the arrangement as a loan from the carrying party to the carried party with the latter's one-sixteenth interest mortgaged as security. The contract was treated as fixing property rights under local law upon which the tax consequences depended.

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<sup>21</sup> 350 U.S. 308 (1956).

<sup>22</sup> See note 9 *supra*.

<sup>23</sup> 102 F.2d 508 (5th Cir. 1939).

<sup>24</sup> 141 F.2d 559, 561 (5th Cir. 1944).

<sup>25</sup> 162 F.2d 338 (5th Cir. 1947).

<sup>26</sup> *Id.* at 340.

In *Prater v. Commissioner*<sup>27</sup> the *Abercrombie* doctrine was carried to its logical extension when the carried party was allowed deductions for depletion, depreciation and intangible drilling and development costs. This was allowed because the carried party retained legal title to his carried interest, notwithstanding his lack of personal liability and the fact that the carrying party could look to his interest for recoupment.<sup>28</sup>

After *Prater*, the Fifth Circuit seemed to limit the *Abercrombie* doctrine while at the same time citing it with approval. In *Wood v. Commissioner*<sup>29</sup> the taxpayer, pursuant to a divorce decree, was awarded a one-half interest in certain oil and gas leases which she and her husband held as community property. Her interest was pledged to the payment of community debts and she was therefore not to receive any income from production until the debts were satisfied. The question for decision was whether the taxpayer was taxable on the income as applied to the debts. The court held that she had no title or interest in the property until the debts were paid and was not taxable for such income. Although the language—no title or interest—seems consistent with *Abercrombie* and even though this was not a conventional carried interest arrangement, the result seems at odds with the title theory of *Abercrombie*.<sup>30</sup>

The most stringent limitation on *Abercrombie* came in *Weinert's Estate v. Commissioner*.<sup>31</sup> Weinert, the carried party, assigned a one-half interest in certain oil interests to Lehman, the carrying party. In addition, Weinert assigned his remaining one-half interest to a trustee who was to pay all income from this portion to Lehman until Lehman recouped the costs of drilling and development. At such time the interest in trust was to revert to Weinert. The issue was whether the carried party was taxable on the income from the property held in trust. The court held that he was not, observing that "income from oil and gas is taxable to the man who risks his stake to produce oil and gas, . . . and Lehman, owning 50% of the property assumed 100% of the risk."<sup>32</sup> The court sought to distinguish and thus save *Abercrombie* on the grounds that Weinert had no present title or interest in the property indicating that the situation more closely resembled *Manaban* and *Herndon* than *Abercrombie* and *Prater*. Despite this distinction the court's reasoning directly repudiated the underlying principles of *Abercrombie*. The opinion is rife with statements to the effect that a carried interest transaction temporarily reallocates the benefits and burdens of an oil and gas interest and that he whose capital is at risk is the rightful reporter and depleter.

After *Weinert*, some commentators felt that the *Abercrombie* doctrine

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<sup>27</sup> 273 F.2d 124 (5th Cir. 1959).

<sup>28</sup> *Id.* at 126.

<sup>29</sup> 274 F.2d 268 (5th Cir. 1960).

<sup>30</sup> *See id.* at 273 (Judge Hutcheson dissenting): "[u]nder the undisputed facts the *Abercrombie* principle and case are controlling here . . ."

<sup>31</sup> 294 F.2d 750 (5th Cir. 1961).

<sup>32</sup> *Id.* at 756-58.

was dead.<sup>33</sup> But such was not to be the case. In 1962, in *Sowell v. Commissioner*,<sup>34</sup> the Fifth Circuit again cited *Abercrombie* with approval.

### III. UNITED STATES V. COCKE

In *United States v. Cocke*<sup>35</sup> the Fifth Circuit Court of Appeals, sitting en banc, expressly overruled *Abercrombie* and applied the economic interest test to carried interest transactions. The court stated that "common law property concepts . . . are relics of an age of surface use of land and are alien to vertical and subterranean ownership."<sup>36</sup> The *Palmer v. Bender*<sup>37</sup> definition of economic interest was adopted. The court determined that the taxpayer (1) must have acquired an interest in the minerals in place by investment and (2) must look to the extraction of oil for a return of his capital. Stated another way, "the income from oil and gas is taxable to the man who risks his stake to produce oil and gas."<sup>38</sup> Thus, the carrying party (operator) risked its stake and, during payout, was entitled to deductions for depletion. The essence of the decision is that "taxation is not so much concerned with the refinements of title as it is with the actual command over the property taxed—the actual benefit for which the tax is paid."<sup>39</sup>

The decision is not without uncertainties. The Government contested deductions claimed on that portion of the carried party's interest which was, in effect, assigned to the carrying party. However, the computation for which the Government contended allowed the carried party depletion but no deductions for intangibles and depreciation on his unencumbered portion. The court did not specifically adopt the Government's computation or directly refer to this part of the arrangement. However, the court did conclude that "depreciation and intangible drilling and development costs are subservient satellites of depletion in situations involving carried interests, and that, as the spoils go to the victor, so these deductions go to the rightful depleter."<sup>40</sup> This sweeping statement is somewhat tempered by other language in the opinion. The court recognized that in order to deduct depreciation, a taxpayer must have an investment in the equipment. Here, the carried party had expended none of his own funds and accordingly had a basis of zero in the equipment. Likewise, he had incurred no expenses for intangibles and thus did not fall within the language of sections 162<sup>41</sup> and 212<sup>42</sup> of the Internal Revenue Code. Apparently, the statement that "these deductions go to the rightful depleter" is to

<sup>33</sup> RYAN, *The Carried Interest in the Fifth Circuit, or, Is Abercrombie Dead*, 4 Hous. L. Rev. 477 (1966).

<sup>34</sup> 302 F.2d 177 (5th Cir. 1962).

<sup>35</sup> 399 F.2d 433 (5th Cir. 1968), cert. denied, 394 U.S. 922 (1969).

<sup>36</sup> *Id.* at 442.

<sup>37</sup> 287 U.S. 551 (1933).

<sup>38</sup> *United States v. Cocke*, 399 F.2d 433, 445 (5th Cir. 1968), quoting *Weinert's Estate v. Commissioner*, 294 F.2d 750, 756 (5th Cir. 1961).

<sup>39</sup> *Id.* at 445, citing *Corliss v. Bowers*, 281 U.S. 376, 378 (1930).

<sup>40</sup> *Id.* at 446.

<sup>41</sup> INT. REV. CODE of 1954, § 162.

<sup>42</sup> INT. REV. CODE of 1954, § 212.

be read in its narrowest sense as applying only to that portion of the interest from which the income has been obligated.<sup>43</sup>

#### IV. CONCLUSION

The Fifth Circuit has marshalled an impressive array of authority calling for the repudiation of the *Abercrombie* doctrine. The court's reasoning is particularly appealing when a carried interest such as that in *Abercrombie*, treated under the rule of that case, is compared with other types of carried interests. In each arrangement the carried party is in the same relative economic position: In each, he has contributed at least a part of his working interest; in each, he has given control of the property and income to the carrying party; and in each, he has given up beneficial use of the income. Each arrangement temporarily reallocates the benefits and burdens of developing and operating an oil lease and in each the reallocation achieves the same economic result. Specifically, a *Herndon* transaction is economically indistinguishable from an *Abercrombie* transaction. In each, the carrying party has the right to the production from the carried party's interest. However, application of the *Abercrombie* doctrine caused opposite tax results on the basis of title alone. Even though in *Manahan*, *Herndon*, and *Burton-Sutton* the carrying party held title to the interest in question, the stance of the Internal Revenue Service and a long series of Supreme Court decisions make it obvious that title should not be controlling.

*Cocke* has been criticized on the grounds that the different forms of carried interests are only approximately the same because the rights of creditors, community property rights, rights under statutes of descent and distribution, and the rights of administrators and executors vary with the type of transaction selected.<sup>44</sup> That such rights vary with the form of the arrangement is clear. Furthermore, it cannot be doubted that *Cocke* will affect the exercise of these rights in many situations. However, it is doubtful that this is sufficient justification for retention of the *Abercrombie* doctrine, particularly in light of the similarity between the economics of the several types of carried interest transactions.

All things considered, *Cocke* is a step in the right direction. Policy justifies favoring the carrying party. He bears the burdens, assumes the risk, expends his capital and controls the property and income. During payout, he is the beneficial owner of the working interest and should acquire the tax benefit (and burdens) appurtenant thereto.

W. Ted Minick

<sup>43</sup> Apparently, the carrying party was allowed to claim the income and expenses at issue in *Cocke*. *United States v. Cocke*, 399 F.2d 433 (5th Cir. 1968). Under the rationale of *Herndon* it appears the carrying party should capitalize these expenses. See note 8 *supra*.

<sup>44</sup> GALVIN, *Deductions: Percentage Depletion—Sharing Arrangements—Person Having Economic Interest*, 29 OIL & GAS RPTER. 527 (1968).