

Winter 1976

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#### Recommended Citation

John E. McKay, *Loan Agreements: A Settlement Device that Deserves Close Scrutiny*, 10 Val. U. L. Rev. 231 (1976).

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## **LOAN AGREEMENT: A SETTLEMENT DEVICE THAT DESERVES CLOSE SCRUTINY**

JOHN E. MCKAY\*

### **INTRODUCTION**

The validity of so-called loan receipt agreements<sup>1</sup> is examined in this article. Historically, the loan receipt agreement has its origin between an insurer and its insured-shipper.<sup>2</sup> For instance, Ray is insured by the Safety Insurance Company on all shipments of sugar cane made in the course of Ray's commercial enterprise. Tarry Shippers is in the business of shipping cargoes of sugar cane. Unfortunately, Tarry Shippers loses the sugar cane which was shipped by Ray. In order to fulfill its contractual obligation to indemnify, Safety Insurance Company enters into a loan receipt agreement with Ray. The agreement provides the following: (1) The amount turned over to Ray, the insured, is received as a loan. (2) It is repayable only in the event and to the extent of a recovery by the insured from Tarry Shippers or other third persons on account of the loss described therein. (3) The insured's claim against third persons who may be liable for the loss is pledged as security for such repayment. (4) Ray, the insured, shall institute an action in his own name against Tarry Shippers and such third persons or appoint the insurer, Safety Insurance Company, his attorney, with irrevocable power to prosecute or settle such an action in the insured's name and to execute any documents necessary to effectuate the agreement. In any event, the action against Tarry Shippers is to be under the insurer's exclusive control, direction, and expense. (5) Ray, the insured, warrants that he is the person entitled to the payment and that he has not and will not settle with or release Tarry Shippers or anyone responsible for the loss without the consent of the insurer, Safety Insurance Company.<sup>3</sup> This example sets forth the typical situation from which these agreements arose and upon which they have been held valid.

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1. See generally *Luckenbach v. W.J. McCahan Sugar Ref. Co.*, 248 U.S. 139 (1918); Annot., 65 A.L.R.3d 602 (1975); Annot., 62 A.L.R.3d 1111 (1973); Annot., 13 A.L.R.3d 42 (1967).

2. See Section I. ORIGIN OF THE SO-CALLED LOAN RECEIPT AGREEMENT *infra*.

3. Annot., 13 A.L.R.3d 42 (1967).

Specifically, this article concedes that so-called loan receipt agreements are valid in their traditional factual setting. Nonetheless, a device proper in one situation is not necessarily valid in *all* situations. This article attacks the validity of these contrivances in a factual context not comprehended by the insurers who originally won court approval for them. Nowadays, such devices are widely used in the plaintiff-codefendant context. For example, assume that Adam is the victim of a car accident allegedly caused by Bob and Charles. Adam institutes a negligence action against Bob and Charles, the two alleged cotortfeasors. Damages alleged are \$100,000. Sometime prior to trial, Bob enters into a loan receipt agreement with Adam whereby Bob "loans" Adam \$75,000. The agreement provides the following: (1) Any recovery from Charles over \$5,000 will be returned to Bob to the extent that Bob is not given more than \$75,000.<sup>4</sup> (2) Bob will remain in the suit as a codefendant. (3) Adam promises not to execute against Bob in the event a verdict is rendered against Bob and Charles. (4) To the extent that Adam's recovery does not exceed the \$75,000 loan, that amount is to be considered a payment by Bob.<sup>5</sup>

It is absolutely crucial to distinguish between the two main contexts in which loan agreements appear: (1) the aforementioned traditional plaintiff-insured and plaintiff's-insurer context, and (2) the more recent plaintiff-codefendant context. Throughout this article the distinction between these two situations will be maintained, because in the former there are several positive reasons in favor of loan agreements while in the latter several negative reasons exist for prohibition of loan receipt agreements.

This article is designed to help the practicing attorney challenge the validity of loan receipt agreements in the plaintiff-codefendant context.<sup>6</sup> Three basic questions provide the founda-

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4. Thus, if Adam secures an \$80,000 judgment against both Bob and Charles but levies only against poor Charles, then Bob gets his original \$75,000. Financially, Bob is left in a net zero position with the added benefit that his liability exposure to Adam has been extinguished. Adam, on the other hand, has the original \$75,000 given by Bob plus an additional \$5,000 as provided by the conditions of the agreement. The real loser is Charles.

5. Thus, if Adam recovers \$40,000 from Charles, only \$25,000 is returned to Bob. The agreement allows Adam to keep the first \$5,000 of recovery. Accordingly, the \$50,000 which Bob loaned but was reimbursed is magically transformed from a loan into a payment. Adam's failure to recover a greater verdict makes Bob the loser in this situation.

6. The issue whether loan receipt devices should be admissible as evidence is beyond the scope of this article. It may be noted, however, that there are at least three approaches to admissibility into evidence of loan re-

tion for the article. First, what are the characteristics of a fiction? Second, is a loan receipt a fiction? Third, what are the limits that should be placed on the use of this fiction? This writer explores the rule that fictions are equitable devices designed to achieve equitable results. It is noted that the Supreme Court has held that fictions should be strictly construed and confined to the original context in which they were developed.<sup>7</sup> Next, after an his-

ceipt devices. One approach holds that the devices are within the cognizance of the court and the parties, but are not admissible as evidence properly submitted to the jury. *Klotz v. Lee*, 36 N.J. Super. 6, 114 A.2d 746 (1955). Another approach holds that the devices are admissible in cross-examination for the limited purpose of attacking the motive and credibility of witnesses, but not on the liability or damage issues. *Reese v. Chicago, B&O R.R.*, 55 Ill.2d 356, 303 N.E.2d 382 (1973). The third approach holds that since the device tends to have the effect of encouraging collusion or dishonest practices on the part of the agreeing codefendant, such agreements must, upon the request of a non-agreeing codefendant, be produced for purposes of pretrial discovery and be introduced into evidence. Failure to do so will constitute prejudicial error. Annot., 65 A.L.R.3d 602 (1975).

The issue of separate trials is beyond the scope of this article. Suffice it to say that in *NIPSCO v. Otis*, 145 Ind. App. 159, 250 N.E.2d 378 (1969), the sole issue before the court was whether a separate trial should have been granted the non-agreeing codefendant. The court, speaking through Judge Sharp, noted that it is within the discretion of the trial court whether to grant such motion. Since Indiana recognizes the policy of limiting the number of trials as far as possible, the *Otis* court denied the motion. Judicial time is saved; the plaintiff who may have been seriously injured is not forced to undergo two lengthy trials; and there is no risk where there is one trial that two juries might believe the absent defendant was the wrongdoer leaving the plaintiff totally uncompensated. The *Otis* court noted that the test for a separate trial is whether the moving party has affirmatively shown that legal prejudice either will result or will likely result. *Id.* at 389. The court cannot anticipate that instructions will confuse the jury. Nor is the fact that codefendants are antagonistic an affirmative showing of legal prejudice. *Id.* at 390. But since the second part of the test requires only a showing that prejudice "will likely result," it is incredible that the *Otis* court did not reverse the trial court on the ground that a device which encourages perjury is a sufficient showing that prejudice will likely result.

7. *Blackstone v. Miller* 188 U.S. 189 (1919); *United States v. 1960 Bags of Coffee*, 3 U.S. (8 Cranch) 188, 198 (1814) ("It seems to be a rule founded in common sense, as well as strict justice, that 'fictions of law' shall not be permitted to work *any* wrong, but shall be used *ut res magis valeat quam pereat*."); *Purdy v. McGarity*, 30 N.Y.S.2d 966, 262 A. 623 (1941); *Parker Peanut Co. v. Felder*, 200 S.C. 203, 20 S.E.2d 716, 720 (1942) ("Fictions are invented and instituted for the promotion of justice. It is a certain rule that a fiction of law shall never be contradicted so as to defeat the end for which it was invented, but for every other purpose it may be contradicted."). *Cf.* 95 U. PA. L. REV. 231, 234 (1946) ("the use of a legal device, proper in its setting, should not be extended to a situation foreign to its nature for the purpose of thwarting the decisions of the courts.").

torical analysis, it is concluded that loan receipt agreements are fictions for something that really amounts to a payment. To effectively convey the idea that the term, "loan receipt agreement," is merely a label, it is crucial to consistently refer to the transaction either as a "fiction" or as a "device." Precise use of language helps lay the foundation for fiction treatment of the so-called loan receipt. Accordingly, it is concluded that loan receipts should be narrowly construed and confined to the original insurer-insured context in which they were initiated, not extended into the plaintiff-codefendant area. To facilitate presentation of the relevant arguments, frequent reference is made to Indiana law. It is felt that this reliance on Indiana law is particularly appropriate since Indiana is currently one of the leading jurisdictions favoring the use of these devices.<sup>8</sup> Since careful separation of the factual context from which the agreement arises is essential in evaluating the advantages and disadvantages of allowing such agreements, the following outline will be utilized to help clarify the issues and demonstrate the interrelationship of these issues.

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8. Scott v. Krueger, 280 N.E.2d 336 (1972); American Transport Co. v. Central Indiana Ry., 255 Ind. 319, 264 N.E.2d 64 (1970); NIPSCO v. Otis, 145 Ind. App. 159, 250 N.E.2d 378 (1969); Klukas v. Yount, 121 Ind. App. 160, 98 N.E.2d 227 (1951). Two additional reasons for relying on Indiana law are that the INDIANA CODE OF PROFESSIONAL RESPONSIBILITY was adopted from the ABA CODE OF PROFESSIONAL RESPONSIBILITY, and that the Indiana Trial Rules are modeled after the Federal Rules of Civil Procedure.

## II. BEYOND THE INSURER-INSURED SHIPPER

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I. ORIGIN OF THE SO-CALLED LOAN  
RECEIPT AGREEMENT

A. *Needs for the Fiction*

The label, "loan receipt agreement," originally referred to a fiction used exclusively in the insurer-insured context.<sup>9</sup> The loan receipt device appears to have had its origin in the struggle between common carriers and insurers to shift the burden of loss upon each other.<sup>10</sup> The carrier would insert in his bill of lading a provision that the carrier should have the benefit of any insurance carried by the shipper. Contra to the carrier's provision, marine and inland marine insurers inserted stipulations in policies issued to shippers that the insurers would not be liable for any loss for which the carrier was liable regardless of the carrier's provision in the bill of lading to the contrary. And further, the insurers stipulated that the shipper-insured would make no agreement and do no act whereby the insurer's right of action against the carrier might be affected. In the face of such conflicting provisions, a shipper whose cargo had been damaged or destroyed might be out of funds until final adjudication of an action by him against the

9. See *Luckenbach v. W.J. McCahan Sugar Ref. Co.*, 248 U.S. 139 (1918).

10. See 13 A.L.R.3d 42 (1967).

carrier determining whether the carrier was liable. To keep alive the carrier's liability and prevent the inequitable shifting of a burden which was rightfully the carrier's to the shipper's insurer, and to fulfill its contractual obligation of providing indemnity to its insured, the insurers devised the loan receipt.

From the insurer's point of view there were two main advantages to the loan receipt agreement. First and certainly foremost in the minds of the insurers, it preserved the insurer's rights against negligent carriers, serving to extinguish the insurer's liability completely where the insured's suit against the carrier was successful.<sup>11</sup> Second, the device fulfilled the insurer's contractual obligation to its insured to provide an indemnity.<sup>12</sup> Although the insurer's duty to indemnify was often contingent upon the carrier's nonliability,<sup>13</sup> by definition, indemnity necessarily includes immediate reimbursement.<sup>14</sup> Any delay in reimbursement would impair a shipper's ability to meet its commercial contracts with suppliers, thereby compounding the insured-shipper's injury.

In the insurer-insured context then, for all practical purposes, the insured-shipper had received payments for his loss, not a loan. If there was any recovery from the carrier, the money ultimately went from the carrier to the insurer, not to the insured in whose name the action had been instituted. And if there was no recovery at all from the carrier, then the insurer was bound by a provision of the device to magically transform the loan into a payment. The shipper-insured could not lose under such an arrangement where the insurer's liability was absolute or the amount of the loan was for the full amount of the shipper-insured's loss.<sup>15</sup>

Since the device was characterized by courts as a loan, rather than a payment, the insurer received the benefit of avoiding subrogation.<sup>16</sup> Suit against the carrier was instituted in the name of its insured-shipper. Three main reasons existed for characterizing the device as a loan: (1) The economy of the entire country was benefited by such a fiction. The United States, toward the end

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11. *Id.*

12. *Id.*

13. *See Luckenbach v. W.J. McCahan Sugar Ref. Co.*, 248 U.S. 139 (1918).

14. The meaning of indemnity is to place the insured in the same position he would have been in had the injury not occurred. *See Luckenbach v. W.J. McCahan Sugar Ref. Co.*, 248 U.S. 139, 146 (1918) (recognizing the rule).

15. *See* notes 42 and 44 *infra*.

16. 248 U.S. at 146-49.

of the nineteenth century, was trying to expand its commercial trade. Immediate indemnity by insurers to their insured-shippers was essential to a growing commerce.<sup>17</sup> (2) The fiction helped the insured meet his personal business losses.<sup>18</sup> (3) The fiction helped the insurer avoid judicially recognized jury prejudice against insurance companies.<sup>19</sup> It is absolutely crucial for precise analysis that these three judicially recognized *needs* for the fiction are kept in mind. Throughout the remainder of the article the question will be asked whether these three original *needs* are present today in other potential loan receipt contexts.

### B. *Evidence of the Fiction*

From the foregoing discussion, it is apparent that the need for the loan receipt device existed at its inception. The next question to consider is whether the device has been treated by the courts as a true loan or whether it has been recognized as a fiction created to meet equitable goals. The following survey is designed to establish that the so-called loan receipt agreement is not a loan but is in fact a payment. That is, the term, loan receipt agreement, is nothing more than a label or fiction for something else.

#### 1. *Outright Recognition of Fiction*

The landmark case validating the use of loan receipt agreements in the insurer-insured context is *Luckenbach v. W.J. McCahan Sugar Ref. Co.*<sup>20</sup> *Luckenbach* involved an inherent conflict between the printed forms of insurers and carriers. More specifically, this was an action wherein the bills of lading provided that the carrier should have the benefit of any insurance procured by the shippers. On the other hand, the insurance policies provided that the insurer should not be liable to the insured-shipper if the carrier was liable. The Court, speaking through Justice Brandeis, upheld a loan receipt between a shipper and its insurer as a valid loan:

The carrier insists that the transaction, while in terms of a loan, is in substance a payment of insurance; that to treat it as if it were a loan is to follow the letter of the agreement and to disregard the actual facts; and that

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17. *Id.* at 146.

18. *Id.* at 149.

19. *See* 13 A.L.R.3d 42 (1967).

20. 248 U.S. 139 (1918).



to give it effect as a loan is to sanction fiction and subterfuge. But no good reason appears either for questioning its legality or for denying its effects.<sup>21</sup>

A superficial reading of the above language indicates that the Court rejected the idea that the whole transaction was a fiction. But closer analysis of the Court's rationale reveals the opposite. Throughout the bulk of the Court's opinion, Justice Brandeis carefully indicates that the loan characterization was justified by the specific equities in the insurer-insured context.<sup>22</sup> The shipper was under no obligation to the carrier to take out insurance on cargo. The carrier did not lower rates if the shipper did take out insurance on the cargo. The general law relevant to shipper-carriers did not give the carrier, upon payment of the shipper's claim, a right by subrogation against the insurers. The insurer, on the other hand, by general law relevant to insurer-insured, provided the insurer with a right of subrogation against the carrier. And the demands of commerce sanctioned the practice.<sup>23</sup> Thus, no party to the suit was prejudiced by the characterization and several *needs* justified it. This type of analysis was the crux of the *Luckenbach* decision although the Court puts a gloss over its analysis by alluding to the traditional test for a valid loan—the intent of the parties.<sup>24</sup>

If intent of the parties was the exclusive test there would have been no need to carefully note that no party was prejudiced by the characterization and that the needs of commerce sanctioned it. When Justice Brandeis talks about the "needs of commerce" and the "demands of justice,"<sup>25</sup> the logical reference is to the country's growing economy and the equitable result of protecting insurance companies from jury prejudice. It is imperative to note that these are equitable justifications for a fiction and have nothing to do with the traditional test for a loan<sup>26</sup>—the party's intent. Furthermore, the idea that Justice Brandeis was justifying the use of a fiction is buttressed by the Court's language. Con-

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21. *Id.* at 148.

22. *Id.*

23. *Id.*

24. *Id.* at 149.

25. *Id.*

26. *Id.* See also *Thompson v. Arnold*, 238 Ind. 177, 147 N.E.2d 903 (1958); *Wayne Pump v. Gross Income Tax Div.*, 232 Ind. 147, 110 N.E.2d 284 (1952); *Klukas v. Yount*, 121 Ind. App. 160, 98 N.E.2d 227 (1951); *Annot.*, 13 A.L.R.3d 42, 54-56 (1967).

tinually the transaction is referred to as "so-called loans,"<sup>27</sup> and agreements which were "devised."<sup>28</sup>

Subsequent to *Luckenbach's* sanction of the loan receipt fiction in the insurer-insured context, other courts<sup>29</sup> have expressly noted the fictional nature of the transaction. One approach has been to recognize the label, loan receipt agreement, as a mere fiction, then to decide if the equities in a given case justify the use of a fiction.<sup>30</sup> For instance, the Kentucky Supreme Court in *Aetna Freight Lines, Inc. v. R.C. Tway Co.*<sup>31</sup> expressly recognized that the difference between a loan under a loan receipt and an absolute payment under a policy is a mere fiction.<sup>32</sup> But the context in which the loan receipt originated was decisive. The plaintiff had borrowed from his own liability insurer, essentially the same context in which the fiction was validated by *Luckenbach*. The court upheld the transaction as a valid loan on two grounds: (1) no party would be prejudiced by use of the fiction, and (2) the insurer should be protected from jury bias.<sup>33</sup>

Seventeen years after the *Tway* decision, the Kentucky Supreme Court again expressly recognized loan receipts as a fiction,

27. 248 U.S. at 148.

28. *Id.* at 149.

29. See generally *Luckenbach v. W.J. McCahan Sugar Ref. Co.*, 248 U.S. 139 (1918); Annot., 65 A.L.R.3d 602 (1975); Annot., 62 A.L.R.3d 1111 (1973); Annot., 13 A.L.R.3d 42 (1967).

30. *Biven v. Charlie's Hobby Shop*, 500 S.W.2d 597 (Ky. 1973); *Aetna Freight Lines, Inc. v. R.C. Tway Co.*, 298 S.W.2d 293 (Ky. 1956); *Blair v. Espeland*, 231 Minn. 444, 43 N.W.2d 274 (1950); *Herring v. Jackson*, 255 N.C. 537, 122 S.E.2d 366 (1961); *Herbert Rosenthal Jewelry Corp. v. St. Paul Fire and Marine Ins. Co.*, 21 App. Div. 2d 160, 249 N.Y.S.2d 208 (1964); *Purdy v. McGarity*, 262 App. Div. 623, 30 N.Y.S.2d 966, *appeal denied*, 263 App. Div. 905, 32 N.Y.S.2d 807 (1941).

31. 298 S.W.2d 293 (Ky. 1956) (case involving consolidated actions by the ultimate purchaser and by the user-lessee of a tractor-trailer against the manufacturer to recover the amounts paid in settlement of actions in Ohio for death and personal injuries resulting from a collision in that state of the tractor-trailer and an automobile, allegedly caused by negligent manufacture of the tractor-trailer).

32. The Kentucky Supreme Court stated:

While it is clear that the difference between a loan of the type under consideration and an absolute payment is mere fiction, that ground alone is insufficient to declare the transaction a nullity. Rather, we will look to the purpose of the fiction created by the parties to the transaction.

*Id.* at 296.

33. *Id.*

but this time denied their validity as a loan.<sup>34</sup> The determinative factor was a change in factual contexts. *Tway* involved an insured and his insurer. The later Kentucky Supreme Court decision involved a loan receipt agreement between a plaintiff and one of two potentially liable tortfeasors. Commerce would not be facilitated, nor was there any contractual obligation to provide indemnity to the plaintiff by the codefendant. The *needs* which originally gave rise to the fiction were not present in the plaintiff-cotortfeasor area.

Similarly, the Minnesota Supreme Court referred to a loan receipt as a "device."<sup>35</sup> New York courts have held that loan receipts were in fact an absolute payment coupled with a fictional implementation to allow the insurer to sue in the insured's name.<sup>36</sup> Likewise, the North Carolina Supreme Court expressly recognized a loan receipt as a fiction.<sup>37</sup> More specifically the North Carolina Supreme Court refused to extend the fiction into a plaintiff-cotortfeasor area since to do so would be to allow a fiction to circumvent the state's strong policy barring contributions between cotortfeasors. These and other similar holdings<sup>38</sup> reflect a judicial awareness that fictions are equitable devices designed to achieve equitable results. Hence, where any party is prejudiced by the use of a fiction or where public policy is contravened, the fiction should be prohibited.

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34. *Biven v. Charlie's Hobby Shop*, 500 S.W.2d 597 (Ky. 1973) (minor accidentally shot and killed by another child using an allegedly defective pistol manufactured by one of the defendants and sold by the other, the agreement providing that the administratrix for the decedent's estate give up all claims she might have against the parents of the negligent child in return for an interest-free loan of \$20,000 from the parents' insurance company, repayable only to the extent of the administratrix net recovery from any other person or entity responsible for the accident).

35. *Blair v. Espeland*, 231 Minn. 444, 43 N.W.2d 274, 277-78 (1950).

36. *Herbert Rosenthal Jewelry Corp. v. St. Paul Fire and Marine Ins. Co.*, 21 App. Div. 2d 160, 249 N.Y.S.2d 208 (1964).

37. *Herring v. Jackson*, 255 N.C. 537, 122 S.E.2d 366 (1961).

38. *Purdy v. McGarity*, 262 App. Div. 623, 30 N.Y.S.2d 966, *appeal denied*, 263 App. Div. 905, 32 N.Y.S.2d 807 (1941) (considering loan receipt whereby the insured received from its own insurer \$69.95 as a loan and repayable only to the extent of any net recovery which the insured may make from any person or persons, corporation or corporations, by reason of the damage to the insured's car, the court stated: "It strains our credulity too far to treat that agreement as one for a loan. . . . [T]o say that this transaction constitutes a loan is a fiction and a sham."). *Id.* at 970.

## 2. *Obvious Lack of Mutual Intent to Create A Loan*

Although some courts expressly recognize loan receipts as a fiction, other courts take a more euphemistic approach. These latter courts pay lip service to the proposition that whether a loan receipt transaction is a payment or a loan is resolved by looking to the mutual intention of the parties to the transaction.<sup>39</sup> To ascertain the mutual intent, courts look not only to the face of the agreement but also to the surrounding circumstances.<sup>40</sup> This means that the label which parties give to a transaction is not controlling. For instance, in a leading Indiana case<sup>41</sup> the parties had labeled their transaction a sale, but the Indiana Supreme Court pierced the form and looked to the substance of the transaction, holding it to be a loan.<sup>42</sup> In spite of this clear method for ascertaining the mutuality of intent requisite to the creation of a valid loan, the cases cited in the next two subheadings of this article have upheld the so-called loan receipt as a valid loan. Mutual intent to create a loan simply is not found in the circumstances of these cases. The purpose of presenting the following cases is to establish further the fact that loan receipt devices are fictions, not true loans.

### a. *Insurer's liability is absolute*

Many courts<sup>43</sup> have upheld the use of loan receipt devices where the insurer is absolutely liable to the insured for the loss.

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39. See *Luckenbach v. W.J. McCahan Sugar Ref. Co.*, 248 U.S. 139 (1918); *Klukas v. Yount*, 121 Ind. App. 160, 98 N.E.2d 227 (1951); *Annot.*, 13 A.L.R.3d 42, 54-56 (1967).

40. *Wayne Pump v. Gross Income Tax Div.*, 232 Ind. 147, 110 N.E.2d 284 (1952) (an action to determine whether a transaction was a *bona fide* sale of conditional sales contracts or whether it was in fact a loan with the assignment of conditional sales contracts as security for a loan for purposes of calculating gross income tax).

41. *Id.*

42. *Accord*, *Thompson v. Arnold*, 238 Ind. 177, 147 N.E.2d 903 (1958).

43. In *Williams v. Union Pacific R.R.*, 94 F. Supp. 174 (D. Neb. 1950), an action by an insured owner for loss of a building and its contents by fire allegedly caused by the defendant's negligence, the insurance contracts held by the plaintiff imposed an absolute liability on the several insurers consequent on the loss by fire. Nonetheless, advancements made to the plaintiff by its insurers under loan receipts were held to be loans and not payments. *Accord*, *Aetna Ins. Co. v. Henry DuBois Sons Co.*, 144 F.2d 262 (2d Cir. 1944), *cert. denied*, 323 U.S. 797 (action by insurance companies for declaratory judgment concerning their liabilities where in a suit of cross libels the defendant's insurer had paid the defendant the entire amount of defendant's loss; held to be valid loan regardless of absolute liability and full reimburse-

In such a context, the plaintiff is entitled to immediate indemnity from its insured. So commerce is neither facilitated by the device nor is the insured enabled to meet private business losses by the device; payment would have been forthcoming anyway. The only effect of the fiction in this context is to enable the insurer to recoup its liability payment from one of the defendants by maintaining an action in the name of its insured. The fact that only the insurer benefits where he is absolutely liable is compelling evidence that the transaction is a fiction.

*b. Insurer makes full payment*

Where the insurer advances the entire amount of plaintiff-insured's loss pursuant to a loan receipt it would stretch the imagination beyond limits to say that the plaintiff considered such advance a loan. In a practical sense, the plaintiff's loss is entirely reimbursed. Only in the event that plaintiff's suit against the defendant prevails will money be returned to the insurer. In no

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ment of loss); *Automatic Sprinkler Corp. v. Robinson-Slagle Lumber Co.*, 147 So. 542 (La. App. 1933) (conditional vendor's action against conditional vendee to recover unpaid purchase price of sprinkler system which was destroyed by fire after installation; conditional vendor's insurer, absolutely liable under provisions of policy, advanced to vendor-insured entire amount of loss under loan receipt authorizing insurer to prosecute suit in insured's name but at the total expense and under exclusive control of insurer); *Waumbec Mills, Inc. v. Bohannon Service Co.*, 193 N.H. 461, 174 A.2d 839 (1961); *Furrer v. Yew Creek Logging Co.*, 206 Ore. 382, 292 P.2d 499 (1956) (insurer's absolute liability no bar to valid loan where plaintiff may have chosen to take something less than absolute payment to which he was entitled under his insurance policy); *Arabian American Oil Co. v. Kirby & Kirby, Inc.*, 171 Pa. Super. 23, 90 A.2d 410 (1952) (court noting that loan receipt was device necessary for the protection of the insurer); *Cadillac Auto Co. v. Fisher*, 54 R.I. 264, 172 A. 393 (1934); *Colonial Finance Corp. v. Schnacht Motor Truck Co.*, 52 R.I. 317, 160 A. 787 (1932); *Wrenn v. Outlaw, Inc. v. Employers Liability Assur. Corp.*, 246 S.C. 97, 142 S.E.2d 741 (1965); *W. Wesley Singletary & Sons, Inc. v. Lake City State Bank*, 243 S.C. 180, 133 S.E.2d 118 (1963); *Martin v. McLeod*, 241 S.C. 71, 127 S.E.2d 129 (1962) (insurer, absolutely liable, advanced full amount of loss under loan receipt agreement, which court characterized as valid loan); *Phillips v. Clifton Mfg. Co.*, 204 S.C. 496, 30 S.E.2d 146 (1944) (insured's action for damages to auto allegedly caused by defendant's negligence; held to be loan even though plaintiff's insurer was absolutely liable for loss and had advanced entire amount of loss minus \$50 deductible under loan receipt device).

*But see* *Yezek v. Delaware, Lackawanna & Western R.R.*, 176 Misc. 553, 28 N.Y.S.2d 35 (1941) where the court concluded that a loan receipt was a payment without regard to its label as a loan agreement on one main ground: the insurer was absolutely liable; therefore, the use of a fiction was unnecessary to secure prompt payment to the insured and no mutuality of consent existed to justify its characterization as a loan.

event will plaintiff's recovery be increased or decreased by the outcome of the suit. Thus, where an insurer advances the full amount of plaintiff's loss, the circumstances do not reveal a mutual intent which is requisite to the creation of a loan. Nonetheless, some cases involving total reimbursement disregard the test for a valid loan—mutuality of intent—and hoist the loan-receipt fiction to help insurers recoup their advances.<sup>44</sup>

3. *Where No Need for Fiction, Transaction Properly Characterized As Payment: The Wisconsin View*

Absent one of the needs for the fiction—to protect insurers from jury bias<sup>45</sup>—the Wisconsin Supreme Court<sup>46</sup> pierced the form of the agreement and held it to be a payment, not a loan. In *Kopperud v. Chick*,<sup>47</sup> an automobile liability insurer brought an action to recoup, by way of indemnity from a joint tortfeasor, money paid to its insured in settlement of death and personal injury claims against its insured as a cotortfeasor. Under Wisconsin law, a person injured in an automobile accident may sue the insurer directly,<sup>48</sup> so the *need* to avoid subrogation due to jury bias did not exist. In addition, the use of the loan receipts for such purpose would have given an advantage to the insurer by hiding its identity while the identity of the third person's insurer could be disclosed. Where there was no *need* for the fiction and where prejudice would result if the fiction were used, the *Kopperud* court rejected the fiction that the transaction was a loan.

C. *Significance of the Fact that A Loan Receipt Agreement Is A Fiction*

The significance of establishing that a loan receipt device is a fiction can be demonstrated by reviewing the methodology suggested in this article. (1) Fictions are equitable devices designed to achieve justice among all parties. (2) Courts narrowly construe fictions, limiting them to the contexts in which fictions originate. (3) A loan receipt agreement is a fiction. (4) Courts

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44. See *Luckenbach v. W.J. McCahan Sugar Ref. Co.*, 248 U.S. 139 (1918); *Aetna Ins. Co. v. Henry DeBois Sons Co.*, 144 F.2d 262 (2d Cir. 1944), *cert. denied*, 323 U.S. 797; *Automatic Sprinkler Corp. v. Robinson-Slagle Lumber Co.*, 147 So. 542 (La. App. 1933); *Phillips v. Clifton Mfg. Co.*, 204 S.C. 496, 30 S.E.2d 146 (1944).

45. See subheading, *Needs for the Fiction, supra*.

46. *Kopperud v. Chick*, 27 Wis. 2d 591, 135 N.W.2d 335 (1965).

47. *Id.*

48. *Id.* at 339.

should narrowly construe the application of the loan receipt fiction. (5) Therefore, the loan receipt fiction should not be extended into the plaintiff-codefendant context where the court and non-agreeing codefendants would be prejudiced, and where the *needs* which originally gave rise to the device are absent.

## II. BEYOND THE INSURER-INSURED SHIPPER CONTEXT: LATER DEVELOPMENTS

Once it is established that a loan receipt device is a fiction, it is crucial to remember that loan receipt devices originated in a very specific historical context involving insured shippers and their insurers.<sup>49</sup> Shrewd attorneys, however, have duped courts into expanding the use of the loan receipt fiction. As a result, loan receipt devices now are employed in the plaintiff-codefendant context.<sup>50</sup> Close scrutiny reveals that the two aforementioned factual contexts involve completely different equities and reasons justifying the use or the non-use of loan receipts.

For example, the landmark Supreme Court case sanctioning the use of the loan receipt fiction was *Luckenbach v. W.J. McCahan Sugar Ref. Co.*<sup>51</sup> This case, however, is distinguishable on the facts and distinguishable on the law from the recent use of loan receipts in the plaintiff-codefendant context. It is factually distinguishable in the following respects: (1) the *Luckenbach* device was between an insurer and its insured-shipper pursuant to their prior contractual relations. The device of the loan agreement was employed to satisfy, at least partially, the contractual obligation of the insurance company. In the more recent factual setting, there is no contractual relation between the plaintiff and the cotortfeasor other than the loan agreement arising after the injury. The cotortfeasor has no duty to enter into a loan agreement. (2) Justice Brandeis, speaking for the *Luckenbach* Court, specifically noted that the loan receipt device would facilitate the expansion of the United States' commercial trade.<sup>52</sup> Quick reimbursement of loss in commerce was essential to enable the shipper to fulfill contracts with other buyers. In contrast, any nexus between the plaintiff-codefendant setting and commerce is hard to perceive. The latter context usually involves a simple personal

49. See *Luckenbach v. W.J. McCahan Sugar Ref. Co.*, 248 U.S. 139 (1918).

50. See, e.g., *NIPSCO v. Otis*, 145 Ind. App. 159, 250 N.E.2d 378 (1969); *Lum v. Stinnet*, 87 Nev. 402, 488 P.2d 347 (1971).

51. 248 U.S. 139 (1918).

52. *Id.* at 148.

injury case in which the compelling demands of the national well-being do not justify the use of a fiction. In fact, the primary effect of the device in a plaintiff-codefendant context is to insulate the cotortfeasor from ultimate liability. And further, the plaintiff is advanced money to which he may already be entitled from his own insurer. In short, the *needs* which originally gave rise to the loan receipt fiction do not exist in the plaintiff-codefendant area. Factual dissimilarity alone is sufficient reason to limit the use of the fiction in areas not contemplated by *Luckenbach*.

*Luckenbach*, however, is also distinguishable on the law in the following respects. Trial Rule 17(a)<sup>53</sup> requires that "every action shall be prosecuted in the name of the real party in interest." This language means that one seeking relief upon a claim legally or equitably must own the claim under the substantive law of the state.<sup>54</sup> Therefore, in determining who is the real party in interest under Rule 17(a), a court in a diversity of citizenship case<sup>55</sup> must first ascertain who has the substantive right of action under the controlling substantive state law. *Luckenbach* is not controlling on this substantive issue since that case was decided under the principles of *Swift v. Tyson*<sup>56</sup> at a time when it was thought that there was federal common law. Of course, *Swift's* authority was extinguished in 1938 when the Supreme Court overruled it in *Erie R.R. v. Tompkins*.<sup>57</sup> *Erie* held that there is no federal common law and that all substantive law of a state in which the district court sits should be applied. Thus, any case after 1938 which relies on *Luckenbach* as authority for the substantive real party in interest question is incorrectly decided.

The preceding analysis demonstrates that the landmark Supreme Court case validating such devices is distinguishable both on the facts and on the law from the plaintiff-cotortfeasor context. Further, close scrutiny reveals that the *needs* which originally gave rise to the loan receipt fiction do not exist in the plaintiff-cotortfeasor area. Any one of these reasons alone would be sufficient for limiting the use of the fiction in question. Comprehensive analysis, however, requires a further probe into the effects of expanding use of loan receipts into the plaintiff-

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53. It should be noted that Indiana Trial Rule 17(a) was modeled after Rule 17(a) of the Federal Rules of Civil Procedure.

54. *Rosenfeld v. Continental Bldg. Operating Co.*, 135 F. Supp. 465 (W.D. Mo. 1955); 3 MOORE'S FEDERAL PRACTICE, 17.02 at 1305 (2d ed. 1964).

55. 28 U.S.C. § 1332 (1966).

56. 16 Pet. 1, 10 L.Ed. 865 (U.S. 1842).

57. 304 U.S. 64 (1938).



cotortfeasor context. The following discussion outlines several highly prejudicial effects both to the court and to the non-agreeing codefendant arising from the application of the fiction in the plaintiff-cotortfeasor context.

#### A. *Prejudice to the Court*

##### 1. *Violation of Ethics*

The validity of enforceability of a loan receipt device in the plaintiff-cotortfeasor area must first be judged in light of a lawyer's ethical responsibility. Several preliminary, but fundamental, maxims should be kept in mind. The *Indiana Code of Professional Responsibility*, concerning contact with witnesses, provides: "A lawyer shall not pay, offer to pay, or acquiesce in the payment of compensation to a witness contingent upon the content of his testimony or the outcome of the case."<sup>58</sup> The rationale underlying this directive is that courts ought to be protected from the danger of collusion and perjury even if none may in fact exist.<sup>59</sup> Lawyers, as officers of the court, are held to the highest standards in the execution of their fiduciary duties to the court.<sup>60</sup> Accordingly, the Ethical Considerations state, "Witnesses should always testify truthfully and should be free from any financial inducements that might tempt them to do otherwise. [I]n no event should a lawyer pay or agree to pay a contingent fee to any witness."<sup>61</sup>

The language of the New York Supreme Court<sup>62</sup> is instructive:

The prevalence of perjury is a serious menace to the administration of justice, to prevent which no means have as yet been satisfactorily devised. But there certainly can be no greater incentive to perjury than to allow a party to make payments to its opponent's witnesses *under any guise or any excuse*, and at least attorneys who are officers of the Court to aid in the administration of justice, must keep themselves clear of any connection which in the *slightest degree* tends to induce witnesses to testify in favor of their client.<sup>63</sup>

58. INDIANA CODE OF PROFESSIONAL RESPONSIBILITY DR 7-107(c).

59. See INDIANA CODE OF PROFESSIONAL RESPONSIBILITY Canon 9 (avoiding the appearance of impropriety even though none may in fact exist).

60. INDIANA CODE OF PROFESSIONAL RESPONSIBILITY, *Preamble*.

61. INDIANA CODE OF PROFESSIONAL RESPONSIBILITY EC 7-28.

62. In re Robinson, 156 App. Div. 589, 136 N.Y.S. 548 (1912), *aff'd*, 209 N.Y. 354, 103 N.E. 160 (1913).

63. *Id.* at 600, 136 N.Y.S. at 556-57 (emphasis added). *Cf.*, INDIANA CODE OF PROFESSIONAL RESPONSIBILITY EC 7-25.

The idea of fiduciary responsibility and protection for the courts even from the possibility of perjury or fraud is further established by Opinion F99 of the *Indiana Code of Professional Responsibility*. Therein it states that it is professionally improper for an attorney to bring a suit on behalf of a mother, owner of an automobile in which she was riding, against her son who was driving, in order to recover against an insurance company for her injury through her son's negligence. The reason such suit would be improper is that the court would be exposed to the risk of collusion and perjury between parties of supposedly conflicting interests.

A lawyer who enters into a loan agreement in the plaintiff-codefendant context breaches his aforementioned fiduciary duties to the court and to the fair administration of justice<sup>64</sup> in the following respects: (1) it is a collusive agreement between parties of supposedly adverse interest, thereby creating an inherent danger for perjury; (2) it misleads the jury into thinking that the agreeing tortfeasor who sits at the defendant's table is adverse to the interests of the plaintiff when in fact he participates in the proceeds of the plaintiff's recovery; and (3) it deprives the non-agreeing codefendant of a substantial number of peremptory challenges which it must share with the agreeing tortfeasor.

The Nevada Supreme Court has been at the forefront in recognizing the ethical problems which inhere when loan receipts are used in the plaintiff-codefendant area. In *Lum v. Stinnett*,<sup>65</sup> a loan receipt agreement between plaintiff and two of the defendant doctors provided that the two agreeing defendants would pay a sum necessary to bring recovery up to \$20,000 if the jury awarded less than that amount. In return, the plaintiff promised not to execute against the agreeing physicians if the verdict exceeded \$20,000. Further, the plaintiff agreed to prosecute his action against the non-agreeing physician and not to settle with him for less than \$20,000. The Nevada Supreme Court found the agreement unethical and therefore violative of public policy. Specifically, the agreement violated the prohibition against representing

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64. INDIANA CODE OF PROFESSIONAL RESPONSIBILITY EC 8-5 clearly states that "Fraudulent, deceptive, or otherwise illegal conduct by a participant in a proceeding before a tribunal or legislative body is inconsistent with the fair administration of justice . . . ."

65. 87 Nev. 402, 488 P.2d 347 (1971) (malpractice action by a patient against three physicians alleging they negligently failed to detect and treat a compression fracture of the spine).

conflicting interests<sup>66</sup> in that defendants' lawyers were representing the interest of the plaintiff in an effort to encourage a large jury verdict against their own side in the litigation. Lawyers for the agreeing defendant doctors violated the canon which requires that a lawyer's conduct before the court and other lawyers be characterized by candor and fairness.<sup>67</sup> In addition, the Code of Professional Responsibility was violated in that it prohibits a lawyer from taking technical advantage of opposing counsel.<sup>68</sup> Finally, the *Lum* court held that the agreement violated the prohibition that it is unprofessional for a lawyer to stir up strife and litigation.<sup>69</sup>

The *Lum* court took special note of a dilemma. The plaintiff could call an agreeing cotortfeasor as an adverse witness. The non-agreeing codefendant would then be forced on cross-examination to impeach the witness with a device containing self-serving language.<sup>70</sup> The Nevada Supreme Court supported its decision by

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66. See INDIANA CODE OF PROFESSIONAL RESPONSIBILITY Canon 6 (1908).

67. *Id.* See INDIANA CODE OF PROFESSIONAL RESPONSIBILITY Canon 22 (1908).

68. *Id.* See INDIANA CODE OF PROFESSIONAL RESPONSIBILITY Canon 25 (1908).

69. *Id.* See INDIANA CODE OF PROFESSIONAL RESPONSIBILITY Canon 28 (1908).

70. Insertion of self-serving language is a gimmick used by parties to the fiction in order to deter the non-agreeing defendant from introducing the device into evidence. Following is an example of typical self-serving language. The device was entered into by plaintiffs Delbert and Regina Otis and defendant NIPSCO in the case of Northern Indiana Public Service Company v. Otis, 145 Ind. App. 159, 250 N.E.2d 378 (1969):

WHEREAS, Delbert Otis and Regina Otis are husband and wife and residents of Fort Wayne, Indiana; Northern Indiana Public Service Company (NIPSCO) is a public utility, engaged, among other things in supplying natural gas to residents of Fort Wayne, Indiana; John Drehner, Inc. ("Drehner") is a construction company; and

WHEREAS, in the year 1951 NIPSCO, embarked upon a construction program which included the installation of a main for the transmission of natural gas under a portion of a certain thoroughfare in Fort Wayne known as "Broadway." NIPSCO, and Drehner entered into a written agreement dated July 16, 1951, under which Drehner agreed to install said main; Drehner in fact installed said main; and

WHEREAS, a gas explosion occurred in said main on February 3, 1966, allegedly inflicting severe and painful injuries upon Regina Otis and allegedly causing consequential damages in a large amount to her husband, Delbert Otis; and

WHEREAS, Regina Otis has brought an action in the Allen Superior Court No. 3, Allen County, Indiana, to recover for her injuries and for the resulting pain and suffering of which action bears the Cause No. 11540;

Delbert Otis has brought an action in the Superior Court of Allen County, Allen County, Indiana, to recover for his consequential damages; Drehner and NIPSCO, are joined as defendants in each action; and

WHEREAS, the Complaint in each action is drafted upon the theory that said explosion was caused by negligent acts and omissions on the part of each of the defendants and that the defendants are jointly and severally liable for the damages suffered by the plaintiffs; and

WHEREAS, NIPSCO denies that it was negligent in such manner as to cause said explosion and denies that it is liable to the plaintiff in either of the aforesaid actions; but NIPSCO realizes that it might be unable to establish that it is not liable; and so NIPSCO maintains in the alternative, (a) that any liability on its part is secondary; (b) that Drehner is primarily liable to Regina Otis and Delbert Otis; (c) that NIPSCO would be entitled to indemnity from Drehner for any monies it might pay Regina Otis and/or Delbert Otis, either as the result of a judgment in the aforesaid actions, or either of them, or as the result of a compromise and settlement; (d) that NIPSCO would be entitled to such indemnity both expressly under the terms of the aforesaid written agreement dated July 16, 1951, and impliedly under the principles of law applicable when one secondarily liable makes payments to satisfy in whole or in part an obligation for which another is primarily liable; and

WHEREAS, NIPSCO recognizes that the facts are such as to provide a substantial possibility that the plaintiff will be awarded judgment against each defendant in each of the aforesaid actions; NIPSCO further recognizes that any such judgment would, in all probability, be for a large sum of money, particularly in the action brought by Regina Otis where any judgment for her would probably be in excess of \$50,000.00; and

WHEREAS, NIPSCO recognizes that the plaintiff in each of the aforesaid actions could if awarded judgment against each defendant execute the same, in whole or in part, against NIPSCO as he or she chose; that the plaintiff would not have to collect any part of such judgment from Drehner unless he or she wished; that the plaintiffs' rights with regard to the collection of any such judgment would be unaffected by NIPSCO's assertion that any liability on its part is secondary; and

WHEREAS, Delbert Otis and Regina Otis believe that their position in each of the aforesaid actions is strong but they recognize that the ultimate disposition of said action, including appeals, is probably at least three years in the future, particularly inasmuch as Drehner has pursued a policy of delay from the very inception of the aforesaid litigation; pursuant to such policy of delay Drehner has filed frivolous pleadings and Drehner has otherwise manifested a defiant attitude toward the Rules of Supreme Court of Indiana and the Rules of the Allen Superior Court No. 3; that on one occasion the Allen Superior Court No. 3 entered a default judgment against Drehner because of Drehner's obdurate refusal to plead, removing same from the docket sheet prior to the time it was typed into the order book only because Drehner was immediately advised of such entry and filed a pleading before the persons in charge of the order book had an opportunity to type the entry into the order book; Drehner is continuing its policy of delay and there is no reason to expect any change until the ultimate disposition of the litigation; and

WHEREAS, Delbert Otis and Regina Otis realize that any judgment in their favor would not have to be satisfied until the ultimate disposition of

citing language from a leading authority on legal ethics.<sup>71</sup>

A lawyer may not, in order to get decided a question of law in which he is interested, foist a fictitious controversy on the court. . . . He may not ostensibly appear for a stooge client when he represents another.<sup>72</sup>

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the litigation; their investigation to date indicated that NIPSCO is correct in that its part is secondary, that Drehner is primarily responsible for the aforesaid explosion and that Drehner is primarily liable in each of the aforesaid actions; and

WHEREAS, Drehner is one of the largest general contractors in the area and is financially able to pay substantially more than the prayer in the Otis Complaints, without financially impairing Drehner; and

WHEREAS, Otis and NIPSCO are desirous of reaching an agreement which would enable Delbert Otis and Regina Otis to receive monies at the present time without jeopardizing the claims against Drehner alleged in the aforesaid actions and which agreement would limit NIPSCO's ultimate liability without affecting its rights to indemnity from Drehner;

NOW, THEREFORE, in consideration of the promises, and in consideration of the promises hereinafter expressed, it is agreed by and between Delbert Otis and Regina Otis on the one hand and NIPSCO on the other that:

1. Contemporaneously with the execution of this instrument NIPSCO will advance to Delbert Otis and Regina Otis jointly the sum of \$50,000.00 as a loan, without interest, payable only in the event and to the extent that Delbert Otis and Regina Otis, or either of them, receives a recovery (over and above the costs of litigation, including by way of illustration and not of limitation, court costs and experts' and physicians' fees for consultation and appearance at trial, but not including attorneys' fees), from Drehner by reason of the above described injuries and damages.
2. Delbert Otis and Regina Otis agree they will pursue the aforesaid actions diligently; that, in the event judgment is awarded against both defendants and either or both of said actions, they will not cause any execution to issue against NIPSCO by reason of such judgment. In the event either or both of said actions results in a judgment against NIPSCO alone, the plaintiff in such action may levy execution against NIPSCO but only for the sum by which such judgment exceeds \$50,000.00.
3. Delbert Otis and Regina Otis further agree that they will not initiate suit against NIPSCO or in any manner demand, claim, accept or receive any monies from NIPSCO by reason of the aforesaid explosion and the resulting injuries and damages other than as hereinabove provided.

It is understood and agreed by and between the parties that this agreement does not effect a release of the claims of Delbert Otis and/or Regina Otis against NIPSCO, and it is further understood and agreed that the parties do not intend to, nor do they relinquish their respective claims against Drehner, but each of the aforesaid actions shall be prosecuted diligently, as hereinabove stated, and NIPSCO shall take whatever steps it deems necessary to protect and assert its rights to indemnity against Drehner and actively contest any liability.

71. H. DRINKER, *LEGAL ETHICS* (1953).

72. *Id.* at 75.

The *Lum* court held that although the preceding language is not exactly parallel, the underlying idea is applicable.<sup>73</sup> To retain the agreeing codefendants as parties, as adverse witnesses, and as a device to encourage large jury verdicts is to foist a fiction before the court prejudicial to the nonagreeing codefendant, prejudicial to the integrity of the court, and prejudicial to the fair administration of justice.

## 2. *Contra to Public Policy on Grounds Other than Ethical Violations*

First, loan receipt agreements in the plaintiff-codefendant context are violative of public policy where joint tortfeasors differ in the degree of blame they bear for an injury. The device tends to shift the entire burden of loss to the less blameworthy tortfeasor, since his cotortfeasor will be willing to offer more to the injured party under such an agreement in an effort to minimize his greater exposure or to escape liability altogether.<sup>74</sup>

Second, although courts have often noted that codefendants do not always cooperate in an effort to defeat the plaintiff,<sup>75</sup> the adversary nature of the proceeding is severely undermined by the collusive nature of the agreement and the monetary incentive to commit perjury. It is one thing to try to place blame on the other party, but it is a totally different matter when a collusive agreement with a monetary reward for a favorable outcome to the plaintiff insures the defendant's cooperation with the plaintiff. The policy of full development and presentation of facts in an adversary context is virtually stifled.

At least one case has suggested that the device simplifies multi-party litigation while at the same time facilitating private settlement.<sup>76</sup> Nothing could be further from the truth. In the plaintiff-codefendant context, the agreeing tortfeasor remains as a defendant so the same number of parties still exists. No simplification is present. In the plaintiff-codefendant context, it is true that one party enters into a private agreement. Although this may settle his claim, the effect of the so-called loan is to encourage the plaintiff to pursue the remaining codefendant, appeal

73. 488 P.2d at 352.

74. *Reese v. Chicago, B.&Q. R.R.*, 55 Ill. 2d 356, 303 N.E.2d 382 (1973) (Judges Schaefer, Ward and Ryan dissenting).

75. *See NIPSCO v. Otis*, 145 Ind. App. 159, 250 N.E.2d 378 (1969).

76. *Reese v. Chicago, B.&Q. R.R.*, 55 Ill. 2d 356, 303 N.E.2d 382 (1973).

after appeal, until the final pound of flesh is extracted.<sup>77</sup> The non-agreeing codefendant is barred from settling out of court by the very nature and contractual provisions of the loan receipt device. In short, the loan receipt device in the plaintiff-codefendant context is contra to public policy on the ground that it prevents complete settlement of suits, thereby increasing costs of litigation and impairing the efficient administration of justice.

### 3. *Circumvention of Rule Prohibiting Contribution or Indemnity Between Cotortfeasors*

In the United States, the overwhelming majority of courts<sup>78</sup> refuse to allow contribution.<sup>79</sup> Since the injured party's success in an action against a cotortfeasor makes it possible for the loaning tortfeasor to recoup all or a portion of the funds advanced, at the expense of the non-agreeing codefendant, the loan receipt agreement can properly be characterized as a device enabling one joint tortfeasor to obtain indemnity or contribution from another.<sup>80</sup> Because this fiction circumvents the rule prohibiting contribution, several courts have pierced the fiction and denied the validity of a loan.<sup>81</sup>

### 4. *Circumvention of Real Party In Interest Statute*

Pursuant to Trial Rule 17, every action must be prosecuted in the name of the real party in interest. The fiction of a loan

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77. 303 N.E.2d at 387-88.

78. See *Bolton v. Ziegler*, 111 F. Supp. 516 (W.D. Iowa 1953); *Jackson v. Record*, 211 Ind. 141, 5 N.E.2d 897 (1937); *American Exp. Co. v. Patterson*, 73 Ind. 430 (1881); *Silvers v. Nerdlinger*, 30 Ind. 53 (1868); *Hunt v. Lape*, 9 Ind. 248 (1857); *Smith v. Graves*, 59 Ind. App. 55, 108 N.E. 168 (1915); *Cullen v. Atchison, T.&S.F. Ry.*, 211 Kan. 368, 507 P.2d 353 (1973); *Tober v. Hampton*, 178 Neb. 858, 136 N.W.2d 194 (1965).

79. The reason underlying the prohibition against contribution or indemnity is that courts should not be used for the relief of wrongdoers. Noting this rationale, the Illinois Supreme Court in *Reese v. Chicago, B.&O. R.R.*, 55 Ill. 2d 356, 303 N.E.2d 382 (1973), held that the courts are not involved in private, out-of-court loan receipt agreements. *Reese* is clearly in the minority in this view. See note 81 *infra*. Not only are both parties to the agreement still involved in the litigation, but the direct effect of the fiction is to secure for the agreeing codefendant a portion of the plaintiff's recovery to which he would not otherwise be entitled.

80. See Annot., 62 A.L.R.3d 1111, 1115 (1973).

81. *Alder v. Garcia*, 324 F.2d 483 (10th Cir. 1963) (applying New Mexico law); *Bolton v. Ziegler*, 111 F. Supp. 516 (W.D. Iowa 1953); *Cullen v. Atchison, T.&S.F. Ry.*, 211 Kan. 368, 507 P.2d 353 (1973); *Herring v. Jackson*, 255 N.C. 537, 122 S.E.2d 366 (1961); *Tober v. Hampton*, 178 Neb. 858, 136 N.W.2d 194 (1965).

agreement obscures the fact that only the agreeing codefendant has a substantial interest in the outcome of the case. For all practical purposes, the plaintiff is reimbursed for his loss. The outcome of the case will neither diminish nor increase his recovery. The net effect of the fiction is to allow the agreeing codefendant to circumvent the real party in interest statute.

One case so holding was *Tober v. Hampton*,<sup>82</sup> an action brought by a landlord and tenant against a construction company which allegedly ruptured a gas line while digging a ditch. The result was an explosion and consequential injuries to the plaintiff. The gas company which owned the line, being potentially liable as joint tortfeasor for having failed to detect the source of the leak during an investigation, advanced money to the plaintiff under so-called loan receipts giving the company irrevocable control over the prosecution. The Nebraska Supreme Court in *Tober* noted that absent a statute to the contrary, an assignee of a chose in action is generally considered to be the real party in interest within a real-party-in-interest statute.<sup>83</sup> Consistent with this principle, the *Tober* court pierced the loan receipt fiction holding such devices between a plaintiff and a joint tortfeasor to be an assignment of the claim against the remaining codefendant. No valid loan was found. As a result, an action brought by the injured party against the non-agreeing cotortfeasor was subject to dismissal upon the ground that it was not being prosecuted in the name of the real party in interest.<sup>84</sup>

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82. 17 Neb. 858, 136 N.W.2d 194 (1965).

83. *Id.* at 207. *Accord*, 59 AM. JUR. 2d *Parties* § 41 (1971).

84. Plaintiff in a plaintiff-codefendant context should not be allowed to rely on any exception to the real party in interest statute. Indiana Trial Rule 17(a)(1) allows a trustee of an express trust to sue without joining with him the person for whose benefit the action is prosecuted. However, the parties to a loan receipt device ordinarily do not expressly label their transaction a trust. Nor does it normally appear that the parties intended the device to be a trust. Accordingly, to first label this device a loan then to label it a trust is to play word games, fictions being created at the whim and for the sole benefit of the agreeing tortfeasor and to the circumvention of the real party in interest statute. Indiana courts have repeatedly stated the test for a real party in interest to be one with an actual, not fictional, substantial interest in the subject matter of the action, that is, the owner of the claims sued on or the one who ultimately is entitled to the fruits of the action. *Davis v. King*, 108 Ind. 387, 103 N.E. 98 (1913); *John A. Boyd Motor Co. v. Claffey*, 94 Ind. App. 492, 165 N.E. 255 (1929).



### 5. *Circumvention of Rule Barring Assignment of Tort Claims*

As a general rule, it is unlawful to assign a tort claim. The use of the loan receipt fiction seriously undermines that long-standing doctrine. By the fiction, one of two joint tortfeasors is permitted to buy from the injured person or his administrator the cause of action as it relates to him, and then to participate in the assertion of the cause of action against his codefendants.<sup>85</sup>

### 6. *Circumvention of the Rule Barring Champerty*

Blackstone defined champerty as a situation where "the champertor is to carry on the party's suit at his own expense."<sup>86</sup> Indiana follows this common law definition on the ground that champerty is a perversion of justice, encourages misuse of the courts, and unfairly harasses defendants.<sup>87</sup> In spite of this tradition, the issue of champerty in the loan receipt context has never been raised in Indiana.<sup>88</sup> The court in *Klukas v. Yount*,<sup>89</sup> refused to

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85. 303 N.E.2d at 387.

86. 14 AM. JUR. 2d *Champerty and Maintenance* § 9 (1971).

87. *Draper v. Zebec*, 219 Ind. 362, 37 N.E.2d 952 (1941), *rehearing denied*, 219 Ind. 362, 38 N.E.2d 995; *Hotmire v. O'Brien*, 44 Ind. App. 694, 90 N.E. 33 (1909) (the aiding of a litigant by a stranger otherwise having no interest in the litigant's claim whereby the stranger is to receive a part of the thing in dispute).

88. One technical problem for one challenging loan receipt devices on grounds of champerty is that only a party to a champertous contract may raise the defense of champerty. *Puett v. Beard*, 86 Ind. 172 (1882) (involving champerty where A advanced money to enable B to prosecute a civil suit for assault and battery). *Accord*, *Zeigler v. Mize*, 132 Ind. 403, 31 N.E. 945 (1892); *Campbell v. Bd. of Commissioners of Boone County*, 41 Ind. App. 710, 83 N.E. 357 (1908). Nonetheless, some courts denying standing to a person not a party to the contract have taken note of the violation and refused to enforce it under the inherent power of courts to preserve their own integrity and maintain public policy. *See note 65 supra*.

Another technical problem for one challenging loan receipt devices is an exception to the traditional bar to champerty: it is not champertous to advance money to finance an action by a poor person. A. CORBIN, CORBIN ON CONTRACTS § 1423 (1962). Although no Indiana case has considered this view, Corbin's exception is consistent with one of the ideas underlying the need for the fiction. That is, the plaintiff is in need of immediate funds both to prosecute the claim and to meet the necessities of life. But it is crucial to note that, by statute, this exception seems to be abrogated. IND. CODE § 34-1-60-4 (1971) stipulates that an attorney has a duty not to encourage the commencement or the continuance of an action or proceeding for any motive of passion or interest. The language of the statute is all inclusive. There is no evidence of legislative intent to create an exception to the bar against champertous suits. In the plaintiff-codefendant context, the device is champertous not only because of a division of proceeds between the plaintiff and a stranger to the plaintiff's interests but also because the device limits the non-agreeing

rule upon the contention that a loan receipt device was champertous on the ground that the issue was not raised at the trial. Other courts,<sup>90</sup> however, have considered the issue, holding the use of a fiction would not be allowed to circumvent the state's rule barring champerty.

For instance, the Nevada Supreme Court has considered the issue of champerty in the plaintiff-cotortfeasor context.<sup>91</sup> In essence, the Nevada Supreme Court held that maintaining the suit of another is unlawful unless the maintaining person has some interest in the subject of the suit or is connected with such other person by ties of consanguinity or affinity.

If insurance companies may contend that . . . they have so little relationship to actions against their insureds that the policies they issue are not discoverable even by vitally concerned plaintiffs . . . then surely no one will contend a carrier has such relationship to a plaintiff's action as justifies fostering it, for profit, against defendants with whom the carrier and its insureds have no relationship whatever.<sup>92</sup>

Thus, agreements whereby a cotortfeasor's insurance carrier agrees to pay the plaintiff any consideration to foster litigation in which it is not interested, in order to avoid its own liabilities, are contrary to public policy and law.

Expansion of loan receipt devices into the plaintiff-codefendant context opens a Pandora's box to the courts. Among the evils exposed to the courts are ethical violations on the part of participating attorneys and the undermining of several well established legal principles, such as the rules prohibiting contribution or indemnity between cotortfeasors, concerning real party in interest, barring assignment of tort claims, and barring champerty. Furthermore, the general analysis that the devices are contrary to public policy militates against their expansion into a factual setting which is inherently prejudicial to courts.

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defendant's right to compromise with the plaintiff. This is clearly violative of IND. CODE § 34-1-60-4 (1971). See also *City of Rochester v. Campbell*, 184 Ind. 421, 111 N.E. 420 (1916) (either unlawful division of proceeds or impairment of right to compromise with non-agreeing party constituted champerty).

89. 121 Ind. App. 160, 98 N.E.2d 227 (1951).

90. 87 Nev. 402, 488 P.2d 347, 350 (1971). See note 65 *supra* and accompanying text.

91. *Id.*

92. *Id.*

B. *Prejudice to Non-agreeing Codefendant*

In addition to the enumerated areas of possible prejudice to courts, expansion of the loan receipt device prejudices non-agreeing codefendants. Examination of jury selection reveals at least one area of possible prejudice to the non-agreeing codefendant. Pursuant to Indiana statute<sup>93</sup> each side gets six peremptory challenges. There is no constitutional right to peremptory challenges; these are statutory entitlements.<sup>94</sup> Within its inherent power to regulate courtroom procedure, a court may exercise discretion in directing the number of peremptory challenges given to the parties on each side so long as the statutory right to challenge is not completely taken away.<sup>95</sup> Although courts have the discretion to apportion peremptory challenges according to the interest, a danger still exists. The agreeing tortfeasor who continues to sit at the defendants' table before the jury, in spite of the fact that his only interest is that the plaintiff extract substantial recovery from the non-agreeing codefendant, may be allowed to split the six peremptory challenges with the non-agreeing codefendant. In effect, the plaintiff is getting nine peremptory challenges—the six normally given to each side plus the three which the agreeing tortfeasor will exercise in plaintiff's favor. Thus, plaintiff gets three more peremptory challenges than his statutory entitlement. This effect has the inherent tendency to be prejudicial to a non-agreeing codefendant.<sup>96</sup>

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93. IND. CODE § 34-1-20-7 (1971).

94. *Jacoby v. State*, 212 Ind. 465, 8 N.E.2d 978 (1937) (criminal trial).

95. *Veach v. McDowell*, 133 Ind. App. 628, 184 N.E.2d 149 (1962).

96. As a general rule, a case will not be reversed because error is committed by the court in a ruling on a peremptory challenge where no harm results to the objecting party from such ruling. 5A C.J.S. *Appeal and Error* § 1708 (1964). It is important to remember that demonstrating prejudice may be difficult. Ordinarily there is no presumption that errors or irregularities in the selection or impaneling of the jury were prejudicial and the burden is on appellant to show prejudice. 5A C.J.S. *Appeal and Error* § 1677 (1964). Accordingly, the fact that a party is allowed more or less than the legal number of peremptory challenges is not cause for reversal of the case in the absence of prejudice to the complaining party. On the other hand, if the complaining party is prejudiced by an erroneous ruling on peremptory challenges, the error is not harmless. Accordingly, Indiana courts have held it to be ground for reversal to totally deprive a party of his legal number of peremptory challenges or to allow one of the parties additional peremptory challenges. *Veach v. McDowell*, 133 Ind. App. 628, 184 N.E.2d 149 (1962) (finding abuse of discretion to allow plaintiff to exercise two of its three allotted challenges, depriving him of the exercise of the last one, where the defendant subsequently accepted the jury as selected). Thus, in the plaintiff-codefendant context, the chance for prejudice to the non-agreeing defendant

## CONCLUSION

It is absolutely crucial to understand the proper nature of a fiction. A fiction is an equitable device designed to achieve equitable results. Where even one party is prejudiced or the mere possibility of adverse consequences is present, the fiction should be dissolved or denied extension into areas not originally comprehended by the fiction.<sup>97</sup> A loan receipt agreement is a fiction. It originated and was properly employed in a very specific historical context involving an insurer and its insured shipper. In this narrow factual setting, there were several legitimate *needs* for the fiction. Accordingly, some courts expressly recognized the so-called loan agreement as a fiction. Other less candid decisions, however, paid lip service to the idea that the true test for a valid loan was the parties' intention. Notably, the circumstances in these decisions do not indicate that the parties mutually intended to create a loan. Most tellingly, the bulk of these decisions is devoted to equitable justifications for the use of a fiction, not the straight forward test for a valid loan.

Given the equitable nature of fictions and the specific fact that loan receipts are fictional, any case extending the use of this fiction into the plaintiff-codefendant context is distinguishable on three main grounds: (1) factually, the *needs* which originally gave rise to the fiction are not present in the new context; (2) the law applied to the procedural issues in the original context has been overruled by *Erie R.R. v. Tompkins*; (3) several negative effects result in the application of the loan receipt fiction in the new context. Thus the loan receipt fiction should be dissolved or denied extension into the plaintiff-codefendant area.<sup>98</sup>

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is great if the effect of giving the plaintiff nine peremptory challenges is not *per se* prejudicial.

97. *Blackstone v. Miller*, 188 U.S. 189 (1919); *United States v. 1960 Bags of Coffee*, 3 U.S. (8 Cranch) 188, 198 (1814) ("It seems to be a rule founded in common sense, as well as strict justice, that 'fictions of law' shall not be permitted to work *any* wrong, but shall be used *ut res magis valeat quam pereat*."); *Purdy v. McGarity*, 30 N.Y.S.2d 966, 262 A. 623 (1941); *Parker Peanut Co. v. Felder*, 200 S.C. 203, 20 S.E.2d 716, 720 (1942) ("Fictions are invented and instituted for the promotion of justice. It is a certain rule that a fiction of law shall never be contradicted so as to defeat the end for which it was invented, but for every other purpose it may be contradicted."). Cf. 95 U. PA. L. REV. 231, 234 (1946) ("the use of a legal device, proper in its setting should not be extended to a situation foreign to its nature for the purpose of thwarting the decisions of the courts").

98. The following is a list of cases which must be distinguished in order to defeat the use of loan receipts in the plaintiff-codefendant context. The

format is designed for the practicing attorney and includes every Indiana case subsequent to *Luckenbach* which has considered validity of the loan receipt fiction.

*Klukas v. Yount*, 121 Ind. App. 160, 98 N.E.2d 227 (1951), was the first Indiana case to consider the use of loan receipts in the plaintiff-cotortfeasor context. (1) The decision was poorly reasoned, omitting any analysis of the historical setting in which the fiction originated or reason for its confinement to the insurer-insured shipper context. (2) Reliance on *Luckenbach* on the procedural issue of real party in interest was both misplaced and indicative of the lack of reasoning given to the decision. Consequently, there is no definitive holding in Indiana on the real party in interest issue. (3) The assumption underlying *Klukas* is that a fiction valid for one purpose is valid for all purposes. Disappointingly, the following contentions were never raised in this Indiana case which has become a mainstay for validating the fiction in Indiana: fiction, circumvention of contribution, circumvention of indemnity, circumvention of assignment of personal injury claim, champerty, ethics violations, and public policy. The total lack of analysis should diminish or extinguish *Klukas* as authority for the validity of loan receipts in the plaintiff-codefendant context.

*NIPSCO v. Otis*, 145 Ind. App. 159, 250 N.E.2d 378 (1969), upheld the validity of loan receipt devices in the plaintiff-cotortfeasor context although the decision could have been decided on a narrower ground. (1) The main issue before the court was whether a separate trial should have been granted. The court admitted that its decision could have been based on either of two grounds: that the granting of motion for separate trial was within the sound discretion of the trial judge, or that the moving codefendant failed to cite a single case in support of his motion for a separate trial. *Id.* at 390. Thus, it can be argued that *Otis* is precedent only for the proposition that a motion for a new trial must be accompanied by supportive cases or that trial judges have wide discretion in this area. The language discussing the validity of loan agreements is mere dicta, not essential to reaching the decision. (2) Alternatively, if *Otis* is considered valid authority for the use of loan receipts in Indiana, then it can be attacked because of its primary reliance on *Klukas* and *Luckenbach*. *Otis* was only the second Indiana case to discuss the use of loan receipt devices in the plaintiff-codefendant context and yet it shirked its duty to examine the historical underpinnings of the device, to examine the needs which originally gave rise to the fiction, and to examine the inequitable results of extending the device into unintended areas. Actually, the lack of historical analysis is not surprising since the issue of the validity of loan agreements was not properly before the court. In fact, a motion for separate trial would assume the validity of such agreements. Thus, in spite of the fact that the court notes "cross contentions" about the validity of the device, the parties were in agreement that such device was valid. *Id.* (3) The court summarily dismissed the idea that the policy against contribution or indemnity was traversed. Likewise, the prohibition against assignment of court claims was summarily dismissed in the same sentence. The court's only authority for such cursory examination was A.L.R. cites which referred to loan receipts arising in the insurer-insured context, not the plaintiff-codefendant context which was before the court. *Id.* at 393, citing 1 A.L.R. 1528 (1919), 132 A.L.R. 607 (1941), and 157 A.L.R. 1261 (1945). (4) Ethics and the real party in interest issues simply were not discussed.

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*American Transport Co. v. Central Indiana Ry.*, 255 Ind. 319, 264 N.E.2d 64 (1970), involved the issue whether plaintiff-administrator after entering an agreement designated "covenant not to execute" with a codefendant was barred from executing against the non-agreeing defendant on the ground that the agreement was a partial payment of partial satisfaction. The Madison Superior Court restrained execution but the Indiana Supreme Court, speaking through Judge Givan, reversed. The court looked behind the label, finding a loan agreement, which it upheld under the validity of *Klukas* and *Otis*. Thus the issue of the validity was not squarely before the Supreme Court of Indiana. Consequently, the parties to the action may have not briefed the relevant issues concerning validity. This could account for the blind adherence to prior lower court results without examining the applicability thereof or the depth of the lower court reasoning. Again the distinction between the original insurer-insured shipper context and the plaintiff-codefendant context was not analyzed. The court at one point stated that the non-agreeing codefendant would not be prejudiced because the plaintiff could have executed against either codefendant he chose. *Id.* at 67. Such a facile argument takes little note of the aforementioned dangers to the integrity of the court and prejudice to the non-agreeing codefendant, not the least of which is the inducement to commit perjury.

*Scott v. Krueger*, 151 Ind. App. 479, 280 N.E.2d 336 (1972), involved the issue whether an agreement between the plaintiff and one codefendant, constituting covenant not to sue, entered into while the jury was deliberating, was proper matter to submit to the jury. (1) Since the case did not involve a loan receipt device, it is not relevant to the validity of the device. Language to the effect that such devices are valid is mere dicta. (2) Even the dicta is erroneous in that it is based on *Otis* and *Klukas*, two decisions suffering from lack of analysis.

