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BUSINESS INSURANCE

Second Edition

BUSINESS INSURANCE

Insured Business Continuation Plans for Proprietorships, Partnerships, and Close Corporations

SECOND EDITION

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To the Life Underwriters of America,
whose finest "stock-in-trade" consists
of ideas that benefit others far more
than themselves.

Preface

PROPRIETORSHIPS

PROPRIETORSHIPS, LARGELY BECAUSE THEY REPRESENT the simplest form of doing business, greatly outnumber all other forms of business organization. There are literally millions of them in the United States alone. Consequently, and notwithstanding the fact that most of them are properly classed as "small business," proprietorships in the aggregate carry on a substantial portion of the country's total economic activity.

A successfully operating business organization, whether proprietorship, partnership, or corporation and whether large or small, has a value as a going concern that is considerably greater than the value of the net assets gathered together in the particular unit. As said by Judge Frank in *Williams v. McGowan,* 152 F.2d 570, "Where a business is sold as a unit, the whole is greater than its parts. Businessmen so recognize. . . ." But when the organization is allowed to become inactive, to close its doors, this "going value" is lost to both the owners and community. In the case of a proprietorship, which is an unincorporated business organization owned by one individual, it is obvious that upon the owner's death the danger of losing this "going-concern" value is imminent unless special provisions have been made for the continuation of the business. Under ordinary circumstances, the laws applying to decedent's estates will require his enterprise to be closed out promptly by his executor or administrator. The proprietor, however, need not

subject his business to this calamity and his heirs to the losses certain to follow such a procedure, for he can provide by will for the limited continuance of the business and thereby lessen the losses. In many cases, he can set up an insured business continuation agreement with one or more of his key employees that will assure that his heirs receive the full "going-concern" value of his proprietorship.

Numerous law cases are cited in this section that deal with proprietorship businesses subsequent to the death of the owner. The facts and law of these cases bring out, as nothing else will, the vicissitudes, hazards, and losses encountered in the absence of a satisfactory business continuation plan and the great need for such a plan.

The material on Proprietorships is grouped into three parts. Part I sets forth the fundamental facts about proprietorships and the economic losses attendant upon their discontinuance and liquidation at the death of the proprietor. Part II deals with the various plans that have been tried in attempts to avoid closing out such businesses on the proprietor's death, in order to avoid these losses. Part III discusses the ideal continuation plan. This is the insured purchase and sale agreement, running between the proprietor and his key employee, which assures, upon the proprietor's death, the disposal of the business for full value without loss to the heirs and its continuance by the employee as a going concern.

PARTNERSHIPS

Partnerships are engaged in almost every branch of economic activity and occupy a particularly significant position in the field of investment banking, the professions, and in the wholesale and retail trade. The number of partnerships now operating in the United States is estimated to be well in excess of 700,000. Although the total number of partnerships is increasing steadily with the growth of the country, their proportionate rate of increase since 1945 has not kept pace with that of proprietorships and corporations. Yet partnerships outnumber corporations by several hundred thousands.

When the business unit is a partnership, the problem of continuing a business after the death of a partner is acute. The laws of partnership provide that on the death of a partner the firm is automatically dissolved and that, in the absence of an agreement to the contrary, its affairs must be promptly liquidated. Fortunately, however, it is not necessary for the partners to allow the laws of partnership liquidation to take their course. Like the provisions of the intestate laws, which function only when no valid will has been drawn, the provisions of the partnership laws requiring liquidation of the business on the death of a partner function only when no valid business continuation agreement has been executed by the partners. Consequently, although the problem is acute, its solution is simple. A properly drawn agreement between the partners, providing that on the death of one the survivor will own the entire business and the estate of the deceased will receive in cash the value of his interest in the firm, will assure the continuation of the business by the survivor, if he can produce the necessary cash when death occurs. This may be done readily when each partner carries insurance on the life of the other in the amount of cash needed.

With such a clear-cut method available by which the surviving partner can be assured of the ownership of the entire business and the deceased partner's estate can be assured of receiving the value of his interest in the business in cash when death occurs, it may appear to some that an extended treatment of the subject is unnecessary. Unfortunately, however, many partners are unfamiliar with the provisions of the partnership laws relating to the death of a partner and are unaware of the underlying problem. Often they do not realize that the surviving partner will be held to the highest standards of duty and accountability in liquidating the firm's affairs and that any "bargaining" with the heirs will not be countenanced by the courts. Therefore, they cannot properly appreciate the dangers involved in the absence of a plan or those that lurk in any plan improvised after a death occurs, and they do not realize the urgency of setting up a continuation agreement in advance.

What has been said regarding the necessity of being informed applies even more strongly to life underwriters. Life insurance

is necessary to make the partnership continuation plan certain of functioning. This fact is of great importance and value to the informed underwriter, upon whom falls a considerable part of the burden of seeing that partners have full and accurate information. Accordingly, liberal space has been allotted to such subjects as the fundamental facts about partnerships, the fiduciary status of the surviving partner, and the various plans that have been improvised after a partner's death in attempts to circumvent liquidation.

A substantial number of leading cases on partnership law bearing on the subject are quoted and discussed in the text. It is hoped that many of these serve a dual role. First, they should convince partners and underwriters alike of the truth of the general points decided. Second, their facts reveal actual partnership situations. One true story should be more convincing than any number of hypothetical examples.

The partnership material has also been divided into three parts. Part I deals with the fundamental facts about partnerships, particular emphasis being placed upon liquidation and its consequences. It shows the normal course of the law on the death of a partner and the inevitable losses to everyone concerned. Part II discusses, each in its turn, the plans that have been used in attempts to avoid liquidation on the death of a partner. This discussion leads, by the process of examining and eliminating defective schemes, to the one workable plan by which the partnership business may be continued. Part III deals with the details of this plan, the purchase and sale agreement between the partners themselves, or with their firm, financed by life insurance.

Greater emphasis has been placed on demonstrating the necessity of a binding partnership business continuation agreement than on the minutae of such an agreement. This has been done because there still exist thousands of partners, and also a substantial number of life underwriters, as well as many lawyers who are not yet convinced that there is one plan, and only one, by which the continuation of a partnership business may be absolutely assured.

CORPORATIONS

Close corporations in the United States number about half a million and comprise over ninety per cent of all corporations. In almost every industry they carry on a substantial amount of the total trade and commerce, and in almost every community they furnish the livelihood for a large proportion of the inhabitants. Altogether, upwards of five million American citizens are dependent upon the earnings and the continued success of these "incorporated partnerships."

The successful continuation of the business of a close corporation after the death of a stockholder presents a problem quite different from that encountered upon the death of a proprietor or a partner. The death of a proprietor spells the death of the proprietorship. Likewise, the death of a partner works the dissolution of the partnership. In each case, therefore, the problem of the continuation of the business involved is immediate and manifest to all concerned. On the other hand, the death of a close corporation stockholder has no legal effect on the life of the corporation. Hence the problem of successful business continuation in the case of a close corporation, although just as serious in the long run, does not appear to be an immediate problem; it is often invisible to those concerned until too late. The fact that the business entity continues after the death of a stockholder deceives the parties into believing that the enterprise itself may be continued as successfully and as harmoniously as before.

But sooner or later there is trouble, usually caused either by the demands of "drone" stockholders who have inherited the deceased's stock, or by the interference of unwelcome outsiders who have purchased their way into the management. From then on, future unfortunate events may be expected to hinge upon the balance of power, taking the form of attempts to oust the survivors from their jobs and careers, or to "freeze out" the new stockholders, depending upon who is in control.

Obviously, there is no hope of finding an adequate remedy if the parties wait until the problem engulfs the surviving stockholders and the heirs of the deceased. But wait they will, un-

less the cloak of invisibility is removed and the true situation is exposed to view. The main purpose of the book on Corporations, therefore, is to make close corporation stockholders aware of the events that usually follow upon the death of one of their number. Then, clearly perceiving the difficulties that must be surmounted and the desirable objectives to be gained, they will have ample opportunity to install an appropriate business continuation plan before a death occurs.

The material has again been divided into three parts. Part I deals with the fundamental facts about corporations, including the characteristics of the close corporation and the effect of the death of a close corporation stockholder. Part II discusses the various plans that have been used in attempts to avoid the deleterious effects ordinarily following upon the death of an associate in a close corporation. Part III presents the one successful plan for the continuation of the close corporation business, the insured stock purchase and sale plan.

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BUSINESS INSURANCE

Second Edition

Book I

PROPRIETORSHIPS

Part I

FUNDAMENTAL FACTS ABOUT PROPRIETORSHIPS

CHAPTER 1

General Information About Sole Proprietorships

A PROPER UNDERSTANDING AND APPRECIATION OF the most efficient plans that have been developed for the continuation of the one-man business after the death of the proprietor must rest upon an adequate knowledge of the problems involved. An awareness of these problems and their implications, in turn, calls for a clear conception of the nature of the sole proprietorship.

Sole proprietorship defined. The case of *Turner v. Cross,* 83 Tex. 218, 18 S. W. 578, 580, says regarding proprietorships:

> One who has the legal right or exclusive title to anything is said to be a "proprietor." Webst. In many instances, if not usually, the word is the synonym of the word "owner." Abb.; Bouv.; Webst. The "owner" is said to be "he who has dominion of a thing, real or personal, corporeal or incorporeal, which he has the right to enjoy and do with as he pleases, even to spoil or destroy it, so far as the law permits, unless he be prevented by some agreement or covenant which restrains his right."

The opinion in the case of *Koppel v. Downing,* 11 App. D. C., 93, 103, states:

> The term "Proprietor" has a well-defined meaning, and, according to lexicographers, its meaning is "one who has the legal right or exclusive title to anything, whether in possession or not; an owner; as the proprietor of a farm or mill." Webster Dict. And Worcester defines the term "proprietor" as meaning "a possessor in his own right; an owner; a proprietary."

Murray's *New English Dictionary* (Oxford) informs us that the word "proprietor" was anomalously formed and substituted in the seventeenth century for the etymological word "proprietary." With these quotations as a background, we can readily accept Dr. Gerstenberg's definition of an individual proprietorship as "a business enterprise owned by an individual, who is usually the manager and the pivot of the business, as well as its owner." [1]

From the foregoing and from our common knowledge, we can characterize a sole proprietorship business as follows:

1. It is a business enterprise owned entirely by one person in his individual capacity, as distinguished from ownership by a partnership or by a corporation.
2. It is customarily conducted by the owner—the sole proprietor—its business being transacted by him alone, or with the assistance of any agents or employees that he may hire.

HOW SOLE PROPRIETORSHIPS ARE FORMED

A sole proprietorship is created simply by the bringing together of those components necessary to carry on the particular enterprise and then opening shop. It is thus distinguished from the creation of a partnership, brought about by the voluntary agreement of the members, or the creation by law of a corporation upon completion of the necessary legal steps and the granting of the corporate charter by the appropriate state or federal government.

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[1] C. W. Gerstenberg, *Principles of Business,* 5th ed, rev. New York: Prentice-Hall Inc., 1931, p. 27.

Joe King notices a vacant store space at the corner of "Main and Elm." Around the corner on Elm Street is a prosperous residential neighborhood, the inhabitants of which must go two blocks farther e.g. down Main Street for their groceries. Joe obtains a long-term lease on the store, stocks up, places a freshly painted sign over the door bearing the legend JOE KING, GROCERIES, and opens for business. As simply as that, a new sole proprietorship has been born. No formal documents are required and no legal procedure is necessary.

True, if Joe had desired to do business as the ACME GROCERY STORE he would probably have had to file with the proper authorities a certificate of doing business under an assumed name. True also, if he had intended to open up a business peculiarly affecting the health, safety, or morals of the community, such as, for example, a restaurant or a liquor store, a special license to do so would no doubt have been a prerequisite. But aside from meeting the necessary requirements of regulatory laws of this type (laws which apply equally whether the business is to be conducted as a proprietorship, partnership, or corporation), the birth of a sole proprietorship is legally unhampered.

PROPERTY RIGHTS IN A SOLE PROPRIETORSHIP

Before he opened his grocery store, Joe King owned various kinds of property. These he could keep, use, destroy, or otherwise dispose of as he chose, subject only to the general laws restricting uses of property that would encroach upon the rights of others. Happily, among these items was a sturdy bank account, part of which he has now expended in the purchase of store fixtures, stocks of merchandise, and other needed business property—the property for his sole proprietorship.

What changes have been wrought by this substitution of business property for that which was personal? Legally, none of any consequence. Joe has, in general, the same rights of dominion and control over the business assets that he has over his personal assets. Subject to the rights of others and subject to any voluntary restricting agreements that he may make, his

legal property rights are still entire. Changes have taken place with respect to his property, but they are economic and financial in nature rather than legal. On the economic front, there has been recorded a new business unit: a sole proprietorship possessing valuable "place utility" because of its accessability and convenience to the housewives of Elm Street. On the financial front, Joe has received, or shortly will receive, a credit rating as a proprietor. He has opened up a set of business books, and at the end of the year will be required to complete a special schedule in his income tax forms exhibiting the income, expenses and net profits of his business enterprise.

In spite of these economic and financial changes however, the establishment of the sole proprietorship business has wrought no new pattern of property rights, as would have been the case had a partnership or a corporation been formed. The assets of the business remain Joe's personal assets in the legal sense, and they will, in the event of his death and in the absence of a special statute or of special will provisions specifically dealing with them, be distinquishable only by description from the other items in his estate.

LIABILITIES IN A SOLE PROPRIETORSHIP

Before the establishment of JOE KING, GROCERIES, Joe had from time to time entered into various obligations for himself and his family. A small outstanding account at his family's favorite department store is not unusual, his last car was purchased on the instalment plan, and only a few months ago he signed a new lease on his residence. For all these obligations Joe always knew, of course, that he was fully liable.

But what about his liability for the new obligations he is now assuming as proprietor of the corner grocery store? He is as completely liable under his store lease as he has been, and is, under his house lease. If he buys a delivery truck for the store on the instalment plan, he will be as personally liable for any unpaid balance as was the case when he bought his family automobile. In short, there is no legal distinction between his so-called personal liabilities and the liabilities that he creates as a

proprietor. In each case he is fully liable and his liability is unlimited and unshared.

Nor would any distinction be made between his "business" and his "personal" liabilities in the event of Joe's death—as contrasted with the case were he a partner in a partnership or a stockholder in a corporation. (See Chapter 3 in Book II on Partnerships and Chapter 5 in Book III on Corporations.) Subject to the prior payment of such items as funeral and administration expenses, subject to the statutory order in which personal and real property and property generally and specifically bequeathed is applicable to the payment of debts, and subject to any outstanding mortgages and pledges, all of his property not expressly exempt by special statute would ultimately be liable for the payments of all his debts. Proprietorship debts would have no preferential right to be paid out of his proprietorship property, nor would personal debts have any priority of payment out of his other property. Naturally, a proprietor may make special provisions in his will with reference to his business or personal obligations, but in the absence of any such special will provisions, his debts would not be separated into the categories of "business" and "personal" in his estate; they would be treated indiscriminately.

ADVANTAGES OF PROPRIETORSHIP AS A MODE OF CONDUCTING BUSINESS

The advantages of the individual proprietorship as a method of carrying on a business stem largely from its simplicity, the outstanding characteristic of this form of business enterprise. An undertaking owned and operated by one man who hires all his other help, it may be established without any formal organizational procedures. No special legal requirements must be met, unless the venture is to be conducted under an assumed name or unless the business is to be of a type requiring a state or local license as a prerequisite to its operation. The former is readily complied with and the latter is a requirement unrelated to the form of business organization.

Once established, the pattern of operation of the individual

proprietorship is plain. The single owner and "boss" has the distinct advantage of being able to make decisions regarding its conduct as the exigencies of the business may demand, unhampered by a board of directors or any other impediment to swift and decisive action. Thus, new opportunities may be quickly grasped, new fields of business entered, or old ones abandoned with a freedom of choice and celerity of execution granted only to the sole proprietor.

Owning all of the business, the sole proprietor is entitled to all the profits of his enterprise. This is in direct contrast with the situation in a partnership or in a corporation. In a partnership, each partner receives his agreed share of the earnings of the firm. In a corporation, the profits go to the individual stockholders in proportion to their dividend-paying stock. Thus, except where a corporation is entirely owned by one person—a status in many respects more analogous to a proprietorship than to the ordinary corporation, in spite of the corporate legal structure—other forms of business organization call for the sharing of profits between at least two individuals and, usually, among several. In the case of the sole proprietor, the profits are his alone.

DISADVANTAGES INHERENT IN A SOLE PROPRIETORSHIP

Simplicity of structure not only accounts for the advantages of the sole proprietorship as a mode of conducting business, but conversely is the source of its chief disadvantages.

Foremost among these disadvantages is the complete liability of the proprietor for all the obligations of the enterprise. As we shall see later, this outstanding handicap is also present in the partnership form of organization but not in the corporation, where the stockholders enjoy limited liability. In a partnership, a partner who has discharged more than his share of the firm's ordinary obligations has—for whatever it may be worth in the particular case—either a right of contribution from the other partners of their respective shares of the total obligations, or the right to be reimbursed or indemnified by the partnership

itself. The sole proprietor shoulders alone the obligations that he can so freely create. His liability is entire and unshared.

This complete liability is accompanied by the full responsibility which the individual proprietor must assume at all times for the conduct of the business. Being the sole boss, he is in a position to "call the shots," but by the same token he cannot avoid bearing the burden of all weighty decisions. True, he can delegate many minor responsibilities to his employees (and if he is a capable executive he will do so whenever possible), but the "yoke" must be borne ultimately by the proprietor himself. Unlike a partner, he has no one on his own plane of responsibility with whom to share the mental load. Unlike the corporate executive, there is no fellow-officer or director with whom he can divide the responsibility for the management of the enterprise.

A third disadvantage of the proprietorship is that whereas the owner is entitled to all the profits, he must also bear all the losses. There are few businesses that can show net profits year in and year out, and when a poor year does come, the sole proprietor must pay his employees' salaries as usual. He stands the loss alone.

A disadvantage which circumscribes the field of operations of sole proprietorships generally is the limited capital funds usually available to them. Ordinarily, such an enterprise must be conducted with the money which the owner can personally put into it, supplemented only by the money he can borrow and the credit he can obtain. Consequently he must usually forego opportunities requiring considerable investments of capital. But many of these same opportunities might be grasped by a partnership, the resources of all of whose partners may be made available, or by a corporation, in which the funds of numerous individual investors are pooled to form the capital of a single corporate enterprise.

We now take up that disadvantage of the sole proprietorship which most concerns us: the fact that the proprietorship ends with the death of the proprietor. This follows from the circumstance that such a business has no legal entity apart from the owner. Immediately upon his death, the assets and liabilities

of the business become assets and liabilities of his estate along with—and in the absence of special statute, special agreement, or special will provisions, not distinguishable from—all of his other assets and liabilities. In any event, the old proprietorship is gone and unless effective plans have been made in advance by the proprietor, the once profiable and valuable going business will go out of existence with substantial losses to his family and to the community as a whole. These losses will be discussed in some detail in the following chapter.

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CHAPTER 2

Termination of a Sole Proprietorship

CAUSES OF TERMINATION

TERMINATION OF A SOLE PROPRIETORSHIP MAY be brought about either by the voluntary act of the proprietor or from causes beyond his control as, for example, bankruptcy or death.

Voluntary termination. Since he owns and directs the business entirely by himself, the individual proprietor may conclude at any time to cease operations. In such event, he would first fulfill outstanding commitments and then liquidate the assets of the proprietorship in whatever manner he believed was to his best advantage; or he might sell the business as a going concern to a partnership or to a corporation. Again, he might decide to continue the business, but not as a proprietorship. This he could accomplish by taking in a partner or by incorporating the enterprise. Voluntary changes such as these are, of course, a commonplace sight in the daily "kaleidoscope" of the nation's business.

Death of proprietor. In the previous chapter it was pointed out that, at the death of the proprietor, the proprietorship is terminated, because it has no legal entity distinct from that of the proprietor as an individual. When a proprietor dies the assets and liabilities constituting the proprietorship immediately become assets and liabilities of his estate along with his so-called personal assets and liabilities. If he has left a valid and sub-

sisting will, his property and obligations will be administered by his executor in accordance with its terms. If there is no will, an administrator will be appointed to wind up his affairs in conformity with the applicable intestate laws. Briefly sketched —and consequently over-simplified—the administration of his estate in either event will require his personal representative executor or administrator, as the case may be) to take possession and to inventory all of the deceased proprietor's property, convert it into cash (excepting real property, property specifically bequeathed by will, and items agreed to be accepted by the heirs in kind unless these items are required for the payment of debts or preferred legacies), pay the expenses of administration and the obligations of the deceased, and distribute the remainder to those properly entitled to it.

The procedure as to the proprietorship assets and liabilities is particularly rigid and costly, but departure from it may be made under certain exceptional circumstances. Some such circumstances are the existence of special will provisions relating to the business, the existence of special statutes authorizing a limited continuation of the business beyond the owner's death, or the existence of some form of special business continuation agreement. Each of these special situations will be discussed in detail in later chapters. Here we are concerned with the situation which prevails, in the absence of any such special alleviating or remedial circumstances, on the death of a proprietor and its effect in requiring prompt termination and liquidation of the proprietorship business.

ECONOMIC EFFECTS OF TERMINATION OF PROPRIETORSHIP BUSINESS

The deleterious economic effects of terminating the proprietorship business on the death of the proprietor are fivefold. The first relates to the general economy and the others relate to the economic status of those immediately concerned.

Effect on the general economy. The sustenance of our economic life consists of the innumerable commercial transactions occurring continually within the nation. The "blood corpuscles"

that carry this nourishment into every community are its business units—its proprietorships, partnerships and corporations. When one of these units goes out of existence and its business is terminated, whether it be a large, nationally known corporation or a small, local proprietorship, the economic might of the country is to that extent weakened.

Careers of employees interrupted. Most proprietorships have in their employ one or more employees whose livelihoods and those of their dependents are derived from the business. Termination of the enterprise, of course, destroys these jobs, usually with financial loss to the employee and to the community. To the newer and younger employees, the set-back will be temporary, but to those old in years and service, it will often cause a permanent loss.

Stoppage of income to the family from the business. During the lifetime of the proprietor, his income consists of the profits made from the business transactions of his proprietorship. He and his family live on this income. But on his death, these transactions cease abruptly, except for the completion of any contractual obligations which may have to be carried out by his executor or administrator. With their generating source rendered impotent, profits are no longer made and the flow of sustaining funds to the family is arrested.

Possible delay in administration of the estate. Among the duties of the executor or administrator is the carrying through to completion of the unfinished contractual obligations of the deceased proprietor, excepting, however, those contracts that could have been performed only by him personally. For example, a sole proprietor engaged in the contracting business and carrying on extensive operations in many localities may have contracted with Jones to fill in a tract of low land. The proprietor dies. His contract with Jones is not discharged and his personal representative will have to perform it unless he can procure a release on terms satisfactory to the probate court and to all those interested in the estate.

The foregoing example, which was taken from the modern *Restatement, Law of Contracts* (1932), Volume 2, page 857, illustrates a rule of ancient origin. In the early English case

of *Quick v. Ludburrow,* reported in 3 Bulstrode's Reports, 30, in the year 1685, Chief Justice Coke said: "If a man be bound to build a house for another before such a time, and he which is bound dies before the time, his executors are bound to perform this."

To illustrate further, Joe King, the corner grocer, may have contracted with the local American Legion Post to supply it with certain canned goods during the next year. In anticipation of this, Joe has scheduled certain purchases of the requisite goods from his wholesaler. Neither contract would be discharged upon Joe's death and his personal representative would be called upon to perform. On the other hand, had Joe been contractually engaged by the Legion post to supervise personally the food purchases of the post canteen, this contract, requiring personal performance on his part, would be discharged upon Joe's death.

Little imagination is required to visualize many instances where, upon the death of a proprietor, delay in the settlement of his estate will be caused by the necessary performance of obligations that the proprietor has entered into and that have outlived him. Such delays invariably result in increased administration costs, and create vexations, if not hardships, for the heirs.

Shrinkage of assets upon liquidation. As stated by Henderson, Surrogate, *In re Lazer's Estate,* 247 N.Y.S. 230 (1930): "It is the duty of the administrator to convert the assets of the estate into money within a reasonable time after his appointment." In the event the deceased proprietor leaves a will, it is the duty of his executor to convert all personal property into cash except that specifically bequeathed or that permitted by the will or consented to among the heirs to be distributed "in kind." Delivery of specific items of property, however, even though directed or permitted, can be accomplished only to a limited degree in any case, because a substantial amount of cash is required in every estate to pay the costs of last illness and funeral, taxes, executor's fees, legal fees, probate charges, and all outstanding personal and business debts. Normally, delivery in kind of the assets of a proprietorship is utterly impracticable, not only because of the need for cash to pay the above items

(which on the average will absorb approximately one-third of the gross estate value), but also because the unsuitable nature of such assets makes them unacceptable to the heirs as bequests "in kind." Therefore, in the absence of specially designed plans for the disposal of a proprietorship business, it will be incumbent upon the personal representative, whether executor or administrator, to liquidate the assets of the business for cash.

It is common knowledge that the liquidation of the assets of an enterprise usually results in severe losses. Accounts receivable will be impossible to collect in full. The forced sale of inventories must often be made at fractional prices and equipment frequently is sold "for a song." Moreover, good will, an asset that accounts for a significant percentage of the profits in many an active business, evaporates upon the closing out of the enterprise by the personal representative; its value is totally lost. Only on those rare and fortuitous occasions when a single buyer can be found who will purchase the proprietorship business "in bulk" as a going concern will these sacrificial losses be materially reduced. And only when the proprietor, during his lifetime, has set up an effective plan for the continuation of his business—a plan to prevent the normal processes of estate liquidation from running their costly course—will this destruction of values be entirely averted.

The ruinous economic effects of the termination of the proprietorship business on the death of the owner are such that every proprietor should search diligently for a business continuation plan that will enable him to pass along to his heirs the true "going" value of his enterprise.

Part II

PLANS USED IN ATTEMPTS TO AVOID LIQUIDATION AT THE DEATH OF THE PROPRIETOR [1]

CHAPTER 3

Continuation of the Business Without Authority

THE HEAVY FINANCIAL LOSSES THAT ARE PRECIPITATED when a proprietorship business is liquidated on the death of the proprietor clearly demonstrate the need for some plan that will eliminate such liquidation. In the hope of avoiding a sacrifice of values, many schemes have been attempted to keep such business operating. In this and the two following chapters, we shall examine various plans that have been improvised after the proprietor's death.

CONTINUATION BY THE PERSONAL REPRESENTATIVE

Upon the death of a proprietor, one of the duties of his personal representative is to take possession immediately of the assets of the proprietorship. Frequently these assets represent a thriving, profitable business, and the executor or administra-

[1] In part II, Chapters 3 through 6 deal with alternatives to liquidation improvised after the proprietor's death; Chapter 7 treats of alternatives to liquidation set up prior to the death of the proprietor.

tor, well aware of this fact but ignorant of the legal perils involved, may decide on his own initiative, without authority, to continue operations for the benefit of those interested in the estate. This happened in the case of *In re Moran's Estate,* 261 Pa. 269, 104 Atl. 585 (1918).

In re Moran. Patrick F. Moran was the proprietor of a leased hotel in Scranton, Pennsylvania, at the time of his death in April, 1913. His widow, Daisy M. Moran, was appointed administratrix with the will annexed. The will contained no authority to continue operating the hotel, but Mrs. Moran nevertheless decided to continue its operation until the lease expired in April, 1914. The following quotation from the case, an appeal from her accounting proceeding in the probate court, shows that Mrs. Moran's decision cost her heavily.

> In the conduct of the hotel Mrs. Moran expended $9,786.79 and received $8,726, sustaining a net loss of $1,060.79, for which she claims credit in the account. This was properly disallowed. The will gives no authority to continue the business, and as a general rule in such case the executor or administrator may not properly do so; when he does, the gain, if any, belongs to the estate, while the loss falls upon him. *Allam's Estate,* 199 Pa. 573, 583, 49 Atl. 252. It was Mrs. Moran's duty to make disposition of the property for the best price obtainable. . . .

Thus, we find that Mrs. Moran paid over one thousand dollars to learn that, should a personal representative continue a business without authority, "the gain, if any, belongs to the estate, while the loss falls upon" the personal representative.

However, the "tuition" paid by Mrs. Moran for her lesson was small when compared with the judgments rendered in many cases. An extreme example is the cluster of four cases reported as *Kick v. McCauley* and *Schwerzler v. McCauley* in 118 N. J. Eq. 252, 178 Atl. 637 (1935). At the time of John Orest's death, he was the proprietor of the Peerless Embroidery Works and a partner in the firm of Orest & Schwerzler. He died in January, 1920, without leaving a will, and because all of his next of kin were residing in Switzerland, Judge McCauley was appointed administrator during their absence. He qualified as administrator and supervised the business interests of the de-

ceased, although Schwerzler apparently continued in charge of the business of the former partnership.

Shortly after McCauley took over, a slump occurred in the embroidery business and heavy losses were suffered. Then, about six months after Orest's death, a brother came to this country, and he and McCauley were appointed general administrators of the estate. However, by this time the assets had apparently all been lost, for none were received by them as general administrators. As could be expected, the legal "fireworks" began.

Proceedings were instituted in the Orphan's Court to compel an accounting by McCauley as administrator for the period prior to the appointment of himself and the decedent's brother as general administrators. The matter was referred to a master, who reported that McCauley was liable to the extent of over $86,000, but this report was never confirmed because by that time other suits were pending in the Court of Chancery. In that court, Kick, who alleged that he had been a partner in the Peerless Embroidery Works, was suing for an accounting. At the same time, Schwerzler, the surviving partner in the firm of Orest & Schwerzler, brought suit against McCauley as administrator and against McCauley and decedent's brother as general administrators for an accounting of the partnership assets. In the last suit, decedent's brother filed a counterclaim against the surviving partner on the ground that it was the latter who was liable for the partnership assets.

Ultimately, the Court of Chancery took jurisdiction over all of these controversies and held: that Kick had not been a partner of the deceased but that the Peerless Embroidery Works was a proprietorship; that McCauley was liable for all the losses that had occurred in continuing the embroidery business; that Schwerzler had conducted the business of the partnership for an unreasonable length of time after the death of his partner, and therefore that he was primarily liable and McCauley secondarily liable to the heirs for the loss of partnership assets. The court then directed accountings to be made by all parties held liable.

Subsequently, after nine years of litigation, McCauley having failed to account, the Court of Chancery referred the cases to a

master to state and file an account for him. The master found Schwerzler, the surviving partner in the firm of Orest & Schwerzler, primarily liable, and McCauley secondarily liable, for the sum of $12,853.57 on account of loss of partnership assets. He also found McCauley solely liable for the other assets of the deceased, his total liability being found to be $89,761.61. The decedent's brother was found not liable, because he and McCauley as general administrators had never received any of the assets, which had been lost long before.

On appeal to New Jersey's highest equity court, the cases were affirmed, the court saying in part:

> It is apparent that after nine years of litigation the Court of Chancery cut the Gordian knot and placed the matters before it in the hands of a master. . . .
>
> We can find no error in the manner in which liability was imposed in the Court of Chancery. A fiduciary, who neglects every rule of positive law and good judgment, is in no position to complain that the Court of Chancery proceeds to hear and determine the whole matter before it. Nor is there any more reason to complain that the court charged him with assets, which he was admittedly under a duty to administer as part of his trust, and failed to do so.

As the foregoing cases clearly show, the unauthorized continuation of a proprietorship business by an inexperienced personal representative, instead of avoiding sacrifice of estate values, usually results only in sustaining additional losses, for which the imprudent executor or administrator is personally liable. Later we shall resume our discussion of the plight of the personal representative.

CONTINUATION BY AN HEIR

Sometimes the business of a deceased proprietor is carried on without authority, not by the personal representative himself, but by an heir. This was the situation in *Martin Bros. Co. v. Peterson,* 38 S. D. 494, 162 N. W. 154 (1917). J. Peterson was engaged in the mercantile business in Newark, South Dakota

at the time of his death in March, 1909, and Bjorn B. Gislason, who lived in Minnesota, was named in the will and qualified as executor. At the time of Peterson's death, his son Emil was in charge of and conducting the business for his father, and without authority to do so in the will, the executor allowed Emil to continue it in the name of the J. Peterson Estate. During the continuance of the business, Martin Bros. Co. had sold goods to Emil, who was unable to pay for them because of financial difficulties. Martin Bros. Co. brought suit against Emil and also against Gislason, suing the latter both as an individual and as executor of the estate. The executor denied any liability on the ground that he had had nothing to do with the continuation of the business. South Dakota's highest court, however, affirmed a lower court's decision dismissing the action against the executor as such, but holding both the executor and the son personally liable for the debt as individuals. The following quotation from the opinion is enlightening:

> The evidence can leave no doubt in the mind of any person but that, because of family ties existing between appellant [Gislason] and defendant Peterson and because of misplaced confidence which appellant had in the honesty and ability of Peterson, appellant failed to administer this estate and close up such mercantile business in accordance with the requirements of the law. Appellant was undoubtedly in ignorance of the personal liability that would result from his continuing such business, and there is no evidence that in the slightest degree tends to impugn the honesty of his purpose; he is merely the victim of misplaced confidence; but that, under the facts, he is holden to respondent [Martin Bros. Co.] is beyond question. The law is concisely stated in 11 R. C. L. *Executors and Administrators,* section 142, as follows:
>
> > An executor or administrator ordinarily has no power to continue the business in which the decedent was engaged at the time of his death; and this is true although he acts in the utmost good faith and believes that he is proceeding for the best interests of the estate. The penalty for continuing a business of the decedent without authority is the imposition of a personal liability on the executor or administrator so doing for all the debts of the business.

PERSONAL REPRESENTATIVE INDIVIDUALLY LIABLE WITHOUT RIGHT OF REIMBURSEMENT (WHERE UNAUTHORIZED)

The last sentence quoted is somewhat misleading without further explanation. In the absence of a special agreement or special statute, an executor or administrator is personally liable for the debts of a business which he continues, whether or not its continuance has been authorized. It is stated in part in 11 R. C. L., s. 147:

> Although where a business or trade is carried on under the provisions of a will, by virtue of a statute permitting it, or by an order of a competent court, a personal representative will be relieved from individual liability to the estate for losses, he will continue to be bound personally for all debts incurred by him in reference to the business. The courts take the position that he need not carry on the trade and incur this hazard, although authorized or directed to do so by the will; but by engaging in the business he voluntarily assumes the responsibility of making its contracts his personal obligations. Such authority will also entitle the executor or administrator to be indemnified out of the estate for any liability lawfully incurred within the scope of the power. If, however, the testator has directed that particular assets shall be employed in the trade, the right of indemnity of an executor or of a person claiming through him will be limited to the particular fund.

The important distinction, therefore, is the personal representative's right of indemnity when authorized, and his lack of such right when not authorized, to continue a decedent's business; in either case he assumes personal liability.

Marshall Field & Co. v. Himelstein. The absence of this right to be indemnified when an administrator continues a decedent's business without authority is brought out in *Marshall Field & Co. v. Himelstein,* 253 Mich. 344, 235 N. W. 181 (1931). In this case, the administrator, in continuing the business of deceased, had purchased merchandise from Marshall Field & Co. on credit, and, failing to pay the account when due, he was

sued personally. The court held that he alone was liable for the debt, Michigan's highest court saying in part:

> In the instant case, defendant has no authority to continue the business. It was a personal undertaking altogether outside of his duties as administrator. He was not acting for his estate. He could not bind it by any of his contracts. His creditors could not sue him in his representative capacity. Their only remedy would be in an action against him personally. . . . His creditors could not look to the estate for payment of his debts. He alone was liable and, if he paid for goods received while conducting the business, the probate court could not reimburse him out of the assets of the estate.

TRADE CREDITOR MAY ALSO LOSE

However, assuming the collectability of judgments obtained against personal representatives as individuals, it would be incorrect to conclude that the trade creditor of a business continued without proper sanction never himself sustains the loss. In the following case it appears that the creditor "sat down between two chairs" with respect to part of the debt owed him, neither the estate nor the representative individually being liable for it.

In *True W. Jones Brewing Co. v. Flaherty,* 80 N. H. 571, 120 Atl. 432 (1923), the brother of the deceased, who had been appointed administrator, continued the decedent's saloon business without authority, running up a bill for ale purchased from the brewing company. He gave two promissory notes to the company for part of this debt, the balance being on open-book account. Both parties were acquainted with the facts; defendant Flaherty had considered that he was acting for the estate and apparently had come to an oral agreement with the brewing company to look to the estate for payment. The notes not being honored, the company sued to recover on them and also on the open account owed. On the trial it was found that the administrator's agreement with the brewing company provided for exclusion of personal liability on his part. However, a rule of evidence that forbids the introduction of parol evidence to vary

or control a written contract excluded testimony on this agreement with respect to the notes, and the brewing company obtained judgment on them. As for the open account, however, the testimony, accredited by the jury and affirmed on appeal to New Hampshire's highest court, was admitted to absolve the administrator of any liability. While the court did not have before it the question of the liability of the estate, it is obvious that since the administrator had no authority to act for it, he could not create any liability against it. Hence it appears that under the special agreement made, the brewing company was left without legal recourse with respect to the open account. In arriving at its decision in favor of the defendant, on the open account, the court stated in part:

> The question is not whether the estate is bound, but whether defendant is. If he fully disclosed the situation to the plaintiff, and the plaintiff chose to make a sale, or an attempted sale, to the estate, he is not made liable personally because it appears that the principal for whom he assumed to act was not bound.
>
> . . . The complement to the general rule that the administration is liable is that—
>
> > "He might have made a special contract, excluding any personal liability on his part, if he had chosen to do so." *Livermore v. Rand,* 26 N. H. 85, 90.
>
> The evidence offered by the defendant tended to prove that this is what was done in the present instance.

Thus we find a trade creditor absorbing a substantial portion of the cost of this unauthorized business continuation.

ESTATE MAY PROFIT, BUT NOT PERSONAL REPRESENTATIVE

In the foregoing cases, the proprietorship businesses were continued with consequent losses. Because of the inexperience of the executor or administrator in the particular business involved and often because of his lack of vital concern, "red ink" results are usually to be expected, but there are some exceptions. One of these is well illustrated in the case of *Matter of Peck,* 79 App. Div. 296 (1903), affirmed, 177 N. Y. 538.

Matter of Peck. George Banker, at the time of his death,

was engaged in the business of selling certain merchandise under patents owned by himself. His will left all of his property to his wife, Henrietta, and nominated Peck as executor. Although no authority was given in the will to continue the business, Peck and the widow immediately entered into a partnership agreement to do so. The widow, however, died twelve days after the death of her husband, and since her will had named her husband as executor and Peck as contingent executor, the latter took charge of all the assets. He then decided to continue the business himself, despite the advice of his lawyer that Peck as executor would be personally liable to the widow's estate and legatees for any losses incurred, and that whatever profits he might make would be deemed the property of the estate.

Peck continued the decedent's business for over a year and made out very well, finally selling the business on satisfactory terms. In his accounting, he showed a profit of $2,764.31 after he had deducted $2,371.53 paid to his son for services rendered as his assistant in running the store, and also the sum of $3,071.95 as compensation to himself in conducting the business. The final decision in the case held him liable not only for the profits as shown in his account, but also for the additional sum of $3,071.95 he had credited to himself as salary. The opinion stated as follows:

> It is a well-settled rule of equity that a trustee is not permitted to deal with the trust property so as to gain any advantage, directly or indirectly, for himself, beyond his lawful compensation. He may not use it in his own private business. He may not make any incidental profits for himself in its management, and he may not acquire any *pecuniary gains* from his fiduciary position. The beneficiary is entitled to claim all advantages actually gained, and to hold the trustee chargeable for all losses, if any, happening from *a violation of his duty.* (Pom. Eq. Juris. s. 1075.) Within this rule I am unable to see upon what theory Peck may withhold from the estate of which he is executor any portion of such earnings to his own use or benefit. . . . The estate owes him nothing for his services, but may, under the rules of equity, demand from him everything that *he*—that is, his labor and skill—has succeeded in clearing up out of the business. And such de-

mand is imposed against him for his wrongful act in using the funds of the estate in a manner forbidden by law.

SUMMARY

The following short but sufficiently explanatory quotation from the surrogate's opinion in *In re Archer,* 77 Misc. 288, 137 N.Y.S. 770, 774 (1912), succinctly sums up the liability of the personal representative to the heirs if he continues a proprietorship without authority:

> The executors, not having authority under the will to either continue the brick-manufacturing business of the testator or to engage as executors in a new brick-manufacturing business, were bound to account for the net profits derived from these businesses, or, at the option of those entitled thereto (who herein elected to accept the net profits), to refund the amount of the property diverted, with 6 per cent interest. *Matter of Peck* . . . [Other cases also cited].

Clearly, the position of the estate in the law of unauthorized continuance of businesses in relation to the personal representative is "heads, I win—tails, you lose." In carrying on a business without authority the representative violates his fiduciary duty. Moreover, he risks his own savings because of the personal liability he alone must assume without the right of indemnity for obligations created in continuing the enterprise. And if his business ventures prove successful, he is told, as were the executors in the Archer case, that "the court will not permit them [him] to profit by their own misconduct." The estate, on the other hand, is protected to the best ability of the courts. If, perchance, profits are made, they go to the lucky heirs; and if profits are not made, the personal representative is surcharged for the losses. But it must never be forgotten that a judgment is only as good as its collectability. Obviously, unauthorized continuance as an alternative to the liquidation of the business, spawned from a breach of trust, and nurtured solely by the personal liability of the executor or administrator as an individual, is the antithesis of a solution to the problem.

CHAPTER 4

Continuation of a Proprietorship Business on Consent of the Heirs

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OCCASIONALLY, UPON THE DEATH OF A PROprietor, his heirs will request the personal representative to continue the proprietorship business or, if they are importuned by such representative, will give their consent to it (although such continuation has not been authorized), in the hope that the enterprise will ultimately be disposed of as a going concern and forced liquidation of its assets will be avoided. The effect of such consent on the parties concerned will now be examined.

MINOR HEIRS CANNOT CONSENT

This improvisation is in the first instance confined to those situations in which all of the heirs are adults, minor heirs being legally incapable of giving their sanction. This limitation is clearly brought out in the case of *Gilligan v. Daly,* 79 N. J. Eq. 36, 80 Atl. 994 (1911), in which the court stated:

> In carrying on the business, the executor clearly acted without authority, not only because of the general rule relating to the administration of estates, but also because all of the legatees were infants, incapable of consenting to the continuance, and one of them is still an infant.

PERSONAL REPRESENTATIVE NOT LIABLE TO CONSENTING HEIRS FOR LOSSES

Even if all heirs are competent adults, the personal representative has a difficult if not impossible task to obtain their

unanimous consent to keep the business running, for usually some of them are inaccessible or they are unwilling to expose their heritage to the risks involved. But if all of the heirs are of age, are within reach, and are competent and willing to consent, their unanimous sanction to the continuation of the business by the executor or administrator usually gives him a modicum of protection, at the expense of the heirs. If, under such circumstances, profits result, the obligation of the personal representative to turn the increment over to the heirs remains unchanged. But if the personal representative sustains losses, the consenting heirs will find that they have surrendered their right to hold him liable. The rule is well stated in the case of *In re Ennis' Estate* (Wash.) at page 124 of 165 Pac., in which the court said:

> The weight of authority undoubtedly is that the consent of the adult heirs that the administrator may carry on the business conducted by the decedent will estop them from enforcing any personal liability against the administrator for losses incurred by him in such business. *Swaine v. Hemphill,* 165 Mich. 561, 131 N. W. 68, 40 L. R. A. (NS) 201.

This rule is stated even more clearly in *Mathews v. Sheehan,* 76 Conn. 654, 56 Atl. 694 (1904), as follows:

> Where an administrator or executor, acting in good faith and with ordinary care and prudence for the good of the beneficiaries of the estate, deviates, with their consent and approbation, from the strict line of his duty, and loss results therefrom—as for instance by continuing the property in business without authority—the consenting beneficiaries cannot charge the representative of the estate with such loss. *Poole v. Munday,* 103 Mass. 174; *Duffield v. Brainerd,* 45 Conn. 424.

The facts of this last case show an interesting application of the principle. At first all the heirs had consented to a continuance of the decedent's business activities by the administrators, but some months later, in February, 1893, one of them withdrew her consent. The administrators were held liable to her for any losses to her distributive share of the estate occurring after February, 1893.

PERSONAL REPRESENTATIVE NEVERTHELESS LIABLE TO CREDITORS

This rule relieves the personal representative of liability to the consenting heirs for losses incurred in continuing a decedent's business, but he remains in financial jeopardy nevertheless. It has been noted earlier that an executor or administrator who continues the business of a deceased becomes personally liable for the obligations entered into on behalf of such business. If the assets of the business are sufficient for the purpose, he can retire these obligations therefrom, and even if the final result of such operations constitutes a loss, he cannot be held responsible by the consenting heirs for the depletion in assets. If, however, the assets of the business become exhausted, any unsatisfied trade creditors may hold him to his personal liability to them. Compelled thus to pay such debts out of his own pocket, he ordinarily would have no recourse against other estate assets or against the heirs individually.

Creditors of the deceased, however, constitute a far greater financial hazard to the personal representative than do the new creditors of the continuing business. As stated in § 259 of 21 American Jurisprudence: "A personal representative who carries on the trade or business of his decedent without authority may be relieved from individual liability for resulting losses by conduct amounting to estoppel on the part of those interested in the estate, as where he does so at the solicitation or with the consent of all beneficiaries interested in the decedent's estate, notwithstanding he did not inform the beneficiaries that the operations were not being conducted at a profit." Relief from individual liability, however, requires the consent of *all* persons interested in the estate, including all the creditors of the estate as well as all the heirs. The effect on the personal representative of failure to obtain the consent of the decedent's creditors is dramatically illustrated by the decision of Pennsylvania's highest court in the case of *In re Shinn's Estate,* 166 Pa. St. 121, 30 Atl. 1026, 1030 (1895).

In re Shinn's Estate. Before his death, William P. Shinn, a resident of the state of Pennsylvania, had taken a twenty-year

lease on a tract of iron-ore land in Westchester County, New York, that granted him the right to mine and remove the ore at an annual minimum royalty of $5,000. During his lifetime, Shinn had expended more than $100,000 in improvements and patents, and when he died there was a chattel mortgage on the leasehold and other charges of about $40,000. At Shinn's death, his next of kin, after examining the leasehold, advised the administrator of the estate to continue the operation. This was done, but without his consulting the estate's creditors. The administrator then expended $44,736.36 of general estate funds in an effort to make the iron-ore mining project successful. However, as stated in the court's opinion, "The business proved a most disastrous failure." On his accounting, the administrator claimed credit for the expenditure of this money. The decision of the court surcharged the administrator for the $44,736.36, the opinion stating in part:

> On the facts found, the action of the administrator was wholly unwarranted. The iron-ore operation was a speculative venture, which the decedent, in his lifetime, had a perfect right to enter upon. His business was to accumulate an estate. If his venture turned out successful, he reaped the profits; if unsuccessful, no others were interested or had a right to complain. But the business of this administrator was not to make money for the estate by hazardous ventures, but to save that which came into his hands, for creditors and kin, by prudent business management. . . . Without consultation with the creditors, with no cautionary order from the court on a statement of the facts, he put into this plant, in hopes of profit, this large sum of money—money realized from the estate in Pennsylvania. The business proved a most disastrous failure. The whole was sold under legal proceedings in New York, and did not bring the amount of claims against it. He advised with none as to the judiciousness of expending this $45,000 of the creditors money, except those whose interests were, in a certain sense, antagonistic to the creditors. . . Joseph A. and John K. Shinn, next of kin, examined the property, and they advised him to continue it in operation. It was to their interest to do so. They, doubtless, knew, as did the administrator, that, unless at least a portion of the large amount invested in this operation by decedent in his life-

time was saved, the estate was practically insolvent. If it proved successful, there would be a surplus to go to them (the next of kin); if unsuccessful, they were no worse off, as the loss would fall upon the creditors. Yet the administrator took the creditor's money, and invested it in a wild speculation. He might almost as safely have invested it in stocks on the prospect of a rise. This was not ordinary business sagacity or prudent management. His conduct, on the facts found by the auditing judge, therefore, warranted the surcharge.

SUMMARY

The plan of continuing a proprietorship business by the personal representative on consent of the heirs has now been examined in sufficient detail to make evident the conclusion that it is at best a financially dangerous expedient. The heirs, by their own consent, forfeit their most valuable legal right: the right to hold the personal representative to account. And the executor or administrator is nevertheless personally liable to any new creditors, and remains fully liable to the present creditors of the estate. For these obvious reasons the plan is totally undesirable if there are unsatisfied estated creditors who have not consented to the continuance of the business.

We shall next look at the situation presented when all parties interested in an estate, including the estate creditors, consent to the continuance of a decedent's business.

CHAPTER 5

Continuation of a Proprietorship Business on Consent of All Parties Interested in the Estate

FROM WHAT WE HAVE ALREADY SEEN, NO WELL-informed personal representative unauthorized to continue the business of his decedent would do so without first obtaining the consent of all interested parties, both the heirs of the estate and its creditors. Now, let us see what happens when such consents, in fact or in effect, have been given.

PERSONAL REPRESENTATIVE NOT LIABLE TO CONSENTING HEIRS FOR LOSSES

Swaine v. Hemphill. One of the leading cases on the subject is *Swaine v. Hemphill,* 165 Mich. 561, 131 N. W. 68 (1911). Frederick J. Swaine had conducted a proprietorship in Ypsilanti, Michigan, consisting of a small malting business. At his death, his personal estate amounted to $16,261.01. His liabilities amounted to $16,132.14. His heirs were his widow and two daughters, the youngest about nineteen years old. The widow turned over to the administrator $5,650, consisting of life insurance which she had received on her husband's life together with a legacy from a brother, this fund to be applied against the debts of the estate. With the consent of all interested parties and fortified with a waiver of notice of hearing on his final account and a power of attorney from the heirs, the personal representative continued the malting business for eight years. During this time, the administrator paid $9,493.88 to the heirs,

heated their home from the plant, paid for real estate improvements amounting to $1,578.66, and from time to time even sent a man from the plant to do work about their residence. Profits were realized in each of the first three years (during which the minor daughter became of age), but of the next five years only two showed a profit.

When the administrator submitted his final account, showing a net loss of $1,685.65 in the operation of the business, his account was approved by the court of probate. The widow and daughters then filed a bill of complaint, asserting that they had consented to the continuance of the business for only so long as it proved profitable, that the administrator had continued it at a loss without informing them, and that he had fraudently secured their consent to his discharge as administrator. They petitioned that he be held liable for the loss and be ordered to reimburse them for it. Michigan's highest court held, however, that where all the persons interested in an estate had agreed that the continuation of the decedent's business was for the best interests of the estate, and had advised its continuance by the administrator, he could not be held personally liable for any resulting losses in the business. The court said in part:

> We are of opinion that it was the conviction of all the complainants . . . that it was best to continue the business in the hope that it might be disposed of as a going concern. Changes and improvements in the method of manufacturing malt and large combinations of malting interests made it impossible to realize this hope. It would be unjust and unequitable to now compel this defendant to bear the loss occasioned by this course of action.
>
> The duty of administrators generally to liquidate estates without undue delay is not questioned, nor can it be doubted that they cannot leave estates at the risk of business disaster by continuing without authority to operate business ventures in which the estates are invested when they come into their hands. The authorities cited by complainants clearly establish this doctrine and executors or administrators who violate the rule, even if acting in the utmost good faith, are held strictly liable for all losses incurred, and are not even permitted to offset the profits against the losses [citing several cases].

> There seems to be no doubt, however, that, when all those interested in an estate agree that a certain course should be followed, the executor or administrator will be relieved from personal liability if disaster follows. Schouler on Executors, p. 422, lays down the rule as follows: "We may presume that the personal representative can never be strictly justified in deviating from the line of bailment or fiduciary duty. But in case of doubt as to his proper course he may protect himself by prudently pursuing in advance one of two courses: (1) He may procure the advice and consent of all the parties in interest; or (2) he may take the direction of the court. * * * He may prosecute or defend suits, compromise claims upon the estate, or deal with the estate in a particular way, not usual or strictly legal, as by continuing the property in business, and those parties in interest by whose request or consent it has been done, will not be permitted to impute it as maladministration"—citing *Poole v. Munday,* 103 Mass. 174; *Perry v. Wooten,* 5 Humph. (Tenn.) 524; and *Watkins v. Stewart,* 78 Va. 111.

With reference to the daughter who was a minor at the time of Swaine's death, the court said:

> It is noted that no complaint is made of the continuation of the business during the first three years while it was making a profit. During those years the youngest daughter attained her majority, and had then a right as well as her mother and elder sister to demand discontinuance. This neither she nor they did.

CREDITORS OF CONTINUED BUSINESS PREFERRED OVER CONSENTING ESTATE CREDITORS AS TO ASSETS EMBARKED IN TRADE

In the ordinary process of administering an estate, the personal representative's first duty is to conserve the decedent's assets and to apply them so far as necessary to the payment of the claims of the estate creditors. When, however, these creditors consent to the continuance of a proprietorship after the proprietor's death, they are in effect consenting also to the creation of new debts and new creditors. The estate creditors are allowing their claims to assets of the estate to be subordinated to those of the new trade creditors. This is the primary holding

in another leading case, *In re Ennis' Estate,* 96 Wash, 352, 165 Pac. 119 (1917).

In re Ennis' Estate. A. C. Ennis had operated a dry goods store in Elma, Washington. He died in January, 1911, without having made a will and leaving a widow and four adult children. The widow was appointed administratrix. The assets of the estate consisted of $4,000 of merchandise in his store and real estate appraised at $11,250. He owed $800 on the merchandise, $400 to a son, Mark, and $2,000 on a note given his bankers. Patently, the estate was solvent. Prior to his death Ennis had expressed a wish that his son Donald be entrusted with the carrying on of the business, and that, on settlement of his estate, Donald be paid $1,000 over and above his distributive share. Upon Ennis' death, all the heirs entered into an agreement to carry out this oral wish.

The store was conducted by Donald for more than a year, but the venture was not successful, and the heirs petitioned under the Washington statute for an order of private sale of the stock of goods. This order was granted, but it was not strictly complied with. The store at Elma was closed out and a new one opened at Centralia, the administratrix assisting Donald at the new location. Several months later, after $3,824.82 of debts had been incurred at Centralia, Donald died. The following month the heirs procured another court order authorizing a private sale of the stock. From this sale the administratrix reported net proceeds of $879.90. The Centralia creditors then presented their claims to her, whereupon she petitioned the court for an order against the claimants to show cause why their claims should not be disallowed on the ground that the purchases had been made by Donald without her knowledge or consent.

After a hearing, the court granted the order, and judgment was entered rejecting the creditor's claims. The trade creditors then appealed, contending that they were not only entitled to have the proceeds of the sale applied against their claims, but that the inaction of the estate creditor, the banking firm, gave the Centralia store creditors the right to be paid out of the general estate assets. All the other estate creditors had long since been paid, but the banking firm, although they knew the store

business was being carried on, had neither expressly consented to it nor pressed for the payment of their claim. This creditor, in other words, slept on its rights.

Washington's highest court reversed the lower court's decision and held that the creditors of the continued business were entitled to have the proceeds of the store sale applied against their claims. But it was added that such creditors had no rights against assets of the estate not embarked in the business. Regarding the decedent's wish that his son Donald carry on the business, the court, said:

> Such a parol direction prior to death is not, however, recognized in law as a sufficient justification for a personal representative to continue the business for the benefit of the family or estate. *Raynes v. Raynes,* 54 N. H. 201; *In re McCollum,* 80 App. Div. 362, 80 N.Y.S. 755. The general rule is that a personal representative has no power to continue the business of a decedent unless expressly authorized by will, by statute, or by an order of the court.

In reference to the first order granted by the court to sell the store stock at private sale, the opinion stated:

> This order goes no further than to authorize the disposal of the stock of goods. It does not authorize the continuance of the business to the extent of replenishing the stock of goods.

Regarding the legal relationship that existed between Donald and his mother, the administratrix, the court said:

> We hold, however, that Donald Ennis, as manager of the store, was merely the agent of the administratrix, and that she would be bound by his acts within the apparent scope of his authority. . . . She is clearly estopped to assert that she is not bound by the acts of her agent, which she charges were in excess of his authority.

In holding that the Centralia store creditors were entitled to the proceeds of the sale of store goods, the opinion stated as follows:

> Where the heirs and general creditors consent that that portion of the estate may be carried on as a business venture, they are estopped to dispute the liability of the

> trade assets of the estate for debts incurred therein by the administrator . . . .
>
> The general creditor Hayes & Hayes, Bankers, never expressly consented to the course of conduct here outlined; but, as the holder of a substantial claim, it must have been cognizant that this business was being conducted as a going business, and its failure to take any action to assert its rights estops it from now claiming as against the trade creditors.

In holding that the Centralia store creditors could not get the balance of their claims paid from the general assets of the estate, the court held that the trade creditors "stand on a different footing from that of the heirs and creditors of the decedent, in that they never had an interest in the general assets." Therefore the trade creditors could not take advantage of the principle of estoppel against the heirs and the general creditors to reach such assets. The court also held that "while the fact that the business was carried on with the consent of the heirs and the administatrix was sufficient to estop them from disputing the prior rights of appellants in the trade assets, it does not estop them [the heirs and administratrix] from denying liability as to the general assets." The court further explained its judgment that the store creditors had no right against general estate assets not used in the continued business with the following statement:

> Trade creditors have no right to be placed on an equality with those existing at the date of decedent's death, and who are entitled to share in the estate as it then existed.
>
> They contract with the personal representative, chargeable with notice as to any limitations on his powers to bind the estate. They are not in any sense creditors of the decedent. They deal with the administrator on his personal credit and on the credit of the business conducted by him. The primary idea of administration is to preserve the estate for the benefit of those interested in it at the time of the owner's death, and courts should be slow to adopt a rule involving departure from that idea.

In closing, the court referred to the personal liability of the administratrix for the store debts:

> Whatever rights the appellants may have against the

> administratrix, while raised in the briefs of counsel, are not properly before us for consideration, and hence will not be passed upon at this time.

Had this question been before the court, however, there could have been but one answer. As above quoted, the trade creditors "deal with the administrator on his personal credit." The court had held that Donald acted as her agent and that she was clearly estopped to assert that she was not bound by his acts; undoubtedly it follows that the widow was personally liable and could have had a personal judgment rendered against her if the case had been handled differently. The leading case of *Willis v. Sharp,* 113 N.Y. 586, at page 591 states as follows: "It is the settled doctrine of the courts of common law that a debt contracted by an executor after the death of his testator, binds him individually, and does not bind the estate which he represents, notwithstanding it may have been contracted for the benefit of the estate."

CREDITORS OF CONTINUED BUSINESS SOMETIMES REACH ASSETS NOT EMBARKED IN THE BUSINESS

It was noted in the Ennis case that although the trade creditors were successful in reaching the assets of the continued business, they were unable to reach the other assets of the estate and have them applied againt the unpaid balance of their claims. This holding appears to be sound law, but sometimes the courts, in dealing with exceptional circumstances, have allowed such creditors access to the assets not embarked in the continued business. This is illustrated in the following cases.

Philco Radio & Television Corporation of New York v. Damsky, 250 App. Div. 485, 294 N.Y.S. 776 (1937). Abraham Damsky had conducted a radio store in Brooklyn. He died in 1934 without a will, leaving adult heirs, and his son Bernard was appointed administrator. With the consent of all the heirs, the administrator continued the operation of the store. At this time it was not certain whether there were any unsatisfied estate creditors. The Philco Radio Corporation sold the continuing business large quantities of merchandise, but when the adminis-

trator was alleged to be insolvent, the corporation brought suit in equity against the administrator and all heirs to recover out of the assets of the general estate for an unpaid bill of $3,627.57. On a motion by the defendants to dismiss the complaint, the court held that the action could be brought on the facts alleged. The court held in effect that a creditor of a continued business may recover in equity out of the general assets of the estate when, although no authority existed to continue the decedent's business, all the heirs, being of age, have consented to such continuance and when the personal representative is insolvent. This recovery is subject, however, to the rights of creditors of the decedent, if any. The basis of the court's decision is contained in the following excerpt from the opinion:

> The situation here disclosed constitutes a species of fraud which, combined with the financial inability of the parties, individually, to meet the obligation, entitles the plaintiff to payment out of the assets of the estate, subject, of course, to the rights of creditors of the intestate, if any there be.

Daniel v. Bank of West Point, 147 Ga. 695, 95 S. E. 255 (1918). This case is closely akin to the preceding one, although it appears to have been more soundly reasoned. In *Daniel v. Bank of West Point* the deceased's several enterprises, a general merchandise store, a cotton warehouse, a cotton gin, and a farming business, were all continued in operation despite the fact that the estate had not been formally closed out. However, the debts of the estate were paid. The businesses were conducted at a profit for several years by the administrator, Daniel, who was the decedent's son-in-law. He did this with the co-operation and at the behest of his wife, decedent's only daughter, and Mrs. Meetze, decedent's widow. During this time they all received their support from the businesses, Daniel continuing to receive the same salary as manager that he had received as an employee of the decedent. In the course of business Daniel borrowed $3,673.93 from the West Point Bank, putting up as collateral warehouse receipts for 100 bales of cotton. Subsequently, the bank, on learning that the cotton had been moved to another warehouse and believing that the administrator had become insolvent and that he might be attempting to sell the bales, brought

suit to restrict their sale, to subject the cotton to the payment of the loan, and to recover a judgment against the administrator and heirs payable out of general estate assets still possessed by Daniel.

The heirs had originally included the widow, Mrs. Meetze; her daughter, Mrs. Daniel; and two sons, one a minor for whom the administrator had been appointed guardian. The adult son, however, promptly after the death of his father had sold his interest in the estate to the other three heirs.

The lower court gave judgment in favor of the minor heir, but granted the bank judgment, payable out of the general estate assets, against the other two. The judgment in favor of the minor son was settled, and the case was then appealed to Georgia's highest court, where it was affirmed in favor of the bank. The decision is based upon the reasoning shown in the following quotations from the opinion:

> The record disclosed that all of the debts of the estate of W. B. Meetze have been paid. There was therefore nothing left for the administrator to do, so far as the record shows, except to turn the property owned by the two adult heirs over to them and be discharged. But the record shows that he continued to conduct the business. On the death of a person in this state intestate, owning real estate, the title to the real estate vests in his heirs immediately, subject to be administered for the purpose of paying the debts and for distribution among the heirs at law. The title to personal property vests in the administrator; but after the debts are paid the equitable title thereto is in the heirs at law. See Civ. Code 1910, ss. 3157, 3929-3933. The debts of the estate of W. B. Meetze having been paid, the remaining adult heirs, Mrs. Meetze and Mrs. Daniel, could bind themselves and their interest in the estate. . . . the evidence authorizes the conclusion reached by the jury to the effect that the business was conducted by Daniel as the agent or manager of Mrs. Meetze and Mrs. Daniel, who during the conduct of the business derived maintenance and support from it. This case is bottomed on the principle that Mrs. Meetze and Mrs. Daniel are the legal and equitable owners of the estate, and, all the debts of the decedent having been paid, that they can bind their interest in the estate for whatever debts they create or authorize. . . .

> After authorizing and acquiescing in this management by Daniel, and receiving their living expenses from it for several years, it would be contrary to every principle of equity and justice to permit the plaintiffs in error [Mrs. Meetze and Mrs. Daniel] to repudiate now the acts of their agent and leave their creditors to the mercy of an insolvent manager.

Stripped down to the essentials, the court's reasoning seems to have been as follows: The debts of the estate having been paid, the title to the general estate assets would in effect be considered as vested in the heirs; and the administrator, in continuing the business with their consent, would be considered to be acting as their agent. Because principals are liable for the authorized obligations entered into for them by their agents, the debt created by agent Daniel could be collected out of the general estate assets owned by the principals and managed by their agent.

SUMMARY

Although the foregoing cases do not deal with all of the ramifications of the situation created when, without legal authority but with the consent of all the parties interested in the estate, a deceased proprietor's enterprise is carried on after his death, still they do afford a sufficient background against which to summarize the ultimate effect on the various interests of the parties involved.

First, the personal representative cannot be held liable to the consenting heirs and creditors of the proprietor's estate for any losses incurred by him in conducting the business, excepting, of course, such losses as are the result of his own negligence or dishonesty. He continues to be accountable for any profits made. Although he remains personally liable for the obligations created in continuing the proprietorship business, he may, in so far as possible, retire these obligations out of the trade assets and any net loss will be allowed on his accounting, as in the case of *Swaine v. Hemphill.* However, because his right to be reimbursed, that is, his right of indemnity, would ordinarily be limited to the trade assets, he may find himself ultimately absorbing some of the trade debts, if the trade assets are insufficient, as they

were in the Ennis case. In spite of this possibility, however, the consent of the parties interested in the estate to the continuance of the business largely transfers the hazards involved from the personal representative to the persons consenting to such continuance.

Second, the creditors of the continued business, the trade creditors, who are in fact individual creditors of the personal representative, may sue him individually. Moreover, through the personal representative's right of indemnity, the trade creditors are entitled to be paid out of the trade assets of the continued business, and they are entitled to be paid before the consenting creditors of the deceased proprietor's estate and ahead of any interest in such assets of the consenting heirs. But the trade creditors ordinarily possess no right to have their claims paid out of the general estate assets, that is, the property of the decedent not embarked in the continuing business.

This last rule is the holding in the Ennis case and appears to be sound, especially where there remain unpaid estate creditors. As stated in *Frey v. Eisenhardt*, 116 Mich. 160, 74 N.W. 511, and quoted in the Ennis case: "We understand the rule is that where an administrator or executor, instead of closing out the business, continues it, even when authorized by will to do so, the trade debts will reach only the trade assets; that is, the property that was employed in the business or that was the result of doing business. *Laible v. Ferry*, 32 N.J. Eq. 791. See also *Altheimer v. Hunter*, 56 Ark. 159; *Lucht v. Behrens*, 28 Ohio St. 231." *Lucht v. Behrens* specifically held that the creditor of a business continued without authority could not subject general estate assets that were not embarked in the business to the judgment of his claim.

Of course, a decedent may, by specific terms in his will, put his entire estate at risk in continuing a business, but as Justice Story of the United States Supreme Court said in *Burwell v. Cawood*, 43 U.S. 560, "nothing but the most clear and unambiguous language, demonstrating in the most positive manner that the testator intends to make his general assets liable for all debts contracted in the continued trade after his death, and not merely to limit it to the funds embarked in that trade, would

justify the court in arriving at such a conclusion from the manifest inconvenience thereof." And of course, the consent of the heirs and creditors in a specific case could be couched in such language as to risk the entire estate. But "the most clear and unambiguous language" should be required before trade creditors, who "contract with the personal representatative, chargeable with notice as to any limitations on his powers to bind the estate," are allowed access to the general estate assets for the payment of their claims. The holding in the Philco case, therefore, was extreme, and it would have been interesting to have seen whether New York's highest court would have affirmed it, had the case reached the Court of Appeals.

The Daniel case may be distinguished because of the fact that all the estate creditors had been paid, and although the personal representative continued as such by title, it was found that he was acting merely as agent of the adult heirs in dealing with the business and continuing to hold estate property. Its reasoning is confirmed by *Matter of Mullon,* 145 N.Y. 98, 39 N.E. 821 (1895), wherein the court states: "Upon the payment of all debts, legacies and charges against the estate, the title to the remaining assets would at once vest in the residuary legatees under the will, without any formal transfer from themselves as administrators. (*Blood v. Kane,* 130 N.Y. 518.)"

Whether or not, however, the trade creditors in a particular case can reach the assets of the general estate, we find them still unpaid in the Ennis case and in the other cases reviewed, in two of which the personal representatives had allegedly become insolvent. Nevertheless, the consent of the parties interested in the estate to the continuance of the business has definitely improved the position of the trade creditors by giving them ultimate access to the trade assets in payment of their claims.

Third, the estate creditors of the deceased proprietor, by their own consent, give up the right to have the assets embarked in the proprietorship business promptly applied to the payment of their claims. In the absence of consent, "they have the power and the means of calling forth after the decedent's death the whole of his property in discharge of their demands" (Lord Chancellor Eldon, in *Ex parte Garland,* 10 Ves. Jr. 110). Fur-

thermore, the estate creditors, by their consent, allow the trade creditors priority of access against the assets of the continued proprietorship. These estate creditors therefore subject their claims to the hazards involved in the continuance. In the Swain case, one estate creditor was still owed $4,000 when the continued proprietorship business was closed out because of overpowering competition. In the Ennis case, the decedent's bankers were still unpaid, although the estate assets had been, at time of Ennis' death, ample for the discharge of all estate obligations. And in a case not previously referred to, *Hicks v. Purvis*, 208 N.C. 657 (1935), the consenting estate creditors with an unpaid claim of $21,587.41, failed to recover from the administratrix, who continued the decedent's nursery business, or from her surety. The facts showed no estate assets left from which to pay the claims, although the opinion stated that "originally the estate was regarded as a comparatively large one and abundantly solvent." We can only conclude that if the estate creditor can obtain his money at time of death, he will be well advised to do so.

Fourth and last, come the heirs of the deceased proprietor, who are the natural objects of his bounty. By their consent, they gamble the possibility of the profits to be made in the continuing business against the possibility of the loss of the property embarked in it. Against that property, trade creditors have first claim. If any such assets are left (there proved to be a deficiency in the Ennis case), the consenting estate creditors are next in line with their unpaid claims. Finally, if any proprietorship property remains, the heirs may have it. In the vast majority of cases, the heirs would be far better off, in the absence of a suitable continuation plan, to allow the personal representative to carry through a prompt liquidation of the proprietorship upon the death of the proprietor, in spite of the certain and substantial liquidation losses likely to be suffered.

CHAPTER 6

Continuation of Proprietorship Business by Court Order

PREVIOUSLY, WE HAVE CONSIDERED SITUATIONS in which executors or administrators have continued proprietorship businesses without the proper authority to do so, and have noted in detail the generally disastrous results that followed. We now come to the one avenue of authority available after the death of the proprietor to the personal representative who lacks proper sanction under the decedent's will to continue the business: the order of a probate court.

NARROW SCOPE OF COURT ORDERS AT COMMON LAW

Originally, all such court orders were based upon the principles of common law. However, as each state has developed its own interpretation of common law principles, there has been considerable disagreement as to the existence and extent of the power of a court of probate to authorize continuation of a dedecedent's business. A few states held that their courts had no power to grant such orders. For example, it was stated in *Altheimer v. Hunter,* 56 Ark. 159, (1892): "It is certainly not within the ordinary authority of a probate court to empower an administrator to continue the mercantile business of the deceased." At the other extreme, a few states held that their courts could authorize continuance of a business for sale as a going concern during the usual period of administration. The majority of states, however, held that authority could be granted

to the personal representative to carry on a business temporarily but only for the purpose of winding it up.

Gordon-Tiger Mining & Reduction Co. v. Loomer. The restricted scope of the majority of such orders is apparent in the case of *Gordon-Tiger Mining & Reduction Co. v. Loomer,* 50 Colo. 409, 115 Pac. 717 (1911). In it the order of the county court authorized the administrator to continue the decedent's second-hand business and replenish stock as necessity might require to make the entire stock of goods more salable in closing it out. The administrator, however, went to the extent of borrowing funds to use in the business. Under the local probate statute, expenses incurred in settling an estate were proper claims against the estate. When the lender attempted to redeem the amount of his loan, contending that it was an administration expense, the court disallowed it on the basis that the administrator had not been granted authority to borrow the money. The narrow scope of such orders is apparent from the following quotation from the court's opinion:

> Generally speaking, an administrator may not continue the business of the decedent, nor use the assets of the estate for business purposes. To this rule, however, there are exceptions, as, where the decedent was engaged in the mercantile or manufacturing business, his representative may, under order of court, carry on the business for a sufficient time to close it up. The administrator, if properly authorized, could continue the business for the purpose of disposing of the stock to advantage, and might purchase necessary merchandise to make the property more salable. . . .
>
> There is a great difference between buying goods for the purpose of replenishing short stock while closing out, and borrowing money to put into the business. . . . The county court gave him no authority to borrow money to put into the business; it would have been a remarkable exercise of power.

Although the lender was thus unable to procure repayment from the assets of the estate, he would be able to pursue the administrator individually, based upon the latter's personal liability for obligations created after the death of the proprietor. That

this can be done is clearly shown in *Miller v. Didisheim & Brother,* 95 Ill. App. 321 (1900).

Miller v. Didisheim & Brother. On the death of Miller, his widow, Mary Miller, qualified as executrix under his will and she continued her deceased husband's mercantile business under order of the Probate Court of Cook County. The court order had stated, "that said executrix have leave to carry on the business formerly conducted by said deceased in his lifetime, at 102 Madison Street, Chicago, Illinois, as long as the same is conducted with a profit to the estate of said decedent; and it is further ordered by the court that said executrix have leave to sell the said business at not less than the appraised value thereof at private sale." While the business was being conducted by the widow, she incurred a trade obligation in favor of Didisheim & Brother. The continuation of the business by the widow, however, resulted in a loss. She resigned as executrix and was succeeded by an administrator. The widow made up the loss in her accounting by paying over that amount to her successor from her own resources. The business was afterwards closed out by the administrator, who paid 59 per cent of the debt owed to Didisheim & Brother. Didisheim & Brother then brought action against the widow for the 41 per cent of their claim remaining unpaid. The court held the widow liable for this debt, ruling that a personal representative is personally liable for debts of a continuing business, despite the fact that such business is operated under the authority of the court. The opinion stated in part:

> The main objection to the judgment is that, the business having been conducted by the appellant under the authority of the Probate Court, the estate alone, and not the appellant individually, is liable. But this appears not to be the law.
>
> "The decisions are uniform that a guardian, executor, administrator, trustee or other person acting in such relation, binds himself personally, unless he exacts an agreement from the person with whom he contracts to look to the funds exclusively. This personal liability does not depend upon whether the charge would be a proper one by the trustee against the fund or estate, or whether he should

> be allowed reimbursement for the money paid. That is a matter wholly between him and the beneficiaries of the trust * * * It is for the trustee to justify his contracts to the court, and if they are proper he has a right to look for his reimbursement through the estate." *Bradner Smith & Co. v. Williams,* 178 Ill. 42.
>
> We discover no evidence that appellees had any knowledge or notice of the capacity in which appellant was conducting the business, much less that they made any agreement with her to look only to the funds of the estate.

Thus we find that the widow, who had continued his business under a proper court order and who had already paid from her own funds the amount of losses suffered, was nevertheless required to pay the balance of a debt owed an unsatisfied creditor of the continued business.

COURT ORDERS UNDER STATUTORY AUTHORITY

Because of the uncertainty and confusion regarding the authority that could be granted to the personal representative by court order at common law, and because the common law failed to evolve a satisfactory method of dealing with the business of a decedent, a majority of the states have enacted statutes on the subject. Some of these laws are of many years' standing, but in general they are a recent development, as shown by the fact that the number of such statutes has more than doubled since 1937. Space does not permit of a complete analysis of these various enactments, but something should be said of their scope and general effect.

As might be expected, no two of these statutes are identical (although the Connecticut and Rhode Island sections are nearly so). Many of them consist of a single short sentence; others, such as the new Michigan law, comprise several pages. A goodly number of them function merely to put an end to any uncertainty that may have existed at common law in their respective jurisdictions; they grant the personal representative the authority by court order—when the decedent's will has failed to do so—to continue a business for a reasonable time for the purpose of permitting the sale of the stock of merchandise

in the ordinary course of business. This avoids forcing the business to close its doors and causing the assets to be sold piecemeal along with other estate assets.

Statutes of this type provide for a more prolonged and more orderly liquidation, by which the losses on a forced sale may be circumvented. Nevertheless, they fail to provide a satisfactory solution. While the business is being liquidated, the ordinary overhead expenses continue and may offset any profits gained in selling the goods in the regular course of trade. But most important, the continuation of a business merely to close it must ultimately result in a total loss of the good will and going-concern value of the enterprise. Futhermore, the personal representative is left in the same precarious position that he is under the common law: He is not relieved of personal liability for debts contracted in continuing the business under the court orders issued. This is clearly brought out in *Anglo-American Direct Tea Trading Co. v. Seward,* 294 Mass. 349, 2 N.E. 2d 448 (1936).

Anglo-American Direct Tea Trading Co. v. Seward. William T. Abbott had conducted a proprietorship under the name of William T. Abbott and Company. At his death, his estate was insolvent, but on petition of the executors and beneficiaries of the estate, the probate court, by authority of the Massachusetts statute, authorized continuation of the business by the personal representatives. During such continuance, the plaintiff tea company sold tea to the executors. Subsequently Ide, one of the executors, died and the tea company brought an action against Seward and others, Ida's personal representatives, to recover the price of the tea. The tea company won the case, the court holding that an executor carrying on a business under the authority of a decree of the probate court is nevertheless liable personally on his contracts in furtherance of such business, in the absence of any agreement excluding personal liability.

The opinion stated in part as follows:

> Defendant's first contention is in substance that Charles M. Ide—one of the executors of the will of William T. Abbott—as matter of law was not liable personally on a contract found by the judge to have been "entered into by

> the executors." But an executor carrying on the business of his testator under authority of a decree of the probate court (G.L. [Ter. Ed.] c. 195, s. 7) is liable personally to a third person on a contract made with him by the executor in carrying on such business, at least in the absence of an agreement, express or implied, with such third person excluding personal liability of the executor. . . [citing cases] This is the rule applicable generally to trustees and like fiduciaries. . . [citing cases] And it is not limited to such fiduciaries acting without authority. *Mason v. Pomeroy,* 151 Mass. 164, 167. Absence of authority in an executor or trustee to contract might leave the person contracting with him to recourse solely against such executor or trustee personally. . . [citing cases] But authority in such executor or trustee, to contract would entitle him to allowance in his accounts for losses or expenditures resulting from the contract, subject to the ordinary principles of accounting, and would permit the person contracting with him to resort to the estate, in a proper proceeding, for payment of his claim. . . [citing cases] The authority to carry on the business of the testators conferred on the executors by decree of the probate court went no further. It did not relieve them from personal liability on contracts entered into in carrying on the business. The defendant, however, relies on the principle that an executor or trustee is liable not for mere errors in judgment but only if he acts in bad faith or fails to exercise sound discretion. (*Pine v. White,* 175 Mass. 585, 590; *Malden Trust Co. v. Brooks,* (Mass.) 197 N. E. 100.) This principle defines the duty of an executor, acting within the scope of his authority, to account, but even when his transactions are authorized it does not govern his personal liability to third persons with whom he has contracted in behalf of the estate. No question of an agreement between the executors and the plaintiff excluding personal liability of the executors is here involved.

Statutes allowing continuance for sale as a going concern. A second group of statutes goes a step further, allowing continuation of a business in the ordinary course for the purpose of its sale as a going concern during the normal period of estate administration. In the hands of an efficient personal representative, and under propitious circumstances, a satisfactory disposal of the business of the decedent can be effected. But under these

statutes, too much depends upon the general business conditions prevailing in the months immediately following the proprietor's death. The period of permissible continuance is too short to grant any assurance that an advantageous sale of the business can be negotiated. And in this connection it should be noted that if the personal representative should take it upon himself to conduct the business beyond the term provided by the statute, or by the court order under which the continuance is authorized, he puts himself in the position of a person carrying on a business without authority and becomes responsible for any losses thereafter incurred. On the other hand if the personal representative properly keeps within his authority, the presence of unfavorable economic conditions during the period of administration will nevertheless result in heavy losses to the persons interested in the estate. We must conclude, therefore, that statutes falling into this category still leave much to be desired.

Broad statutory authority. Approximately a dozen states have enacted statutes sufficiently broad to authorize continuation of a decedent's business in the regular course until a sale of the enterprise as a going concern can be made, even though such a sale cannot be made during the usual period of estate administration. Given favorable business conditions and given an alert and capable personal representative who is familiar with the problems and duties involved in running the business, these statutes provide as satisfactory a method of disposing of a proprietor's business as can be improvised in the absence of any plan worked out and implemented by the proprietor himself during his lifetime.

Under approximately half of the statutes mentioned in the broad group above, authority may be granted to carry on a decedent's business with a view to making a profit for those interested in the estate, instead of merely to allow its continuance until it can be sold as a going concern. In these particular states, the personal representative, on proper court order, is allowed to exceed the function of an executorship, which is to close out the estate, and to take on the function of a trusteeship. This last allows him to continue the business for a definite or

an indefinite period for the purpose of deriving income from it. Whether under these laws the periphery of permissible continuance by an executor or administrator has not been extended too far is an open question. How far a personal representative will be authorized to go in a particular case, however, is left to the discretion of the court having supervision of the administration of the particular estate. Furthermore, some of these statutes wisely permit anyone interested in the estate, on showing proper cause, to petition for a discontinuance of the business.

Statutes permitting incorporation of decedent's business. Both the long-standing Pennsylvania law and the later Hawaii statute specifically permit incorporation of a decedent's business, in which event the new creditors will be creditors of the corporation rather than of the personal representative. But relieving the executor or administrator who continues a decedent's business from personal liability can be a two-edged sword. While it facilitates the problem of inducing the personal representative to act in this capacity, at the same time it renders his task of carrying on the enterprise far more difficult, and sometimes impossible. Individuals and concerns are inclined to deal rather freely with a personal representative who possesses the requisite authority, when they know that his personal liability for his obligations makes him their primary debtor and that, should he prove financially unable to respond, they can reach the assets engaged in the business through his right of indemnity. The elimination of the personal liability of the executor or administrator, therefore, takes away from the potential new creditor of the continuing business his primary debtor, with the inevitable result that such potential creditors will refuse to do business unless the continuing enterprise is left by the decedent in a strong financial position, a requirement which, unfortunately, is only too often lacking.

SUMMARY

The broader statutes provide, insofar as it is possible to do by legislative enactment, that the discretion of the court fill in

the gap left by the failure of the proprietor to leave a subsisting plan for the disposal of his enterprise. In the light of the fact that great numbers of proprietors will continue to neglect to plan adequately for the disposal of their businesses, such statutes deserve both our highest commendation and the emulation of other states still following the antiquated and costly procedure, regardless of circumstances, of requiring forced liquidation of a business on the death of the owner.

Nevertheless, the best drawn statutes fall short of providing an ideal solution of the problems involved when a proprietor dies. Almost every small business is built by the sweat and toil of its proprietor over a substantial period of time. He knows intimately every facet of its operation, every pillar and every frailty in its economic structure. As a going concern, it reflects the ability, industry and personality of one man—its owner. Consequently, he and he alone has the knowledge, experience and keen personal interest requisite to plan effectively for its disposal upon his death. The ideal solution must come from him.

CHAPTER 7

Continuation Plans Made by the Proprietor Acting Alone

In the four previous chapters a reasonably close examination has been made of the alternatives to the immediate liquidation of a proprietorship business on the death of the owner who has left no subsisting plan for the disposal of his enterprise. This investigation has demonstrated both the need for, and the value of, up-to-date statutory provisions that will give the personal representative a limited opportunity to continue the business, in order that he may avoid disastrous losses on a forced sale and that he may have some chance of selling the enterprise as a going concern. Obviously, however, a general statute, coming into play after the death of the proprietor and in the absence of provisions made by him, cannot be expected to function as effectively as a plan drawn up and implemented by the proprietor himself. In our search for the most desirable plans for the continuation of proprietorship businesses, we shall now turn our attention to those plans set up by the owners in advance of the emergency calling for their use.

PROPRIETOR'S ORAL DIRECTIONS FOR CONTINUANCE

Sometimes a proprietor will sit down with the members of his family and come to an oral agreement with them regarding the continuation of his enterprise after his death. In fact, this is what A. C. Ennis did with respect to his dry goods store in Elma, Washington, arranging verbally for his son Donald to

continue it. On page 35, we saw that such a provision was held to be totally ineffective in point of law and hence provided no authority whatever for the continution of the proprietorship business after death. Such a plan, therefore, may be discarded without further consideration.

PROVISION IN PROPRIETOR'S WILL FOR CONTINUANCE OF BUSINESS

General principles. Nowhere are the general principles governing the continuance of a business under authority of a decedent's will more clearly and concisely stated than by Surrogate Wingate in *Matter of Gorra,* 135 Misc. 93, 236 N. Y. S. 709, (1929). Although this case summarizes the New York law, these rules apply in most jurisdictions. They are as follows:

First. "A testator may authorize or direct his executor to continue a trade * * * or business." (*Willis v. Sharp,* 113 N. Y. 586, 589.)

Second. "The intention of a testator to confer upon an executor power to continue a trade must be found in the direct, explicit and unequivocal language of the will or else it will not be deemed to have been conferred." (*Willis v. Sharp, supra,* p. 590); [other New York cases also cited].

Third. Such authority, if found, authorizes the conduct of the business in the usual manner unless otherwise expressly directed or limited. (*Matter of Rosenberg,* 213 App. Div. 167.)

Fourth. A power "to carry on the testator's trade, or to continue his business in a firm of which he was a partner, without anything more, will be construed as an authority simply to carry on the trade or business with the fund already invested in it at the time of the testator's death, and to subject that fund only to the hazards of the trade and not the general assets of the estate." (*Willis v. Sharp, supra* p. 590); [other N. Y. cases cited].

Fifth. The trade fund which may thus be employed embraces the general property employed by testator in the business including accounts receivable. (*Boulle v. Tompkins,* 5 Redf. 472, 478.)

Sixth. The ordinary expenses of the conduct of the business are chargeable to income. (*Dannat v. Jones,* 2

Dem. Sur. 602, affd. *sub nom, Matter of Jones,* 103 N. Y. 621).

Seventh. Since "the creditors of the testator * * * are entitled to have the assets collected in and applied upon their debts * * * a direction of the testator that his business should be continued would not be allowed to interfere with his right of existing creditors, or put to hazard the property of the testator applicable to the payment of their debts." (*Willis v. Sharp, supra* p. 590.)

Eighth. An executor who continues testator's business pursuant to powers granted by the will is not entitled to extra compensation for so doing in the absence of agreement by all persons interested in the estate. (*Matter of Popp,* 123 App. Div. 2 modifying s. c. *sub nom. Matter of Kempf,* 53 Misc. 200.)

Ninth. "An authority or direction" for continuance of the business, "if strictly pursued, will protect the executor from responsibility to those claiming under the will, in case of loss happening without his fault or negligence." (*Willis v. Sharp, supra,* p. 590); [other N. Y. cases cited].

Tenth. "An executor, carrying on a trade under the authority of the will, binds himself individually by his contracts in the trade. He is not bound to carry on the trade and incur this hazard, although authorized or directed to do so; but if he does carry it on, the contracts of the business are his individual contracts." (*Willis v. Sharp, supra,* p. 591; . . . *Austin v. Munro,* 47 N. Y. 360.) As is said in the last cited case at page 366: "The principle is, that an executor may disburse and use the funds of the estate for purposes authorized by law, but may not bind the estate by an executory contract, and thus create a liability not founded upon a contract or obligation of the testator."

Eleventh. "An authority or direction" for continuance of the business will entitle the executor "to indemnity out of the estate, for any liability lawfully incurred within the scope of the power." (*Willis v. Sharp, supra* p. 590); [other New York cases cited].

Twelfth. Those having claims resulting from the continuance of the business may, in the ordinary case, proceed only against the executor in his individual capacity, (*Austin v. Munro, supra* p. 366; [other N. Y. cases cited]) although there is some authority for the position that where the trade conducted is a partnership, or the executor

is insolvent they may go against trade assets. (Cf. *Willis v. Sharp, supra* p. 591); [other N. Y. cases cited].

Thirteenth. But where the testator has expressed in his will an intention to "bind his general assets for all the debts of a business to be carried on after his death * * * then, in case of the insolvency of the executor * * * in equity, the general assets become liable for the debts of the business." (*Willis v. Sharp, supra* p. 591); [other N. Y. cases cited].

POSSIBLE PURPOSES OF WILL PROVISIONS

A proprietor in his will may authorize the continuance of his enterprise for any of the following purposes: (1) to enable the stock of goods on hand to be sold in the ordinary course of trade instead of piecemeal; (2) to afford his personal representative an opportunity for selling the business as a going concern during the normal period of estate administration; (3) to enable his business to be sold as a going concern, whether or not an advantageous sale can be made in due course of administration; (4) to keep the enterprise intact until a later time when some member of his family can take it over; (5) for the purpose of providing a more or less permanent source of income to his family; and (6) to allow his personal representative to use his discretion for the disposal of the business in the light of the circumstances encountered.

CONTINUANCE OF BUSINESS UNTIL STOCK SOLD OUT

A provision in the proprietor's will authorizing continuation of the business until the stock of merchandise on hand can be disposed of in the ordinary course of trade is necessary only in those states where the prevailing law is exceedingly narrow. It will avoid the tremendous losses that usually follow the immediate closing of a business and the piecemeal selling of its assets along with the other assets of the estate. It is nevertheless an undesirable provision because both the good will and going concern value of the enterprise will be totally lost.

CONTINUANCE OF BUSINESS FOR SALE AS A GOING CONCERN DURING ADMINISTRATION

A clause in the will directing the personal representative to continue the business until he can sell it as a going concern during the normal period of administration of his estate is an improvement on the foregoing provision, but it too must be rated as generally unsatisfactory. This has been clearly demonstrated by the experience gained under a parallel provision contained in the Massachusetts statute that, until recently amended, gave the probate court authority to "authorize an executor or administrator to continue the business of the deceased for the benefit of the estate for a period not exceeding one year from the date of his appointment." Several cases had occurred in which the personal representatives, unable to dispose satisfactorily of businesses during the time limited, had taken it upon themselves to continue the enterprises beyond the year and had subsequently made creditable disposals of the businesses as going concerns. When some of these cases came before Massachusetts' highest court, the court refused to penalize the personal representatives for losses and expenses during the periods of unauthorized continuance on the ground that by ultimately selling the enterprises as going concerns, they had actually saved money for the estates involved. Based upon these experiences, the Massachusetts statute was amended in 1945 to provide that "The court, for cause shown, may extend such authority beyond one year."

CONTINUANCE OF BUSINESS UNTIL SOLD AS A GOING CONCERN

A will provision for a business to be continued until it can be disposed of as a going concern is similar to the statutory provision found necessary in the Commonwealth of Massachusetts for the satisfactory sale of an enterprise as an operating commercial unit. Hence we may conclude that if, under the circumstances of a particular proprietorship, no better purpose can be served, the proprietor should provide in his will for the continuation of his business by his personal representative "until it

can be advantageously sold as a going concern." This plan cannot be followed, however, unless the proprietor has made sufficient cash available to his executor with which to pay all taxes, administration expenses and personal and business debts, together with sufficient cash capital so that the proprietorship operations may be continued. Life insurance is, of course, the most certain and most practical method of providing this cash. However, such a plan should not be followed unless the proprietor is satisfied that there is no superior plan available to him. Nor should such provision be made unless he has appointed in his will an executor who is both willing and competent to take over the business and conduct it until such time as it can be advantageously sold. This point cannot be overemphasized. It is necessary that the executor be willing to run the business, for as we have already seen under the tenth rule given in *Matter of Gorra,* "He is not bound to carry on the trade and incur this hazard, although authorized or directed to do so." And it is, of course, equally necessary that the executor be competent if the continuance is to be successful.

The task of procuring a competent executor is unusually difficult. The personal representative must step in on a moment's notice and successfully carry on an enterprise that is largely the result of the peculiar abilities and personality of the decedent. As Francis W. Jacob states in 18 Iowa Law Review, pages 44, 45: "Experience gives no great assurance that a new hand, taking over the business under these circumstances, will administer it successfully. There is a substantial risk, except in abnormal times, that the business will be continued at a loss."

The risk involved has been legislatively recognized in Arkansas. That state has a statute which provides that, unless the will directs otherwise, the personal representative may continue a business for one month without a court order, and may, as authorized thereafter by the probate court, continue it for successive periods of three months each. The last sentence of the statute reads: "It is specifically recognized that the operation of any business undertaking involves hazard, chance, and danger of loss; and in recognition of this condition, it is declared herein to be the legislative intent that no executor or administrator

shall be held personally liable for loss resulting from mere lack of familiarity with the business operations, mistakes of judgment made in good faith, or like causes."

But experience and familiarity with the business operations do not eliminate the risk under adverse conditions. *Conant v. Blount,* 141 Fla. 27, 192 S. 481 (1939), illustrates the difficulties that may be encountered under depression conditions in carrying out will provisions authorizing limited continuation of a business, even when exceedingly well qualified. In the case of *Conant v. Blount* it was the key employee of the proprietor who remained in active charge of operations for six years following the proprietor's death. The case also shows how far a simple will provision is sometimes "stretched" by exigencies and by the injection of the personal ideas of the executor with respect to the ultimate destination of the business.

Marcus Conant had for many years conducted a proprietorship, a mortuary, in Jacksonville, Florida under the trade name of Marcus Conant Company. He died in 1926, leaving a will in which his sixteen-year-old son and his daughter were the surviving legatees, under which Blount was the surviving executor, and which contained the following provision:

> I do authorize my executors and trustees to carry on my business after my death for the necessary length of time to wind same up without unnecessary sacrifice or loss to my estate.

The will also allowed the executors full authority to sell any estate property at public or private sale on terms satisfactory to the executors. Conant's estate totaled approximately $80,000, of which about $17,000 represented assets of the proprietorship. The real property on which the business was located was heavily mortgaged, and the executor sought to devise some plan to defray the expense of this mortgage and also to preserve the business until the son reached an age when he could succeed to the business. Accordingly, the executor organized a corporation under the same name, and the assets of the proprietorship were turned over to it in return for 151 shares of the total 300 shares of $30,000 par value. The remaining 149 shares were bought

by one A. W. Ruus, who had been in the employ of the deceased proprietor for many years and had enjoyed his confidence, and who gave the executor in payment a note for $15,000 payable $200 monthly.

Ruus, who had operated the business for the one month from Conant's death until the corporation was organized, continued in charge until it went into bankruptcy in 1932. The cause of the bankruptcy was neither poor judgment, lack of attention, or inexperience; it resulted from an inability to realize upon accounts receivable during the universal economic depression, complicated by increasingly keen competition.

The executor had rented to the corporation the premises occupied by it. He had received in payment for the account of the estate about $11,550, but $4,600 rent was still due him. He then bought the assets of the corporation for $4,500 at forced sale, releasing as a credit the amount of unpaid rent, and proceeded to organize a new corporation, Conant Funeral Home, which continued the business without interruption. The executor turned over the assets purchased from the bankrupt corporation to the new corporation and received back 73 of its 100 shares of stock, 23 shares being sold for $2,000 to one E. C. Long, who paid $1,000 to the estate and $1,000 to the corporation.

After April, 1933, the son, who had at all times been advised about the condition of the business and who had become of age two years before, was made a director. During the same year the executor, with the son's written consent, sold the estate's stock in the new corporation to Long for $500 cash and took Long's personal note for $1,800 rent then due the estate from the corporation. This corporation lasted until December, 1933, at which time the executor, under distress proceedings for unpaid rent of $1,375, again obtained the assets. These assets, or what was left of them, were finally sold to the Florida Funeral Home by the executor, who then rented the old premises to the successors of the Conant Funeral Home, which was called Long and Ruus and in which the estate had no interest.

In 1935 the son purchased his sister's interest in the estate and subsequently brought action against the executor for an accounting and reimbursement for losses occasioned by the execu-

tor's alleged misconduct in continuing the business. The executor had already made ten annual accountings, all of which had been approved by the county judge.

Florida's highest court affirmed the decision in favor of the executor. It held first, that the period of time "necessary" to wind up the business without unnecessary loss was a matter depending upon the circumstances to be determined by the executor; and second, that where the son had participated in the business, was acquainted with its various phases and had acted as a director in one of the corporations, he had thereby ratified the executor's acts and could not complain of them. Regarding the economic difficulties faced by the executor, the court said:

> The difficulty of liquidation in the economic conditions which have persisted since the year nineteen twenty-nine, or even following the year nineteen twenty-six, when financial depression descended on the state of Florida, is easily understood. The impediments were all the more serious because the property attempted to be sold was adaptable to but one kind of business. Certainly hearses, caskets and the like could be disposed of only to one following the vocation of undertaker.

The facts of this case have been given in some detail for two reasons: to show the ramifications that can follow from a simple will provision; and to raise the pertinent question of whether the proprietor's plan, as he wrote it in the will, or as it was developed by his executor, was the best plan available to him. Here was a valuable key employee, Ruus, who finally set up an undertaking firm of his own despite the failure of the decedent's enterprise. Was there a plan which the proprietor could have entered into with him that would have worked out better for all the parties concerned? We shall return to this question later.

CONTINUANCE OF BUSINESS UNTIL RELATIVE TAKES OVER

Occasionally, a proprietor will have a young son, nephew or other minor relative to whom he desires to leave his proprietor-

ship. In this circumstance he may provide in his will that the enterprise be continued by his personal representative until such time as it can be turned over to the person designated. The hazards involved in such a provision, however, are many. In order to give the personal representative a sporting chance to hold the business assets inviolate during the period of administration of the estate and to carry on the enterprise successfully, he must be provided with ample cash from other sources (e. g., life insurance proceeds) for the payment of taxes, administration expenses, and all business and personal debts, as well as cash capital for the operation of the business. This last item is imperative, because the death of the proprietor will cut off the primary source of credit for the business: his integrity, ability and industry.

The depression hazard. Here again the proprietor must select a competent personal representative, one who is willing to stay on the job in the capacity of an operating trustee over a period of years. Furthermore, he must select a contingent trustee, equally competent, willing to step in and continue the business in the event of the death, disqualification, or renunciation of the representative originally nominated. In most of these situations there is a probable gap of several years duration between the death of the proprietor and the time when the business can be turned over to the legatee. This means that the continued enterprise will have to run the course of the business cycle successfully, or there will be nothing left to be turned over. A comparison of the dates of past business depressions with the dates of failure of businesses set out in the various cases here cited shows that this is a great hazard. This was seen in the case of *Conant v. Blount;* it is also to be noted among the facts in the McCauley cases, *ante* at page 17, that shortly after the administrator took it over, "a slump occurred in the embroidery business and heavy losses were suffered." This occurred in 1920, at the start of the comparatively short depression following World War I.

The hazard of business changes. Another risk which must be contemplated in providing for the continuation of a business over a period of years by a personal representative lies in the

possibility that the business changes which are constantly taking place will render the product, service, or method of doing business inefficient, or obsolete. In *Swaine v. Hemphill,* the decedent's brewing concern was closed down after three years because of losses brought about by the cut-throat competition of large manufacturers of malt, who had come into the field with the then current development of "big business."

The case of *In re Doelger's Estate,* 4 N. Y. S. 2d 334 (1937), affirmed 279 N. Y. 646, is of equal interest in this connection. Peter Doelger died in 1912, leaving a will in which he directed his executors to continue his brewing business in trust—a mammoth proprietorship which at his death had assets approximating $7,000,000—and for that purpose to form a corporation under the name of Peter Doelger Brewing Company. The corporation was formed and was operated successfully for many years, until the passing of the Eighteenth Amendment. Prohibition, of course, changed the entire business picture for the corporation. Some years later the brewing business was sold, the name of the corporation changed to Peter Doelger, Incorporated, and its business confined to the management and operation of its extensive real estate holdings and other investments.

Another example of changed conditions is illustrated in the cases of *Hewitt v. Sanborn,* 103 Conn. 352 (1925), and *Hewitt v. Beattie,* 106 Conn. 602 (1927), both of which involved the estate of John Beattie. Beattie died in 1899, leaving personal property of about $80,000 and debts approximating $35,000. He was survived by a wife, a daughter and six sons. He had operated a large and prosperous stone quarry for many years.

In his will, Beattie named two of his sons as executors and trustees, placed all of his residuary estate, including the business, in trust, and authorized his personal representatives to organize a corporation and at all times to hold in trust at least three-fourths of the stock for the benefit of the family. However, until such corporation was organized, Beattie authorized the two sons to use any or all of the trust estate for the purpose of carrying on the quarry business. The sons qualified and acted as executors until their resignation in 1919, twenty years later.

The demand for the building stone produced at the quarry, however, greatly diminished after Beattie's death until the business could no longer be operated except at a loss, with the result that it was never incorporated. In fact, the sons never placed the property in trust, since they had not paid all of the debts of the testator and had not closed out his estate.

When Hewitt took over as administrator in 1919, about $2,000 in debts of the estate were still outstanding (one debt was owed to the estate of Edmund Zacker for legal services rendered), and approximately $60,000 of debts incurred by the sons in continuing the business were also unpaid. Hewitt proceeded to liquidate the assets in order to raise cash to discharge these obligations, and, after some progress had been made, brought the two actions; the second against Beattie, asking for construction of the will and for a declaratory judgment. Among other things, this case held that if the creditors of the continuing business were not paid in full from the remaining assets of the estate, which were to have been held in trust, they could look for the recovery of the balance from the executors under their personal liability for such debts. Unquestionably, some of the troubles encountered by the two sons in handling the estate and in continuing the business were of their own making, but the great underlying cause of their difficulties undoubtedly was the change in demand from stone to other types of material in the construction of buildings.

The hazard of widow's property rights. The proprietor who desires to make provision in his will whereby his business will be continued and will ultimately be turned over to a relative often has another serious problem. Under the decedent estate laws of most states, a widow is entitled to a specified minimum share of the decedent's estate, and if a lesser portion is given to her in her husband's will, she has the right to elect against the will and thus receive her full share of the estate despite the will provisions. This right cannot be denied her unless she has waived it in a formal manner usually prescribed by statute.

Therefore, where a proprietorship constitutes the major portion of a testator's property — which is frequently the case — such a plan, standing alone, is not practicable if the proprietor's

wife is living. And even where this legal obstacle may be surmounted, the plan alone may not be feasible because of the inequality it works among the heirs. For example, a proprietor with a family consisting of his wife, a son, and a daughter would certainly not want to leave the bulk of his estate to his son at the expense of his wife and daughter, even though the arrangement might meet the minimum requirements of the decedent estate law. Under such circumstances, if this plan for the continuation of a proprietorship otherwise appears to be the best one available, and if the proprietor is insurable, he may purchase additional property in the form of life insurance sufficient to equalize, or at least to bring into suitable ratio, the shares going to the various members of his family.

In this connection, however, it must be kept in mind that in most jurisdictions life insurance proceeds going directly to a widow as named beneficiary are not counted in calculating the minimum share of her husband's property to which she is legally entitled. Therefore, either her waiver of statutory rights should be made a part of the plan, or the insurance proceeds destined for her should be made payable to the proprietor's estate — unless a more elaborate arrangement is added to the plan, including the creation of a living insurance trust.

The insurance trust arrangement. Under this arrangement an insurance trust would be executed immediately, with the amount of life insurance payable to the trustee equal to the value of the proprietorship. The will would provide for the continuation of the business by the designated personal representative under a testamentary trust until the son is ready to take over the business. In the meantime, the net income from the business and from the insurance trust would be paid to the members of the family in suitable shares or to the widow, as may be desired. And when the son is ready to take over the business, the trustee, following instructions contained in the insurance trust, will purchase the proprietorship business from the personal representative under the will, turn it over to the son, and pay the corpus of the insurance trust to the personal representative in payment for the business. The testamentary trust also may be terminated at this point and the funds divided

between widow and daughter, or it may be continued for their benefit, in accordance with the testator's wishes. Of course, the instruments will have to be carefully drawn to include alternative provisions for the disposal of the business in the event that it cannot be operated profitably, or in the event that the son never takes over the business, either because of death or because of a desire to pursue a different career.

The above arrangement will enable a proprietor with a wife and two children to leave each of them one-third of his property provided his proprietorship constitutes one-half of his net estate. If the value of his business amounts to less than one-half, he can equalize the share going to his son, if he wishes to do so, by an additional bequest to the son in the will. Where the value of the business amounts to more than one-half, he can equalize the shares going to his widow and daughter by the purchase of additional life insurance made payable to his estate in an amount that, together with his property other than the proprietorship, will equal the value of his business. Thus it is clear that in any ordinary family situation, an insurable proprietor, by suitable will provisions and by the purchase of the prescribed amount of life insurance, can work out equal shares for each member of the family and at the same time preserve his proprietorship as a unit for one member.

Ability of personal representative of prime importance. Before leaving the discussion of plans by a proprietor for the continuation of his business until a son or other relative is ready to take it over, it should be further emphasized that the carrying through of such a plan depends ultimately upon the ability of the personal representative to conduct the business successfully during the period intervening between the death of the proprietor and the time when the heir can assume the responsibility. Only too frequently, the proprietor delegates this difficult task to an individual lacking the necessary aptitude or experience – often his widow.

This was the situation in the great leading English case of *Ex parte Garland,* 10 Ves. 110 (1804), in which Henry Ballman left his property in trust under his will and directed his widow, Margaret, to carry on his trade as miller until such time as the

trustees should think proper to establish his sons, or either of them, in the business. In addition to the milling business assets of about £1351, Ballman directed in his will that his trustees advance to his widow up to £600 to enable her to carry it on. After his death, the widow continued the enterprise for several years, being advanced the £600 and an additional £768 from the trust estate. She then became bankrupt. The creditors of the continued business tried to reach the other assets of Ballman's estate, but Lord Eldon held, in a decision which has been a landmark of the law since 1804, that where a testator directs a business to be carried on and designates a limited fund to be used for that purpose, the general assets beyond that fund are not liable for the debts of the continued business. For our purpose here, however, the case is one of the oldest that illustrates the dangers inherent in the selecting of an "amateur" to continue a decedent's proprietorship.

Willis v. Sharp. Sometimes, however, it is a widower who proves to be the "amateur" at continuing a decedent's business, as is shown in the leading New York case of *Willis v. Sharp*, 113 N. Y. 586 (1889), a case cited as authority for so many of the rules collated in *Matter of Gorra.* Fida C. Sharp had for many years conducted a merchant-tailoring business in New York City. On her death she left a will directing that all of her property should be placed in trust for the education, maintenance and support of her son Harry until he became 25, and that some legitimate business should be carried on for his benefit until that time, with her husband retained as its manager at a salary of $1,500 a year. The will also provided that her executors could "sell or make such other disposition of my real and personal estate as the safe conduct of such business shall seem to require." The surviving husband alone qualified as executor and continued the merchant-tailoring business, but within six months after the death of his wife he had run up a bill with Willis amounting to $1,380. Willis, who could collect only $65 in payment from the husband and executor, sued in equity to reach the general assets of the estate on the ground that the executor was irresponsible individually. Willis won the case; the court opinion stated that the wording in the will of Mrs.

Sharp "indicates, we think, unmistakably, an intention on her part to subject her general assets to the debts of the business and to authorize the executor to contract debts therein binding her general estate."

Corporate trustee preferred. The books are full of cases which could be cited to emphasize further the fact that any plan for the continuation of a business until an heir can take over can be no better than the ability of the personal representative selected to conduct the enterprise in the interim. By now it should be apparent that such an undertaking should be entrusted only to a professional trustee or to an individual who possesses outstanding qualifications for operating the particular proprietorship in question, and who is willing to do so. And even though such an individual is available, he is subject to the personal hazards of death and disability. For this reason a professional corporate trustee is recommended whenever such an institution is willing to undertake the trust.

CONTINUANCE OF BUSINESS FOR INCOME TO FAMILY

A proprietor may direct in his will that his executor continue his enterprise for the purpose of providing a more or less permanent source of income to his family. Under such a provision, as under the plan of continuance until a relative can take over the business, the personal representative will be called upon to accomplish two distinct and difficult tasks. As executor, he must keep the business intact and operating efficiently; and at the same time he must perform the regular duties of his office with respect to the other assets of the proprietor's estate, including their possession, appraisal, liquidation (if required), the payment of taxes, debts, and administration expenses, and the distribution of the remainder in accordance with the terms of the will. As trustee, he will be called upon to continue the operation of the business successfully during a substantial period of years for the benefit of the members of the deceased proprietor's family.

It should not be necessary at this point to recite again in detail the hazards involved in this plan. Nevertheless, some

of the potential dangers need further underscoring. In settling the estate, the personal representative, as executor, can keep clear of personal liability for the obligations created by the proprietor if he acts prudently and without fault or negligence. In continuing the business, the personal representative, as trustee, is personally bound by the contracts he makes. He is, however, entitled to indemnity out of the assets embarked in the continuing business (or out of the assets of the entire estate if the will unequivocally devotes the whole estate to the carrying on of the enterprise), providing he acts prudently. If, on the other hand, the executor and trustee is guilty of misconduct, bad faith, negligence or imprudence in settling the estate or in continuing the business, the right to be indemnified will be withheld by the court, with the result that the money paid to discharge the obligations involved in any breach of duty must ultimately come out of the personal representative's own pocket.

Undesirability of naming proprietor's widow as personal representative. That the personal representative be held liable obviously is essential, but its application may bring about unforeseen and undesirable consequences from the standpoint of the proprietor if he has designated a member of his family as personal representative to continue his business. An outstanding example showing such undesirable results has already been given in the case *Miller v. Didisheim & Brother* (see pages 46-47), in which the proprietor's widow and executrix continued his business under a court order authorizing its continuation "as long as the same is conducted with a profit to the estate of the decedent." After suffering losses, she resigned and paid the amount of the losses to the successor from her own funds. However, because of her personal liability for obligations incurred, she was subsequently required to pay the balance of a debt owed an unsatisfied creditor of the continued business. The result would have been no different had she continued the business under a will provision similar to the court order granted her—but had that been the case, the deceased proprietor Miller could be criticized for putting his widow in such a predicament.

When will provisions that designate the proprietor's widow

as personal representative are coupled, not with positive directions to continue the decedent's business, but with broad discretionary authority to do so, they are particularly susceptible to undesirable results. There is an added danger that if the widow suffers losses, the court will refuse to allow her to be indemnified on the ground that she was imprudent or negligent in not discontinuing the business at the time when the court may think it should have been done.

This and other points are well illustrated by the case of *In re Onstad,* 224 Wis. 332, 271 N. W. 652, 109 A. L. R. 630 (1937). P. C. Onstad conducted a general store in Cambridge, Wisconsin, during which time one Robert N. Nelson had become an accommodation maker of a note with him for $800. Onstad died August 24, 1929, before the note became due; and when it did fall due, the bank demanded and received payment from Nelson. Onstad's will gave his estate to his widow for the duration of her life and thereafter to his children, appointed her executrix, and stated that it was his desire that his wife, Jennie, should use her discretion in continuing the general merchandise business for the benefit of his estate. In addition, the widow procured a court order authorizing her to continue the business as "special administratrix" and as expense to pay herself $75 per month, her son $100 per month and a woman clerk at $60 per month. She failed to inform the court, however, that at the time of the proprietor's death the business was only paying expenses and that there had been a decided decrease in business since his death and before her appointment as executrix.

Armed with this authority, but without filing proper inventories, keeping segregated records of estate property, or closing out the estate, the widow continued the business until April, 1932. The original inventory of merchandise was $9,206.45 and of fixtures was $1,221.50. When she discontinued operations, the merchandise inventory was $3,348.93 and the fixtures $900. Shortly thereafter the merchandise was sold for $1,200 and the fixtures for $300. (The last two sets of figures illustrate the amount of shrinkage in value suffered on forced sale—approximately two-thirds.) When the widow filed her final account, it showed a balance on hand for distribution of $434.47,

which was sufficient to pay the creditors only 7 per cent of their claims. The account was approved as containing the following items of credit: loss by depreciation through operation of the business, $7,953.29; loss by depreciation of fixtures, $811.50; loss on sale of stock of goods below inventory, $2,148.93; loss on accounts, $1,314.86.

All of the creditors except Nelson accepted 7 per cent of their claims and released the estate. Nelson, however, filed objections and moved for an order requiring the widow to pay his claim in full. The lower court allowed his claim but denied his motion, which left him still in the position of being able to collect only 7 per cent, and he appealed. Wisconsin's highest court reversed the judgment of the lower court that had approved the widow's final account, and remanded the case with direction to order her to pay Nelson's claim in full. While the opinion cannot be taken as a model of pellucidly expressed judicial reasoning, it nevertheless contains several points of interest. First, it shows clearly that provisions for the continuation of a decedent's business must be predicated upon provisions for settlement of the obligations of the deceased. On this point the court said:

> The rule in *Willis v. Sharp,* supra, that creditors of a testator are not bound by the provisions of his will for continuance of his business, follows from the statutory provisions that a decedent's estate less exemptions, preferred claims, widow's allowance during settlement, etc., must be devoted so far as necessary to the payment of the testator's debts. [Wisconsin statutes cited.] This is also implied from the conditions of the statutory bond of an executor, that he will "pay and discharge all debts" out of the personal property of the estate.

The estate at the time of Onstad's death had ample funds with which to pay Nelson, and failure to do so was held a breach of duty on the part of the executrix. Of course, Nelson might have expressly consented to the continuance, or might have been estopped by conduct that would imply consent, as were the bankers in the Ennis case, but the court found to the contrary.

Second, the will provision authorizing the widow to use her discretion as to the continuing of the business impliedly was interpreted to mean her "prudent" discretion. The court held that under the circumstances she had been imprudent in continuing the business and in failing to settle the estate within a year, in the absence of an extension of her original court order beyond that time. On this point, the court says in part:

> It appears clear that the loss sustained by reason of the imprudent continuation of the business by the executrix and the conduct of the business by her after the time when under the statute the estate, in absence of an extension for cause by the court, should have been closed, exceeded the amount of appellant's claim.

Third, it is clear that, had the executrix failed to make settlement and to get releases from the other creditors, her ultimate liability would have been several thousand dollars instead of several hundred. It is evident from the opinion that the court would have ordered a new accounting had there been any creditors then interested in the funds other than Nelson.

Fourth, the case is another example of the disaster that may result if an inexperienced personal representative attempts to continue a proprietorship during a business depression.

Provision in will for incorporation of business. Before leaving the subject of will provisions that direct the continuance of a proprietorship for the purpose of providing a more or less permanent income to the proprietor's family, further reference should be made to plans that call for incorporation of the enterprise after the death of the proprietor and that place all or part of the stock in trust for the benefit of the family. Two such schemes have already been alluded to: the provision for the incorporation and holding in trust of the Peter Doelger Brewing Company, and a similar provision with respect to John Beattie's quarry business. With such an immense proprietorship establishment to deal with, Peter Doelger no doubt selected the best plan for his will that was available to him, even though the trustees found it advisable some years later, as a result of changed conditions, to dispose of the brewing business and to direct their operations into other channels. The quarry

business left by Beattie fared badly, and must be grouped with the large number of other cases evidencing the fact that it is unsafe for a proprietor of an enterprise of ordinary dimensions to rely on the successful continuance of the business for the maintenance and support of his family. A third plan of this nature, a plan set out in the case of *Matter of Noll,* 273 N. Y. 219, 7 N. E. 2d 108 (1937) will now be discussed.

Matter of Noll. Rudolph R. Noll was the sole proprietor of a granite memorial business, employing William Heinz as manager. Noll died in September, 1933, survived by his wife and his daughter, a minor. His will, executed a few months before his death, directed the payment of "all my just debts, and funeral expenses," made certain specific bequests and directed as follows with respect to his business:

> *Fourth.* I authorize and empower my executors to continue my business . . . and I direct that as soon as convenient after my death said business be incorporated under the laws of the State of New York . . . in such sum as my executors may deem desirable, and that my said executors transfer to said corporation all the assets of said business in exchange for an equivalent amount of the capital stock of said corporation, and that the total expense for incorporating said business shall be charged against my estate.
>
> (a) I direct that Twenty Five per cent of the capital stock of said corporation be given to my friend and manager William Heinz; and it is my wish that he be retained as the manager of said business, as incorporated, and adequately compensated for his services as such manager, irrespective of his ownership of the said Twenty Five per cent of the capital stock of said corporation.
>
> (b) I direct that Seventy Five per cent of the capital stock of said corporation, be held by my executors, as hereinafter further provided [in trust, one-half for the benefit of his wife and one-half for the benefit of his daughter].

Noll's gross estate was appraised at $152,000. The value of the business was fixed at $42,925.31, of which $16,000 represented good will and over $19,000 merchandise. There was a cash balance on the books of $2,274.78 and business debts owed in the amount of $5,470.15. His other debts were $1,225.52. The two individual executors and trustees paid all the debts

out of the general funds of the estate, organized the corporation with a capital stock of $44,000, and transferred to it all of the assets of the business free from the liabilities. Trouble brewed on the accounting, however, when the Surrogate decided that the business debts should have been paid out of the business assets and surcharged the personal representatives for that amount. This decision was affirmed by the intermediate appellate court, but was reversed by New York's highest court. Chief Judge Crane pointed out in the opinion that there was no distinction between the business debts of a proprietor and his other debts, that the personal representatives were called upon first to pay "all" of the debts of the testator, and that they could not deal with the assets for incorporation purposes or any other purpose until the creditors were satisfied. With respect to the plan of continuing the business, which is our primary concern here, the opinion states in part:

> William Heinz was his manager. The business presumably could not continue after Noll's death without Heinz. This the testator recognized, and by his will made it an inducement for him to continue, so that his wife and daughter might have the income from the business, or such portion of it as was not given to Heinz. The business had been running down, from a profitable one, to one without profit. The annual income of approximately $14,000 in 1929 and 1930 dwindled each year and, in the first eight months of 1933, the business was operating at a loss. It was during this last year that the will was drawn. The merchandise was of a kind not easily salable, yet no doubt the testator had hopes that with the improvement in financial conditions the business would improve. He counted on Heinz. The criticism, therefore, of the gift of stock to William Heinz, no relative, is unjustifiable. The income, as the testator knew, for his relatives would depend upon Heinz, the manager, after he, the owner, had passed away . . . .
>
> The testator knew his circumstances; his will indicates a desire to provide solely for his wife and daughter, and no doubt he used the best means to accomplish the purpose by keeping Heinz in the business.

Notwithstanding the highest respect for the dictum of the learned judge, the question might still be raised as to whether

Noll *did* use the best means to provide for his wife and daughter. Under the plan they are dependent upon three-fourths of the net income of a small business which, over the five-year period immediately prior to the proprietor's death, had varied from an annual profit of $14,000 to a net loss. Consequently, similar fluctuations might have been expected to occur in the future; hence the beneficiaries of the plan could never be certain of the amount of their income in any year or that there would be any income at all for them. Their interest in the business, therefore, must be classed as speculative. Heinz, in spite of his legacy of one-fourth of the business, had heavy responsibilities. His future salary was dependent upon the board of directors of the corporation, which was controlled by the trustees who held the majority stock. Stock dividends were dependent almost entirely on his own efforts, yet three-fourths of the total amount would go to others. On his shoulders rested the task of carrying on the enterprise and of producing profits satisfactory to the widow and daughter. Criticism of the gift of stock to him was made in the probate proceedings and he could expect a resurgence of criticism at any time profits were not made. At the time Noll acted—just a few months prior to his death—the plan may well have been the best expedient available to him at that late date, but its hazards are so apparent that it cannot be accepted generally as a suitable business continuation plan.

SPECIFIC BEQUEST OF PROPRIETORSHIP

There remains one other distinct type of will provision to review: the will provision that bequeaths the business to a legatee immediately upon the death of the proprietor. If the legatee is an adult son or a brother of the owner, someone who is capable and desirous of carrying on the enterprise, this plan is "a natural." Certain precautions, however, must be taken.

First, it is essential that the proprietor make sure that his will provisions cannot be upset by other legatees. This possibility will exist if there is a surviving widow who has not been given her legal share in the estate, or who for other reasons may elect

against her husband's will, and may be overcome by securing from her in advance a proper waiver of her right to elect against the will; but such procedure is feasible only where she has an ample fortune of her own. Ordinarily, if other property is lacking, the proprietor should be advised to procure, as a minimum, sufficient additional life insurance to be received by his widow in such manner as to satisfy the legal requirements. The same method is, of course, available to do equity to other members of the family if the assets of the proprietorship make up the bulk of the estate.

Second, it is equally essential that the proprietor make sure that his provisions will not be upset after his death by his own creditors. Examination of the cases shows that this precaution is too often neglected, to the embarrassment of the legatees. However, it is also of interest to note that specific legatees (legatees of particular items of property) occupy a preferred position with respect to the creditors of the proprietor. In the first place, such legatees are beneficiaries of the well-nigh universal rule that general assets of the estate must be exhausted in payment of estate debts before resort can be had to property specifically bequeathed. In the second place, if resort must be had to property specifically bequeathed, its legatees are usually liable only to the extent of its value at the time of the testator's death, not being liable for any profits earned from the property after its delivery to them.

An illustration of the effect of these rules in the estate of a proprietor who had neglected to provide for the cash needs of his estate is given in *In re Van Houten's Estate,* 18 App. Div. 301, 46 N. Y. S. 190 (1897). Edward Van Houten had for some years owned a livery stable in Nyack, New York, which was conducted for him by his brother Erastus. By his will Edward specifically bequeathed the livery stable property and good will to Erastus, and the latter also qualified as executor. The tangible livery property was appraised at $3,202.94, representing somewhat less than one-half the estate. As legatee, Erastus immediately continued the operation of the stable, the gross receipts of which amounted to $23,039 during the subsequent four years. His accounting as executor, however, showed that

the entire property of the estate was not sufficient to pay the debts of the deceased proprietor, and the Surrogate charged him not only with the value of his legacy, but also with the amount of profits he had made from the livery property since the testator's death. On appeal, it was held that he was liable to the creditors of the testator to the value of the business, including good will, at the time of the proprietor's death, with interest, and for rent of the premises occupied by such business, but that he was not chargeable with the profits of the business made subsequent to death.

Thus, the continuation of this business was luckily accomplished: first, by the specific bequest of it; second, by its being operated by the legatee as such, rather than as executor, from the moment of the proprietor's death; third, by the fact that the legatee, already experienced in conducting the enterprise, was so successful in continuing its operation that he could afford to pay to the estate creditors the full value of the business out of the profits. The continuation was accomplished, however, at the expense of all other legacies under the will and it left unsatisfied estate creditors in its wake. The results would have been far better for all concerned had the proprietor included in his plan the purchase of life insurance sufficient to wipe out his debts.

SUMMARY OF WILL PLANS

In summary, it may be said that because of the tremendous number of existing proprietorships, situations will be found in which each type of will provision has its place.

In a very few cases, a will provision directing the sale in the ordinary course of the stock on hand in a mercantile business will be called for. It should never be used, however, except as a last resort; heavy losses always may be expected from the liquidation of the business assets. Furthermore, the business enterprise goes out of existence, and its good will value and its value as a going concern are then totally lost to the heirs and to the community. Whenever such a provision must be used, life insurance should be purchased by the proprietor, and paid for out of the profits of the business, in an amount that will

offset these losses and transmit the full value of the business to his heirs.

A provision for the continuance of a proprietorship business as a going concern until it can be sold as such by the personal representative involves danger of substantial losses and should be restricted to those cases in which a competent and experienced personal representative is available who can be furnished with ample cash capital and to those cases in which the proprietor, during his lifetime, has been unable to arrange for a satisfactory sale of his business to be effective at his death.

A provision directing the continuance of a business until a son or other relative can take over has its logical place. Because of the hazards involved, it should not be used if there is a very young son or other relative whose future vocational qualifications, aptitudes and desires are entirely problematical. When used, it calls for an able and willing personal representative who has sufficient funds at his disposal; an equitably balanced will so that other members of the family are suitably provided for without recourse to the proprietorship assets; and a well-established business that, if properly managed, can weather economic recessions and changes in business trends.

A will direction for the continuance of a proprietorship business in order to provide a more or less permanent source of income to the proprietor's family should seldom be used. Experience teaches that it should, in general, be restricted to gargantuan proprietorships such as, for example, the Peter Doelger Brewing Company. In the ordinary situation, the enterprise is largely a one-man affair and it is too much to expect that an outsider will be either able or willing to operate it for the benefit of others besides himself with any like degree of success over a substantial period of years. Therefore, such a provision usually leaves the estate funds for the support of the widow and children unsuitably "invested" in a speculative venture.

A provision specifically bequeathing the proprietorship business to an adult son or other adult relative is desirable if such a legatee has the qualifications, experience and aspiration to continue the enterprise. This provision, however, must be accom-

panied by provisions for the equitable balancing of property given to other members of the proprietor's family, with particular reference to the minimum share of the estate that must be given to his widow. The legatee of the business should also be furnished with additional business capital to offset the loss of the credit and key-man value of the proprietor.

And finally, collateral to any and all of these provisions, the proprietor should provide cash for the payment of debts outstanding at time of death, for it should always be remembered that directions for the continuance of a business will not be allowed to interfere with the right of existing creditors to receive their money.

Thus, we find that in certain well-defined situations special will provisions are suitable to solve the problem of continuing a proprietorship business, but that in the absence of such special situations, provisions available through a proprietor's will are generally unsatisfactory.

In our search for a better solution of the remaining situations, we shall now examine plans available to the proprietor that he may enter into with others during his lifetime.

Part III

THE PROPRIETORSHIP INSURED PURCHASE AND SALE AGREEMENT

CHAPTER 8

Agreements Between Proprietor and Others for Continuation of Business

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TWO TYPES OF AGREEMENTS AVAILABLE

TWO GENERAL TYPES OF AGREEMENTS LOOKING to the continuation of his business after his death are available during the lifetime of the proprietor: a living trust agreement and an agreement of purchase and sale.

The living trust agreement is commended to those proprietors who have minor sons or other relatives to whom it is desired to leave the business but who would not be ready to take over immediately upon the proprietor's death. Such a present trust of the business has the outstanding advantage, over a corresponding will provision, of allowing the owner during his lifetime to familiarize the trustee with the intricacies of operating the business successfully and of testing out the trustee's ability to do so. Among other advantages, it currently relieves the proprietor of some of the burdens of sole management and after his death it largely disengages the business from any will complications that might otherwise arise.

The second type of agreement, an agreement of purchase and sale of the proprietorship, effective upon the proprietor's death, is commended to the vast number of proprietors who have no sons or other relatives as logical successors. This form of agreement will now be discussed.

WHY A PURCHASE AND SALE AGREEMENT IS DESIRABLE

Often a proprietor has devoted the best years of his life to building up a substantial business that, under his ownership and management, affords him and his family a satisfactory livelihood. For many reasons, he does not want to have the enterprise crumble upon his death. But he knows, or should know, that without some *post-mortem* plan, the business will close its doors when he passes away and the assets will be sold, in due course of the administration of his estate, for a fraction of their former worth as assets of a profitable going concern. He also knows that the business, if he provides in his will for its continuance until it can be sold as a going concern, may well run into serious difficulties before a likely buyer can be located; and that such a plan is, therefore, fraught with uncertainty and risk. He knows further that he is leaving a speculative source of income for the maintenance and support of those dearest to him, if he provides in his will for the continuance of the business by his personal representative in order to provide income more or less permanently for his family.

What, then, should he do? It is submitted that he should at once look for a logical successor to his proprietorship business, and when such a person is found, enter into a binding agreement with him for the purchase of the enterprise as a going concern, to be carried out upon the proprietor's death. The buyer of the business under such an agreement will acquire it as an actively operating unit; hence he can well afford to pay its going-concern value and the proprietor's estate will suffer no liquidation losses. With proper arrangements for financing the purchase price, the proprietor's family will receive the full value of the business in cash, which can be placed in investments suitable for the widow

and children. Under such a plan, the proprietorship business will continue uninterrupted, to the benefit of the buyer and the community, and as a monument to the ability and foresight of the proprietor who founded and perpetuated the establishment.

THE PARTIES TO THE PURCHASE AND SALE AGREEMENT

Where will a proprietor find his prospective buyer? In most instances, he need not go afield; he should look among his own employees. There he will usually find one or more individuals of ability and ambition, familiar with the business, who may already have wondered what would happen to their jobs and future business careers should the proprietor suddenly pass away and who would gratefully and enthusiastically respond to the opportunity of becoming successors to the business.

For an apt example, let us turn back for a moment to the case of *Conant v. Blount* (page 59, et seq.). Marcus Conant, proprietor of the undertaking business, had associated with him one A. W. Ruus, "who had been in the employ of the testator for many years and enjoyed his confidence." Ruus, you may remember, bought approximately one-half of the stock of the first corporation organized by the executor after the proprietor's death, Ruus delivering notes calling for payments of $200 a month. Then at the end, on the failure of the second corporation, the executor rented the old premises to the successors of the Conant Funeral Home, Long and Ruus. Clearly, here was a key employee who logically would have welcomed the opportunity during Marcus Conant's lifetime of entering into an agreement with him to purchase the proprietorship business upon his death. As we shall see later, he could have financed the purchase in advance and owned the entire business outright on Conant's death with smaller monthly payments than he obligated himself to pay on the notes, after death, for a half-interest. With the business free and clear, Ruus would then have been in an enviable position to ride out the depression. The executor would have received cash in payment for the sale of the business and could have applied it against the mortgages

which caused him so much trouble. Can it be doubted that everyone concerned would have been far better off had such an agreement been entered into between proprietor Conant and key-man Ruus?

Let us turn to another case, *Matter of Noll* (page 73 et seq.). Here again we find a proprietor, Rudolph Noll, with a key employee, William Heinz, who would have been logical parties to an agreement of purchase and sale of the granite memorial business. Indubitably both Heinz and the proprietor's family would have been better served had such a plan been set up. Had this been done, Heinz would now own the business instead of holding only a one-fourth interest; and the widow and daughter would have had cash to place in suitable investments instead of being dependent upon a portion of the fluctuating earnings of a small enterprise.

These cases are typical of thousands of existing proprietorships, among whose employees will be found a "Ruus" or a "Heinz," eager for the chance to enter into an agreement that will assure his future and will someday make him the proprietor of his own business.

There are, however, many proprietorships that do not have in their employ men of the calibre of Heinz and Ruus. In those situations, it will pay the proprietor well during his lifetime and his estate after his death to search out such an employee and bring him into the business. As the proprietor grows older, he will then have able shoulders on which to shift some of the burdens of management while he enjoys his later years, and he will be afforded the opportunity of ideally solving the problem of the disposal of the business upon his death.

There are, of course, many strictly one-man proprietorships, businesses run without a need for employees. Proprietors of these establishments, so long as their establishments remain such, will have to fall back upon other solutions.

FINANCING THE PURCHASE AND SALE AGREEMENT

A purchase and sale agreement between a proprietor and one or more of his key employees for the purchase of the business

upon the proprietor's death sets up a pre-arranged market for the business. Such an agreement, to be valid, must of course contain a stipulated purchase price or a definite valuation formula that may be applied at the time of death to produce a price. The plan must go further, however; it must assure that the purchaser has the money with which to pay over such price in full, or nearly in full, promptly on the proprietor's death. Life insurance carried on the proprietor by the purchaser in the amount of the purchase price, exactly matching the purchaser's obligation both as to time and amount payable, obviously is the most satisfactory method of financing such an agreement. Life insurance owned by the purchasing employee on the life of the proprietor in the amount of the purchase price not only assures all parties to the agreement that the cash with which to carry out the transaction will be forthcoming when needed, it also constitutes the most convenient and practical method of financing the purchase.

Non-insurance financing methods impractical. It would be a rare case indeed, in which an employee of a proprietor had sufficient wealth to enable him to pay cash for the business on the proprietor's death. Eliminating this possibility because of its rarity, there remain three possible methods open to the employee other than the life insurance method: to stint and thereby save the purchase price; to pay the purchase price in instalments after the proprietor's death; and to borrow the money at the time of the death.

The method of saving the purchase price is entirely impractical. Years of stinting would be required to build up the necessary fund; yet the full amount might be required in a few years or even in a few months—when, no one can possibly foresee.

The method of paying the purchase price in instalments over a period of years after the death would be unsatisfactory to the proprietor because the payments which should go to his family would be dependent upon the future fortunes of the business, one of the major hazards he is attempting to avoid. It would be equally unsatisfactory to the employee for it would drain the future income of the business for many years to come.

The method of borrowing can hardly be considered more than a mere hope or expectancy. Because the credit standing and borrowing ability of the purchasing employee at the unknown future time when the money will be needed cannot be foretold, there would subsist only a hope that he could then obtain the funds somehow in order to carry through the purchase. Not only does this uncertainty condemn this alternative in the eyes of both parties but, if perchance such a loan were made, the required payments of loan interest, together with repayment of the loan principal, would be twin millstones grinding down upon the purchasing employee.

The life insurance method of financing the purchase. The only completely satisfactory method of financing an agreement by which one or more key employees of a proprietorship will purchase the business on the death of the proprietor is by means of life insurance carried by these employees on the life of the proprietor. The effect of such a financing arrangement is to set up an advance instalment plan for the payment of the purchase price. The amount of each annual instalment is small—for example, approximately 2 per cent if the proprietor is age 31, 3 per cent if he is age 43, 4 per cent if age 50, 5 per cent if age 55, *et cetera*—and may be broken down into semi-annual, quarterly, and even monthly payments, if desired. And these instalment payments cease at the death of the proprietor, when the financing plan automatically becomes self-completing.

By this advance method of financing the purchase price, compound interest is put to work immediately in favor of the purchaser, with the result that only in exceedingly rare instances do the total payments equal the purchase price; in contrast, under a purchase arrangement calling for instalments after the death, compound interest works against the purchaser and must be paid in addition to the full purchase price.

From the standpoint of the proprietor, this plan of financing guarantees that his estate will receive the full going value of the business at once, in cash. For him, an immensely difficult estate problem is solved perfectly. From the standpoint of the purchasing employee, the event that causes the purchase price to be due and payable will automatically cancel all future in-

stalment payments and will place in his hands the full purchase price. For him, a going, profitable, familiar business is his, "free and clear."

VALIDITY OF THE PURCHASE AND SALE AGREEMENT

No case has yet come to our attention in which the validity of an agreement of the exact type being discussed has been challenged. The legal principles involved, however, are similar to those involved in agreements for the purchase and sale of a partnership on the death of a partner, or for the purchase and sale of shares of stock of a close corporation on the death of a stockholder. Many cases are cited later, in the sections dealing with Partnerships and Corporations, upholding these last two types of agreements. The underlying principle of such agreements, including an agreement for the purchase and sale of a proprietorship business, is well stated in the partnership case of *McKinnon v. McKinnon,* 56 F. 409, in which the court said in part: "In the State of Missouri . . . it is well settled, as it is in most states of the Union, that an agreement by a person, upon a valuable consideration to give another the whole or a part of his property at the promisor's death, will be specifically enforced in equity, both as to real and personal property, if the consideration is duly rendered by the promisee."

Courts will compel specific performance of agreement. The gist of the rule quoted from the McKinnon case extends further than merely to uphold the validity of an executory contract of this nature; it holds that the courts will require the parties or their representatives to carry through the exact transaction of the purchase and sale of the business that is the subject matter of the agreement, rather than to require the recalcitrant party to pay a judgment for money damages for breach of contract. This is especially important to the purchasing employee, because his future business career naturally will be planned around the contemplated acquisition of the particular proprietorship business with which he is familiar and which he has agreed to buy.

CHAPTER 9

Specific Benefits of the Insured Purchase and Sale Agreement

AN AGREEMENT BETWEEN THE PROPRIETOR AND one or more of his key employees, financed with life insurance, by which the key employee will purchase the proprietorship assets and business for cash on the death of the proprietor, is of immense benefit to all concerned.

BENEFITS TO THE PURCHASING EMPLOYEE

Business future assured. Without such an agreement, the applicable law would normally force the closing out of the business on the death of the proprietor and with it, the closing out of the employee's job. However, with such an agreement, the employee will not only have a job, he will be the new proprietor of a going business, with all of its assets, customers and good will intact. And because he is familiar with the operations of the enterprise, the new proprietor will have every opportunity to continue it successfully. His business future is assured.

BENEFITS TO THE DECEASED PROPRIETOR'S ESTATE AND HEIRS

Estate receives payment in full, in cash, at once. In case after case, we have contemplated the difficulties and disasters that have overtaken estates trying to salvage the true value of a proprietorship in the absence of a practical plan for the disposal of a business on the death of the owner. With a subsisting insured purchase and sale agreement, regardless of the vicissitudes of other estates, the proprietor's estate will receive the full going-concern value of his proprietorship immediately, in cash.

Proprietor's estate can be settled promptly and efficiently. In many of the cases, we have seen estates kept open for long periods of years because of the difficulties encountered in the disposal of a business. To review a few at random: In the Ennis case, the various creditors were litigating the proceeds of a closing-out sale six years after the death of proprietor Ennis; in the Conant case, the executor was being sued for an accounting of the continued funeral home thirteen years after proprietor Conant's death; in *Hewitt v. Beattie,* the personal representative was trying to liquidate the quarry holdings and close out the estate twenty-eight years after proprietor Beattie's death. However, if the proprietors had only arranged their affairs with more foresight, these difficulties could never have arisen. With an insured purchase and sale agreement, the proprietorship business is disposed of for its full value as soon as the transaction can be consummated; and when the proprietorship business has been made over to the purchasing employee for cash, the personal representative can administer the proprietor's estate efficiently, economically, and with dispatch.

Proprietor's widow relieved of business worries. A backward glance shows that the widow of the proprietor has often fared badly. It cost the widow of Moran over $1,000 of her own money to continue Moran's proprietorship for only one year. In the case of *Swaine v. Hemphill,* Mrs. Swaine's consent to continue her husband's malting business cost her approximately $1,700, besides the almost $6,000 of her own funds used to pay estate debts because of lack of cash. In the Ennis case, approximately $13,000 was lost when the widow allowed her son, Donald, to continue the business. In the case of *Miller v. Didisheim & Brother,* the widow of the proprietor Miller was apparently required to pay twice for certain debts incurred by the continued proprietorship. In the Onstad case, widow Onstad was fortunate that only one estate creditor refused to settle at seven cents on the dollar. And to go back to the year 1804, widow Ballman, in the case of *Ex parte Garland,* went bankrupt trying to carry on Ballman's proprietorship until his sons were able to take over.

How different the picture is for the proprietor's widow who is

protected under an insured purchase and sale agreement. She is entirely relieved of future responsibilities in connection with the business; she need not face the insuperable task of attempting to dispose of her husband's proprietorship for its full value, or, without proper training, to cope with highly competitive business operations. Under a pre-arranged plan, the proprietorship is disposed of for its full going-concern value in cash, which may be invested in securities suitable for the widow and children. For her, business burdens, worries, liabilities, and financial hazards have been eliminated.

BENEFITS DURING THE LIFETIME OF THE PROPRIETOR

The business is profitably stabilized. Although the primary objectives of an insured purchase and sale agreement are realized upon the death of the proprietor, very important advantages accrue from such an agreement during the proprietor's lifetime. The future of the proprietorship business having been assured, customers and clients will be more readily obtained and retained, which in turn tends to stabilize the business on a more permanent and profitable basis. Employees, knowing that the enterprise will not "fold up" on the death of the proprietor, will comprise a far more efficient and stable organization. If credit is necessary in the operation of the proprietorship, it will be more readily extended and probably on better terms because of the knowledge that the death of the proprietor will not bring about the termination of the business and the knowledge that the proprietor's estate will be paid fully in cash for the going value of the business. The purchasing employee, instead of continuously looking for better opportunities elsewhere, will redouble his efforts to help conduct the proprietorship successfully in order to enhance the value of his future business. The interplay of all these favorable factors cannot fail to earn added profits for the present proprietor.

Attractive savings medium provided purchasing employee. Each time the purchasing employee pays a premium for the insurance on the life of the proprietor, he has completed another advance instalment payment of the purchase price of the busi-

ness. To him, therefore, each premium represents a saving—a capital investment immediately put to work for him at compound interest. As a savings plan, it possesses many attractive features. Each amount saved is of a convenient size and is made regularly. Furthermore, the plan contains an element of compulsion, without which most savings plans are soon abandoned. The life insurance has a guaranteed cash value, commencing after a year or two and increasing in amount with each premium payment. And despite the fact that these values are available to the employee at once in the event of an emergency, in some of the states they receive the highest degree of legal protection against the claims of others. Thus the purchasing employee is furnished with a convenient, regular, efficient, legally protected savings program that is centered directly on the objective most vital to him—assuring his business future by making certain that the funds required to buy the enterprise will be fully saved at precisely the time they are needed.

Proprietor's burden of responsibilities lightened. Simultaneously with the execution of a purchase and sale agreement, there will spring up a new interest in the problems and opportunities of the proprietorship on the part of the purchasing employee because, from that day on, he will be vitally concerned with its success. This new interest not only removes the likelihood that the employee may some day leave and set up shop for himself in competition with the proprietor, it also makes the employee anxious to assume more and more of the responsibilities of the business. Thus the proprietor, as he grows older, is, without the necessity of taking in a partner and sharing the profits with him, able to "taper off" his business activities and find more time for the enjoyment of living. With an associate equally as interested in the future of the enterprise as he is himself, the proprietor's burden of responsibilities is bound to become lighter and his life more pleasurable with the passing years. Proprietors, like the rest of us, only live once; and this benefit of a purchase and sale agreement alone would justify a proprietor in searching out a person whom he could hire and train as a key employee if his organization now lacks such an individual.

CHAPTER 10

Contents of the Purchase and Sale Agreement with Life Insurance

INTRODUCTORY

Agreement must be drawn by a competent attorney. The insured purchase and sale plan by which one or more key employees of a proprietor will purchase the business on the death of the owner is comparatively simple. The plan is composed of two elements: (1) a written agreement in which the proprietor binds himself and his estate to sell the enterprise to the employee upon the proprietor's death, and in which the employee binds himself to buy such business upon the owner's death at the stipulated price and agrees to maintain life insurance on the life of the owner in an amount equal to the purchase price; and (2) life insurance policies procured in accordance with the terms of the agreement. Because the proprietor must rely on the agreement for the disposal of his business for its full value in cash upon his death and because the purchasing employee will be dependent upon it for his future business career, the instrument itself is of such great importance to both parties concerned that only a competent attorney should be entrusted with its drafting.

THE BROAD PATTERN OF THE AGREEMENT

Although no two agreements for the purchase and sale of a proprietorship are exactly alike, all such agreements follow similar patterns. The essential provisions are as follows:

1. A definite agreement as to the assets and liabilities that comprise the proprietorship business.

2. A definite commitment on the part of both parties in which the employee agrees to buy the proprietorship business upon the proprietor's prior death, and in which the proprietor, binding his estate, agrees to sell and transfer the business to the employee.

3. A definite agreement as to the purchase price to be paid for the business, including underlying provisions for the valuation of the business.

4. A definite commitment to purchase and to maintain, subject to the above agreement, life insurance on the life of the proprietor with which to finance the purchase, the proceeds of the policy to constitute the purchase money for the business when it is received by the proprietor's estate.

5. A definite stipulation as to the ownership and control of the life insurance policy that is made subject to the agreement, and as to the disposal of the policy should the proprietor outlive the purchasing party.

6. A definite commitment with respect to the time and manner of paying any balance of the purchase price in excess of the insurance proceeds, including, for the protection of the estate, security provisions covering the unpaid balance; and conversely, provisions with respect to the disposition of any insurance proceeds in excess of the purchase price.

7. A definite commitment that the buyer will assume all business debts and will save the proprietor's estate from harm from them — unless the purchase price is on a "gross" basis, that is, based upon the business assets without the business debts having been deducted.

8. A definite commitment that the purchasing employee is to continue in the employ of the proprietor so long as the latter carries on the proprietorship business, including an agreement as to the amount or measure of the employee's future compensation.

9. An agreement on the part of the proprietor to grant to the employee the necessary power of attorney to continue the business without interruption. This is advisable if the pro-

prietorship business is of such a nature that a temporary cessation of operations upon the proprietor's death would be injurious, and if a power coupled with an interest can be validly set up in the particular jurisdiction.

10. Provisions with respect to altering, amending, or terminating the agreement.

CONTENTS OF THE AGREEMENT

Since each proprietorship differs in some respects from every other, each insured purchase and sale agreement must be individually "tailored" by the attorney to fit the particular situation. This is accomplished by selecting, from a number of available arrangements, that arrangement most suitable to the situation at hand. A knowledge of the various alternative provisions is therefore necessary, and these will be discussed in the following analysis of the contents of such agreements.

The parties to the agreement. The necessary parties are the proprietor and the purchasing employee or employees. If there is one key employee of the desired caliber, purchase by him alone simplifies matters considerably and is to be recommended. In many instances it is found advisable to have a trustee as an impartial third party both to act as custodian and beneficiary of the life insurance policies during the lifetime of the proprietor and to supervise the carrying out of the purchase and sale upon his death. In community property states, the wife of the proprietor should also be a party to the agreement.

The purpose of the agreement. Any well-drawn agreement will contain recitals of its purpose as well as essential "background" information. For example, the agreement should identify the proprietorship, give the status of the purchasing employee, set forth the desire of the parties to sell and purchase the business upon the proprietor's death and to carry life insurance for that purpose, et cetera. Such recitals help clarify the intention of the parties and might resolve possible ambiguities in the main provisions of the agreement.

Description of the assets and liabilities of the proprietorship. New York's highest court stated as follows regarding proprietor

Noll, in *Matter of Noll,* 273 N. Y. 219: ". . . the estate consisted of everything the deceased owned—his business assets, his real estate or any other property. . . . The debts of the business were his own debts the same as were his living expenses." Since no legal distinction is made between proprietorship assets and liabilities and the other assets and liabilities of the proprietor, in drawing up the agreement it behooves the parties themselves to be particularly careful to describe or define exactly those assets and liabilities that are to constitute the subject matter of the agreement. Any uncertainty in this respect is bound to cause trouble.

The commitment to sell and buy. The agreement should state in precise language that, upon the prior death of the proprietor, his estate will sell, and the other party will buy, the proprietorship business.

The price to be paid, and valuation formula. Discussion of purchase of assets "gross." A choice of several possible provisions is available in designating the purchase price to be paid for the business. Preliminary to the agreement, however, the parties must decide whether the subject matter of the sale is to be the assets and good will of the business, or the assets and good will less the debts of the business. For example, a particular proprietorship may have assets and good will amounting to $35,000 and debts amounting to $10,000. If the employee purchases only the assets and good will, the purchase price should be $35,000, but if he buys the assets and good will less the liabilities, it should be $25,000. Under the first plan, the estate receives a gross amount of cash, including funds with which to pay off the business debts. Under the second plan, the purchasing employee receives a gross amount of property at a net purchase price for the business as a unit and he is required to assume and pay off the business debts. He must pay off promptly, for the business creditors are not likely to give up their right to be paid as estate creditors.

The first plan is preferable where it can be fully financed with life insurance. Upon the consummation of this plan, the deceased's estate will receive, over and above the net going-concern value of the business in cash, cash with which to discharge im-

mediately the business debts, for which it alone is liable. On his part, the purchasing employee will own the assets and good will of the business, unencumbered with the assumption of the proprietor's business debts. This result, as we shall see later in more detail, eliminates one of the more difficult problems in the purchase and sale arrangement, the problem of assuring the estate of the proprietor that the business debts will be paid. Because of this outstanding advantage, this plan is preferable, even in those situations where life insurance cannot be carried in an amount approximately equal to the value of the assets and good will of the business.

Whichever of the above plans is chosen, the agreement must state clearly the purchase price that is to be paid. Two methods for doing this are available.

The first method is to fix the exact purchase price in advance. The price agreed upon is stated in the agreement at the time it is executed, and there is an accompanying provision to the effect that the parties may revise the stated figure annually or more often by endorsing the revised purchase price upon the contract.

The advantages of this provision are:

(1) There can be no misunderstanding as to the amount of the purchase price.

(2) The proprietor, knowing exactly what his estate will receive, can plan for the welfare of his dependents with reasonable accuracy.

(3) The purchasing employee, knowing in advance the amount he will be required to pay for the business, is enabled to keep the purchase price fully insured.

(4) The terms of the agreement and the consummation of the transaction are much simplified.

In spite of these advantages, however, this provision is not well adapted to the average proprietorship. The need for revisions is rather frequent because of changes occurring in the value of the assets engaged in the enterprise or in its net worth. There is always the chance that these revisions may be neglected, and while neglect to keep the purchase price up-to-date would not impair the validity of the agreement, unless the amount

stated proved so inadequate as to work a transfer in fraud of creditors, still it would result in an unfair bargain. To eliminate this possibility in so far as possible, a further provision is sometimes included to the effect that the stated price will govern only in the event that the death of the proprietor occurs within one year from the time the last stated figure was agreed upon; in the event of a longer period the purchase price is to be fixed by an alternate method. This is accomplished either by taking the last agreed upon figure as a base and, on the findings of accountants or appraisers, adjusting it for whatever changes in value have taken place in the business from the time its value was last stated until the date of the proprietor's death; or by an entirely different method of valuation, such as the use of one of the formulae which will be discussed later.

A second and more fundamental disadvantage which militates against the use of the stated-value provision is the fact that it calls for a new meeting of the minds of the proprietor and the key employee upon a revised purchase price. With the self-interest of the key employee naturally favoring a low amount and the self-interest of the proprietor naturally favoring a high amount, there is too strong a likelihood that the provision would malfunction by generating future controversies. It must be realized that the natural self-interest of the parties to a proprietorship purchase and sale plan with respect to price is quite different from that of two or more partners or stockholders under a "two-way" purchase and sale agreement. Under the latter type of agreement, each partner or stockholder has a dual self-interest which tends to be neutralized: each stands to gain from a low price as a buyer if he should survive and to lose as a seller if he dies; and each stands to lose from a high price if he survives as a buyer and to gain as a seller if he dies. Accordingly, there is rarely any difficulty in coming to an agreement on a revised purchase price in the case of partners or stockholders; this provision works well with them. But this is not so in the case of a proprietor and key man; the following method seems better adapted to their "one-way" purchase and sale transaction.

The method recommended to proprietorships is the use of a valuation formula set forth in the agreement and to be applied

upon the death of the proprietor to ascertain the purchase price. If this method is used, care must be exercised, first, to select a formula that, when applied, will accurately reflect the value of the business, and second, to see that it is stated in the agreement in the clearest possible terms.

The simplest formula fixes the purchase price at the book value shown at the time of the proprietor's death, or as of the date of the last financial statement of the business taken off prior to his death. If the date of death is used, then the provision should specify who is to make the audit and appraisal. Often the provision will instruct the accountant as to the basis on which he is to value each of the various classes of property among the assets—e.g., raw materials are to be valued at whichever is the higher, the cost price or the market value. This formula, however, is inadequate in the case of a well-established business because it fails to include a value for good will. Usually the valuation of good will is provided for in the formula.

There appears to be no fixed rule for good will valuation. Sometimes the agreement stipulates that the value of good will is to be determined by certified public accountants who are experienced in the type of business enterprise involved. Frequently, however, such value is ascertained by the following process: The net earnings of the enterprise over a period of years are averaged; two items—a specified sum representing a reasonable compensation for the personal services of the proprietor, and a reasonable percentage of the book value, representing interest on the proprietor's capital—are subtracted from the averaged net earnings; and the resultant amount is multiplied by a stated figure such as 3, 4, or 5. The size of this last figure will depend largely upon the nature and stability of the business.

To illustrate this formula in action, let us assume that a proprietorship is found to have a book value of $60,000 and average annual net earnings over the last five years of $20,000. Let us assume further that the formula specifies a deduction of $12,000 as representing the proprietor's personal services, that a return of six per cent is to be credited to interest on book value, and that the net result is to be multiplied by 3. Six per cent of the

book value is $3,600, which, together with the item of $12,000 representing personal compensation, is subtracted from the $20,000 average annual earnings and the remainder, $4,400, is multiplied by 3. Thus, good will is valued at $13,200; and this figure, added to the $60,000 book value, results in a total valuation of the business at $73,200.

Perhaps a brief explanation should be made of the fact that a sum representing the personal compensation of the proprietor is deducted from the earnings of the business before such earnings are capitalized to arrive at the good will valuation. The reason for this deduction is closely analogous to the reason that justifies the deduction of a reasonable interest return on the book value. The book value represents capital which, if it were not employed in the proprietorship, could be invested elsewhere to produce income. It is therefore proper to pay this invested capital a suitable wage for the work that it does. Or to look at the matter in another light, if the proprietor did not have the capital represented by the book value, he would have to hire that amount and pay it wages in the form of interest to the lender, out of the earnings of the business. So it is also with the proprietor himself. If he were not self-employed, he could be working elsewhere at a salary, in which case he would have to hire another employee and pay him wages to do the work which he himself now performs. Therefore it is equally proper to credit him with a suitable wage out of the earnings before calculating the good will value of the business. In fact, it would be highly improper not to take this deduction in ascertaining this valuation, for his wage value obviously represents a value that cannot survive his death. Furthermore, the amount to be deducted should be large enough to include any good will value attributable to the proprietor personally, because this value is also lost on his death.

It is suggested that where the parties desire to use a formula to determine the purchase price they consult their accountants, who should be best qualified to recommend the particular formula that will most accurately determine the true value of the business.

Sometimes a provision is made specifying that the value of the

business at the proprietor's death is to be ascertained by a panel of three appraisers—often designated "arbitrators" or "arbiters," erroneously so since these words connote an existing dispute or controversy. One such appraiser is to be appointed by the proprietor's personal representative, another by the purchaser, and the third by the two already selected. Serious objections to this method are that delays may result because of the inability of the first two appraisers to agree on a third appointee and that a majority may not agree on a final value.

In each case, the parties should be apprised of the various methods for determining the purchase price and whichever method is, in their opinion, best suited to the situation, should be used.

Financing the purchase with life insurance. The agreement should contain a clause identifying the policies of life insurance made subject to it. It should state that the purpose of such insurance is to provide cash to be applied to the purchase price and that the proceeds when received by either the deceased proprietor's estate or heirs—whether received directly as named beneficiary or indirectly from the purchaser or his trustee—is to be credited to the purchaser as payment on account or in full, as the case may be, of the purchase price for the business. With such statements in the agreement, any danger that the estate or heirs will try to claim not only the insurance proceeds, but the value of the proprietorship as well, is removed.

Provision for adding, substituting, or withdrawing policies. Substantial changes in the value of the proprietorship may take place during the time the purchase and sale agreement is in force, in which event the amount of life insurance made subject to the value of the proprietorship should also be changed. Hence the agreement should provide for the addition, substitution, or withdrawal of policies by the joint action of the parties. Any changes in the composition of the insurance should be recorded in an appropriate schedule attached to the agreement and legally made a part of it.

Adjustment when amount of insurance proceeds differs from purchase price. Every agreement, except those few which provide that the amount of insurance proceeds payable shall con-

stitute ipso facto the amount of the purchase price, should contain provisions applicable if the insurance proceeds and the purchase price should differ in amount.

If the purchase price proves to be less than the insurance proceeds, it is usually provided that the purchase price will nevertheless be the amount of such proceeds. In other words, the amount of insurance proceeds is made the minimum purchase price. If the purchase price is to be ascertained by formula at time of death, an agreement that the amount of the insurance proceeds is the minimum purchase price has the important advantage of enabling the proprietor to know in advance the minimum amount his estate will receive for the business and of allowing him to plan his estate accordingly.

If the purchase price proves to be more than the insurance proceeds, the payment of the balance may be provided for in one of several ways. If such a balance is relatively small, the purchaser should be required to pay it in cash at the time the assets of the business are transferred to him. If the balance is relatively large, other arrangements must be made. For example, the balance may be provided for by a series of interest bearing notes, maturing over a period of time and secured by a mortgage on an appropriate part of the business property. In those cases where the balance is not much greater than an amount that the purchaser could raise in cash, this is probably the most feasible arrangement. If it is used, the recommendation is made that the notes be in stated equal amounts and be made payable at stated intervals, thus allowing the number of instalments, rather than the amount of the instalments, to vary with the size of the total balance owned. The parties usually know approximately the sum that can be paid periodically by the new proprietor without interfering with his successful continuation of the business, and the amount of the periodic payments can, by this provision, be set at a practicable figure. Of course, all such notes should be subject to prepayment at any time.

If it is anticipated that a substantially large balance of the purchase price will be owed by the purchaser, more elaborate provisions may be advisable in order to assure, on the one hand, that the estate of the proprietor will eventually receive the

money and, on the other hand, that the purchaser's credit standing will not be impaired beyond the point at which he could be expected to operate successfully.

One of such provisions would call for the formation of a limited partnership between the purchasing employee as general partner and the personal representative of the proprietor, or a person designated by the proprietor in his will, as the limited partner. (See pages 124 et seq. for brief description of a limited partnership.) Under such an arrangement, the unpaid balance of the purchase price constitutes the capital contribution of the limited partner. The partnership exists for a specified term of years or until the contribution of the limited partner is sooner retired. The general partner would be entitled to draw the same amount that he had received in salary as an employee of the proprietor, after which the net profits would be shared in proportion to the contributions of each partner. During the term of the partnership, however, the general partner should not be permitted to withdraw any of his share of the profits, and he should be required to pay to the limited partner out of such profits each year at least a pro rata part of the limited partner's original contribution. Thus, if the business continues to prosper, the contribution will be refunded out of profits, the limited partnership will be terminated and the purchasing employee will become the new proprietor at the end of the specified partnership term or sooner. For the protection of the estate, it can be further provided that, if in any year there are no profits beyond the general partner's amount of drawing in lieu of salary, he must nevertheless pay an amount equivalent to interest on the limited partner's contribution, and that, if the lack of profits persisted for a stated number of years, the limited partner has the right to demand dissolution and the termination of the partnership.

The foregoing plan is available only in those states that have statutes authorizing the formation of limited partnerships. In other states, the parties may include a provision requiring the formation of a close corporation in which the estate is to receive common or preferred stock—the latter would be logical—representing the amount of the unpaid balance of the purchase price

of the business. The details of such an arrangement can be worked out to provide for the gradual retirement of the shares of stock held by the estate or heirs in a manner similar to that outlined for the retirement of the contribution of the limited partner under that plan. It should be noted that under either plan, the estate is not liable for the debts created on the continuance of the business beyond the investment of the estate in the continued business.

Lest the foregoing résumé of the various arrangements that can be made to discharge the unpaid balance of the purchase price under an insured purchase and sale agreement appear to place undue emphasis on this problem, let us re-examine briefly the basic objectives of such an agreement. The ideal plan is one in which the full purchase price is insured, barring a possible insignificant discrepancy caused by a fluctuation in the value of the business. This is the plan that should be, and is, adopted in most instances. It is only in the exceptional case, therefore, that the parties must resort to one of the more elaborate arrangements sketched above. The parties should adopt the particular plan that will carry out their basic objectives immediately on death of the proprietor: the immediate sale of the business for cash "on the barrel head" paid to the proprietor's estate, and the full ownership of the business by the purchasing employee. Only a fully insured plan will attain these objectives promptly.

The payment of the insurance premiums. Ordinarily it is provided that the purchasing employee is obligated to pay the premiums for the insurance carried on the life of the proprietor, because it is the employee who will benefit from the insurance proceeds in payment for the business. These premium payments constitute advance instalment payments on account for the purchase price of the enterprise which the employee is to buy upon the death of the proprietor. A practical arrangement, and one that assures the proprietor that the insurance will be kept in good standing, is for the proprietor, upon proper authorization from the employee, to deduct the premiums from the employee's salary and himself to make the actual payments to the insurance company.

Occasionally, a situation will exist where an employee, other-

wise a logical party to such an agreement, does not receive an income sufficient to enable him to pay the required premiums. In such event, there are several possibilities. In view of the great benefits that the proprietor and his heirs will receive from the purchase and sale agreement and in view of the increased value of the purchasing employee to the proprietor because of such an arrangement, the best plan is to increase the salary of the employee at least enough so that he can afford to assume the premium obligation. After all, if his services are not sufficiently valuable to warrant paying him enough so that he can pay these premiums, then the entire plan is probably premature and might better be deferred until a better qualified employee is found.

An alternative to the salary increase is for the proprietor himself to assume part of the premium payments. In view of the proprietor's comparative income tax status, however, this is unwise; the proprietor can deduct a salary increase as a business expense, but premium payments made by him would not be deductible. And it has also been suggested in such a situation that the proprietor advance money for the premiums, in which case this is, of course, added to the purchase price at the proprietor's death. However, such a procedure would in most cases cast too heavy a burden of unpaid balance to be carried by the caliber of employee necessarily involved in such an expedient. Another expedient is the setting up of a partially insured plan, by which the employee carries whatever sum of insurance on the proprietor's life he is able to finance. But here again the problem of a large unpaid balance of the purchase price usually must be met, and unless it can be solved satisfactorily, the inauguration of the agreement should be postponed.

Control of the insurance policies. The agreement should specify who is to have the ownership rights in the insurance policies during the lifetime of the proprietor. Logically, the purchasing employee is the owner, unless a trustee is made a party to the agreement and the other parties prefer to have ownership vested in the trustee. If the proprietor is advancing or sharing in the premium payments, then he may be a joint

owner with the employee, unless, again, a trustee is preferred. In any event, the agreement should prohibit the exercise of the rights of ownership in derogation of the agreement without the prior consent of (or notice to) the proprietor.

The insurance beneficiary arrangements. The trust plan. The agreement should also contain a clause stating who is to be beneficiary of the insurance policy or policies. Here again, there is a choice of several arrangements.

If the proprietor and the purchasing employee decide to have a third party to the agreement as trustee, the trustee (preferably a trust company) is usually named as insurance beneficiary. In such case, the purchase and sale agreement is drawn as a trust indenture, the provisions of which follow the form of the general purchase and sale contract, modified and supplemented by the desired trust provisions. These specify that the trustee be made beneficiary of the insurance and custodian of the policies. It is recommended that the ownership rights in the policies also be given to the trustee, with the terms of the agreement outlining the conditions under which he may exercise these rights. However, other agreements provide that ownership be retained by the parties jointly or by the purchasing employee. The trustee is not concerned with the payment of premiums, and therefore the arrangement for their payment is not changed by the adoption of a trust plan.

Upon the death of the proprietor, the trustee collects the insurance proceeds and supervises the consummation of the purchase and sale of the business. If a valuation formula is used to ascertain the purchase price, the trustee sees that it is properly applied. Upon fixing the purchase price, the trustee, after deducting his fee, delivers the purchase money to the proprietor's estate and disposes of any excess insurance proceeds as provided in the agreement. If, however, there is a balance due on the purchase price, the trustee will facilitate the carrying out of the note arrangement to cover the deficiency or of whatever other provisions are called for by the agreement. If releases are required by the estate from the business creditors, the trustee cooperates in their procurement. Simultaneously with the payment of the purchase price, the trustee requires the delivery

to it, from the personal representative of the estate, of the necessary documents in the form of deeds, assignments, and bills of sale transferring the assets of the proprietorship to the purchasing employee.

This brief sketch of the workings of the trust arrangement illustrates its advantages to the parties. The trustee, a responsible, experienced and disinterested third party, functions smoothly and efficiently to consummate the transaction. The trust arrangement is to be preferred over all others.

The insurance beneficiary arrangements without a trustee. If the parties to the agreement decide against using the trust plan, either because the amount involved is comparatively small or for other reasons, there remain various other beneficiary arrangements they may select.

Among these, the most logical is to designate the purchasing employee as insurance beneficiary. In this arrangement not only is the insurance money paid to the person who has created the fund by the payment of premiums, but also the relationship is equilibrated between the purchasing employee and the deceased proprietor's estate upon the latter's death. The purchasing employee, obligated to buy and pay the purchase price for the proprietorship, holds title to the insurance proceeds. The proprietor's personal representative, obligated to sell and transfer the deceased proprietor's business, holds title to the assets of that business. Each party to the transaction holds something that he is obligated to exchange for something of equal value held by the other. And each is in immediate need of what the other holds; the executor is in need of cash, and certainly the surviving employee is in need of title to the business assets. It is therefore to be expected that the plan will function smoothly.

The agreement can also provide for the designation of the proprietor's estate as insurance beneficiary, although this is not recommended. If this is specified, the agreement must also contain a clear and positive statement to the effect that the insurance proceeds received by the estate are to be credited to the employee as purchase money for the proprietorship business. Any looseness of the agreement in this respect provides possi-

bility that the estate may contend itself entitled not only to the insurance proceeds but to the full value of the proprietorship as well. Furthermore, such a beneficiary designation creates an imbalance between the purchasing employee and the estate of the proprietor at the time of death for the obvious reason that the estate then holds both the insurance money and the title to the business assets. This imbalance would reach an irrational extreme unless the agreement also provided that the insurance proceeds were to constitute the minimum purchase price. Although a reasonably balanced situation is not essential because the courts stand ready, if necessary, to enforce the agreement specifically, nevertheless it is wise, as a deterrent to recalcitrance on the part of either side, to arrange for the meeting of the purchasing employee and the proprietor's personal representative on an equal footing to conclude the transaction.

There are at least three other objections to designating the proprietor's estate as beneficiary. First, both the insurance proceeds and the assets of the business are exposed to the claims of creditors of the proprietor's estate. Even though the rights of such creditors are ultimately limited to the insurance proceeds, nevertheless such a one-sided situation might well afford opportunities for interference and might delay the consummation of the purchase and sale. Second, the designation subjects the insurance proceeds to estate taxation. Although the decisions have not permitted taxation both of the value of the business interest being purchased and of the proceeds of insurance constituting purchase-price money for it, yet the placing of the insurance in a taxable status by making it payable to the insured's estate affords the possibility of a controversy on this point. (See discussion of *Estate of John T. Mitchell v. Commissioner,* page 411 of the Book on Corporations.) Third, it creates serious doubt whether the insurance proceeds will be included in the purchasing employee's cost basis for income tax purposes of the assets acquired from the deceased proprietor. (See discussion of *Legallet v. Commissioner,* page 243 et seq. of the Book on Partnerships.)

Occasionally, a proprietor desires to designate that his personal beneficiaries receive the proceeds, in order to take ad-

vantage of the instalment settlement options in the policies and to coordinate such insurance proceeds with the proceeds of his personal insurance. Such a designation is possible, but ordinarily it is not recommended. The obstacles in the way of such a designation and the various arrangements that have been devised to get around them are discussed at some length in dealing with insurance made subject to partnership purchase and sale agreements (see page 243 et seq. of the Book on Partnerships). Because the problems and their solutions remain the same in principle whether the subject matter of the agreement is a partnership interest or a proprietorship business, and because it is believed that the reader will encounter no difficulty in adapting the partnership material to a proprietorship situation, discussion of this type of beneficiary designation is omitted here to avoid repetition.

Disposition of insurance if proprietor outlives key man. Key man insurance also suggested. Normally, the key employee who becomes a party to the agreement is considerably younger than the proprietor, and will survive him to consummate the transaction of purchase and sale as planned. Regardless of the comparative ages of the parties, however, instances occur—and the possibility is always present—in which the key employee dies first. In such event, the agreement is automatically terminated; and it should be provided that the proprietor have an option of perhaps sixty days during which time he may elect to purchase the insurance on his life from the estate of the deceased employee at its then cash value. If the proprietor is at that time uninsurable, or if the policies contain more attractive provisions than those being incorporated in current policies, this will prove to be a very valuable option. Furthermore, with the purchase and sale agreement terminated, and assuming that it is not then feasible to set up another such agreement with another employee, the proprietor is well advised to increase his insurance by the amount of shrinkage that he may expect his estate to suffer in liquidating the business upon his death. This he will then be able to do, whether he is insurable or not, if he is given an option to take over the insurance made subject to the agreement.

A far better plan exists, however, by means of which the proprietor, in case the purchase and sale arrangement falls through because of the prior death of the purchasing employee, can hedge against the shrinkage of the business upon its liquidation at his own death. This plan consists of having the proprietor procure, concurrently with the setting up of the purchase and sale agreement, a key man insurance policy on the life of the purchasing employee in an amount at least equal to the probable shrinkage that would occur in the value of the business on eventual liquidation if the employee dies first. The proprietor would purchase, own, pay the premiums on, and be beneficiary of such insurance, which could be made subject to the purchase and sale agreement to the extent of providing that, on the proprietor's prior death, the policy be maintained by the purchasing employee as collateral for any balance of the purchase price still owed by the employee. Such a policy will prove invaluable to the proprietor if the purchasing employee dies first; it will protect both the proprietor's estate and the purchasing employee if the proprietor dies first and there is a balance of purchase money owed to his estate.

In agreements involving two purchasing employees, it may be provided that, should one of them die during the proprietor's lifetime, the remaining purchasing employee will assume the obligations of the deceased employee and will carry through the agreement. In such event, the surviving purchasing employee obtains additional insurance on the life of the proprietor to cover his added obligations, and the insurance carried on the proprietor by the deceased employee is surrendered by his estate unless, within a specified period, the remaining purchasing employee or the proprietor elects to take over such insurance at its then cash value. The remaining purchasing employee would not be interested in taking over this insurance for value, unless the proprietor were then uninsurable, because he would hold such insurance as a transferee for value, a status that subjects part of the death proceeds to income taxation. Such proceeds, however, are not subject to income tax at his death if the proprietor himself takes over the insurance, and he might well be interested in doing this for the reasons already noted.

Provisions relating to the proprietor's business debts. Alternative of selling assets "gross" recommended. Upon the death of the proprietor, his personal representative is held accountable as a fiduciary for the assets of the estate; first, to collect and conserve such assets and see that they are applied so far as necessary to the payment of all the just debts of the proprietor, whether "business" or "personal," and second, to see that the remaining property of the estate is distributed to those entitled to it. With the above status in mind, let us see what can be done with the outstanding business debts under the purchase and sale agreement.

There are two possibilities, and the choice between them is actually made when the parties decide whether the subject matter of the sale is to be the assets and good will of the business, or the assets and good will less the debts of the business. If the assets are sold "gross" to the purchasing employee on the proprietor's death, then no provision need be made in the agreement with reference to the payment of the business debts; they will be paid by the personal representative along with the other debts in the regular course of administration of the estate. If, on the other hand, the business is sold "net," the agreement must contain a provision requiring the purchasing employee to assume and pay off the business debts. Such employee should also be required to give the estate assurances, in the form of suitable releases running to the estate from such business creditors as remain unpaid upon the transfer of the business, or in some other form, to satisfy the personal representative that he will not be called upon to pay such debts. Since the giving of releases to the estate rests with the creditors involved, further provisions should be included to the effect that if the personal representative is not assured to his satisfaction that such business debts will be paid without recourse back to him, he has the right to nullify the sale of the business and to liquidate it.

It is submitted that the plan of selling the business "gross" will in most cases prove more satisfactory to all concerned. To illustrate, we shall reconsider the previous example (page 94) of a proprietorship with total assets and good will of $35,000 and total liabilities of $10,000. If the proprietorship is pur-

chased on a "net" basis, the employee is required to maintain $25,000 of life insurance on the life of the proprietor to pay the purchase price in full upon his death, but he will also have to assume $10,000 in business debts. Moreover, if the estate cannot obtain proper assurances that these debts will be paid without liability on the part of the personal representative, then, to protect himself, the representative will call off the deal. If, on the other hand, the proprietorship assets and good will are purchased for $35,000 and the employee maintains $25,000 of life insurance as before, the purchasing employee will not assume the $10,000 of business debts but instead, he will owe $10,000 balance of purchase price, payable in installments previously agreed upon and in amounts calculated to be reasonably within his financial ability; and the transaction is not subject to nullification on the part of the proprietor's personal representative. Obviously, the purchasing employee will be better suited by this plan. The personal representative, under such an arrangement, will receive immediately $25,000 in cash, out of which he can promptly discharge all business debts and any other obligations owed by the estate, and the estate will receive $10,000 additional in regular instalments from the purchasing employee. It appears certain that the estate, too, will be better suited by this plan. Now, if under the gross purchase plan $35,000 of life insurance is maintained (approximately $300 of additional annual premiums maintains the extra $10,000 if the proprietor is age 43), this becomes the ideal plan. On the death of the proprietor, the purchasing employee will take over business assets worth $35,000, with the full purchase price paid and with no debts assumed. The personal representative will consummate the sale of the business assets and good will for their going-concern value in cash and will be in an excellent position to carry out promptly and efficiently his duties of paying off the debts of the estate and of distributing the residue to the heirs. Every effort should be made to set up such a plan. It completely solves the problem of the continuation of a proprietorship business, in a manner satisfactory alike to the proprietor and to the purchasing employee.

Provisions relating to purchasing employee's continued employment. The purchase and sale agreement should contain a provision to the effect that the purchasing employee is to continue in the employ of the proprietor at a stipulated rate of compensation and is to devote his time exclusively to the business, without liability to be discharged except for unfaithfulness or patent incompetency, so long as the proprietor lives and conducts the proprietorship. Since the problem of arriving at a satisfactory rate of compensation for services running indefinitely into the future is none too easily solved, some suggestions may be made. It is readily apparent that an agreement to continue the employee at his present salary is unsuitable. Over a period of years there may well take place a gradual increase in the general price level, in which event a set salary actually represents a gradual decrease in buying power. Furthermore, as time goes on, the employee, with his increased knowledge and experience in the business, will deserve more money. At the other extreme, a set schedule of salary increases projecting into the future will seldom meet with the approval of the proprietor. In the great majority of cases, probably the fairest and hence the most suitable scheme is to perpetuate an adequate basic salary, supplemented with an agreed share of the profits of the business after the proprietor has taken out a specified suitable amount for himself in lieu of salary. The purchasing employee's share of the profits could be made a flat percentage, such as 20 per cent or 25 per cent, or it could be based on a schedule of increasing the percentages as the amount of the profits increases. If, as it is recommended, the plan of a basic salary plus a share of the profits is provided for in the agreement, there should also be included an accompanying statement that this limited sharing of profits does not change the status of the purchasing employee from one of employee to that of partner.

Possible provisions for uninterrupted continuance upon the proprietor's death. If, under the circumstances, a power coupled with an interest can be validly set up in the particular jurisdiction, the agreement should provide that upon the death of the proprietor, the purchasing employee shall immediately take

possession of the proprietorship business and continue its operations pending consummation of the transaction of purchase and sale. Where this can be done, an effective way to implement such a provision is for the proprietor to execute, collateral to and simultaneously with the purchase agreement, a broad power of attorney. This power of attorney should be drawn in such fashion that it gives the purchasing employee the power to conduct the business during the proprietor's lifetime if it is supplemented with the proprietor's current consent (this power may be useful on occasion), and the consent would not be revoked upon the occurrence of the proprietor's death but would give the employee the power to continue the business in full operation as a going concern. However, the personal representative of the proprietor should have the right to revoke such power; this he would do upon the consummation of the transaction or upon its failure to go through. With such a power, those doing business with the proprietorship need not hesitate to continue their dealings as usual; without it, they might be unwilling to transact further business until the proprietor's will had been probated, and then only with the personal representative.

Provisions for amending, revoking, or terminating the agreement. The agreement should provide that the individual parties jointly have the right at any time to amend or revoke it. The agreement should further provide that it shall be terminated upon the occurrence of any one of certain specified events —for example: the bankruptcy of either party; the total disability of the purchasing employee, or his discharge, pursuant to the terms of the agreement; the death of the purchasing employee any time prior to the consummation of the transaction; the lapse of the life insurance subject to the agreement; or the sale or liquidation of the business by the proprietor. Should the last enumerated event occur, the agreement might well provide that the purchasing employee will share in any profit realized from the disposal of the business. This would recompense the employee in some measure for the loss of his opportunity to own the business eventually.

Provision binding heirs. The agreement should be made

binding specifically upon the heirs of the proprietor. If such a statement is included for all heirs to see, no misunderstanding will develop on this point.

The foregoing discussion has encompassed the principal provisions required in a proprietorship purchase and sale agreement. Since the document is of immense importance to all parties concerned, it should be carefully "tailored" to fit the individual case by the attorney of their choice.

CHAPTER 11

Tax Problems Involved in the Proprietorship Insured Purchase and Sale Agreement

THE FEDERAL INCOME TAX

The life insurance premiums not deductible expense. The premiums paid for life insurance subject to the purchase and sale agreement do not constitute a deductible business expense by the premium payer.

Of course, arrangements are often made whereby the purchasing employee authorizes the proprietor to pay the insurance premiums as they become due and to charge them to the employee's salary account. In these cases the premiums paid by the proprietor are not deductible by him *as premiums* but are deductible by him *as salary* paid out. The employee, the real premium payer, is entitled to no deduction for them.

The life insurance proceeds not taxable income. As a concomitant to the general rule above that life insurance premiums are not deductible, the Internal Revenue Code (Section 101) provides, except in the case of certain policies that have been transferred for value, for the exclusion from taxable income of the face amount received under a life insurance contract paid by reason of the death of the insured.

The sale of the proprietorship by the estate. Section 1014 of the Code provides that the basis for income tax purposes of property acquired by the decedent's estate from the decedent shall be the fair market value of such property at the time of

death, or on the optional valuation date, if that method of valuation is elected for federal estate tax purposes. If a purchase and sale agreement is in effect, the fair market value of the proprietorship property at death, or on the optional valuation date, obviously should be the price to be paid under the agreement. Therefore, when the transaction is consummated by the executor or administrator at such price, no gain or loss should result to the estate on the sale of the capital assets.

Uncollected accounts receivable of the proprietor, however, are rights to income in respect of a decedent and do not receive a new basis at the proprietor's death. Therefore, if such accounts are sold by the estate the amount received over unrecovered cost will constitute ordinary income to the estate *(Dixon, Executor v. U. S.,* 96 Fed. Supp. 986, affirmed 192 Fed. 2d 82.)

The cost basis of proprietorship assets acquired by the purchasing employee. The cost basis of the assets of the proprietorship taken over by the purchasing employee should be the price he has paid for them. In this respect no material difference results whether the proprietorship assets and good will are bought "gross," without assuming the business debts (see page 94 *et seq.*), or are bought "net," assuming such debts. If the assets and good will are purchased "gross," the amount paid to the deceased proprietor's estate constitutes the cost basis. If the assets and good will are purchased "net," the amount paid to the deceased proprietor's estate, plus the amount paid in discharge of the debts assumed, constitutes the basis. *(Athol Mfg. Co. v. Commissioner,* 54 Fed. 2d 230; *Johnson Motor Co. v. U. S.,* 6 Fed. Supp. 122.) A moment's reflection shows that in either case the basis is substantially the same total figure. This total is then allocated among the various classes of business assets taken over and forms the basis for determining taxable gain or loss as each asset is disposed of later.

The amount that the purchasing employee has paid for the proprietorship will be the purchase price in cases where the employee receives the insurance proceeds as beneficiary and turns the money over to the deceased's personal representative upon consummation of the transaction. The insurance proceeds, together with any remainder of the purchase price paid in instal-

ment notes, also constitutes the cost basis of the acquired property if the insurance proceeds are received by a trustee beneficiary and are paid over by it to the personal representative; in so receiving and paying out the insurance money the trustee is acting for the employee. Furthermore, the funds reach the proprietor's estate, not as insurance proceeds, but as purchase-price money in fact.

If, however, the insurance proceeds are made payable directly to the proprietor's estate or to his personal beneficiaries, there is grave doubt that such proceeds may be included in the cost basis of the proprietorship assets acquired. (*Legallet v. Commissioner,* 41 B. T. A. 294. See discussion of this case at page 243 et seq. of the Book on Partnerships.) Such insurance should be included in the cost basis if the premiums have been paid by the employee; but there has been no clear holding to that effect and an optimistic reading of the Lagallet case is required to predict such a result from that opinion.

THE FEDERAL ESTATE TAX

Method of applying the tax. Because the Estate Tax Law specifically states the circumstances under which life insurance proceeds are included or excluded from the taxable estate of the insured, the current approach to the application of the estate tax is to ascertain first the tax status of these proceeds. If it is found that the insurance occupies a nontaxable position, then the proprietorship business is generally taxed at the value set forth in the purchase and sale agreement. This will be the case if the insurance is purchased, owned and paid for by the purchasing employee and if he or a trustee acting for him is the death beneficiary. If, on the other hand, it is found that the insurance is arranged in such a manner that it comes within the taxable provisions of the law, then the insurance proceeds are included in the taxable estate of the proprietor and the value of the proprietorship is excluded from tax to the extent that such value is represented by the taxable insurance. This will be the case, for example, if the insurance is made payable directly to the proprietor's estate. The net result in the cases where the

insurance proceeds occupy a taxable status is that the total measure of taxability involved in the transaction is the total of the insurance proceeds or the total value of the proprietorship, whichever is the greater.

The insured purchase plan should establish value of business for Federal Estate Tax. Numerous decisions have established the rule that when a business is to be sold upon the owner's death pursuant to a binding purchase and sale agreement, the value that has been stipulated as the purchase price will govern for estate tax purposes provided that the price, at the time agreed upon, fairly represented the value of the business being sold and the business must be offered at no greater price upon disposal during life. (See cases at pages 416 et seq. of Corporations.)

This rule should be of great benefit to the deceased proprietor's estate. In the absence of an agreement, the ascertainment of the value of a business is an extremely difficult task. The Federal estate tax return calls for statements of earnings and of assets and liabilities for the previous five years and states that "Good will must be accounted for." From this it is readily apparent that much bothersome detail and uncertainty as to the ultimate valuation of the business is encountered if no purchase and sale agreement exists, all of which adds to the time and expense of settlement of the proprietor's estate.

With a purchase and sale agreement, entered into fairly, the proprietor gains the definite advantage, in addition to his having the proprietorship disposed of for its full value in cash, of being able to predict his estate taxes in advance. Having this knowledge at hand, he can complete his estate plans with a degree of precision unknown to the proprietor who, without an insured purchase and sale agreement, must leave a heritage of liquidation losses, delays and confusion.

Book II

PARTNERSHIPS

Part I

FUNDAMENTAL FACTS ABOUT PARTNERSHIPS

CHAPTER 1

General Information About Partnerships

A KNOWLEDGE OF THE FUNDAMENTAL NATURE of a partnership is prerequisite to an understanding of the problems involved in arriving at the most satisfactory plan for the continuation of the partnership business on the death of a partner. We should know what a partnership is, how it is formed, and the common types of partnerships that are entered into.

WHAT A PARTNERSHIP IS

Partnership defined. The Uniform Partnership Act, of which more will be said later, contains the following concise definition: "A partnership is an association of two or more persons to carry on as co-owners a business for profit." Bates, one of the outstanding authorities on partnership law, says, "A partnership is the contract relation subsisting between persons who have combined their property, labor or skill in an enterprise or business as principals for the purpose of joint profit." Mechem, another outstanding authority in this field, states that "A partnership may be tentatively defined as a legal relation,

based upon the express or implied agreement of two or more competent persons whereby they unite their property, labor or skill in carrying on some lawful business as principals for their joint profit."

From these very similar definitions it can be seen that the main characteristics of a partnership are:

1. It is an unincorporated association (as distinguished from a corporation).
2. It is created by the voluntary contract of the parties (as distinguished from a corporation, which is created by law).
3. Its formation requires two or more competent parties.
4. Its capital is constituted by means of contributions from each member of property, labor or skill.
5. Its purpose is to carry on a business for the pecuniary gain of the members (as distinguished from charitable, educational, religious, social or other similar purposes).
6. Its business is transacted by the parties as principals, each of whom is a co-owner.

With these basic distinctions in mind no difficulty should be encountered in recognizing the ordinary partnership relation where it exists. Although difficult questions occasionally arise as to whether or not a partnership relation has been entered into, such situations will be left to those immediately concerned and to their lawyers. Our concern here is for the preservation of businesses conducted by persons who clearly recognize their own partnership relation, and who, therefore, have a continuing solicitude for the future welfare of their enterprises.

HOW PARTNERSHIPS ARE FORMED

A partnership is created only by means of a contract between the persons thereby associated as partners. This contract may be oral or written. When the agreement is in writing, which is always advisable, the instrument is usually known as the "Articles of Partnership." However, a startling number of firms are found to be operating with nothing more than loose oral understandings between their members as the basis of their joint business enterprise. Such oral agreements come within the Statute

of Frauds, as a contract to be continued beyond one year, the effect of which is to convert the operating partnership to one at will wherein at any time a partner may bring an action in equity to call his copartner to account. (*Sanger v. French,* 157 N. Y. 213, 51 N.E. 979.) Furthermore, much is left to implication, and it is only because of the close personal relationship of trust and confidence that exists among the partners that misunderstandings about their arrangements are comparatively infrequent. Obviously, it is good legal "housekeeping" and good common sense for a partnership to operate under written articles, and partners should be urged to have their attorneys reduce such agreements to writing if this has not been done.

The Articles of Partnership set forth the agreement of the partners with respect to the formation, conduct and termination of the firm. This contract should cover at least the following essential points: names of the partners; partnership name; business to be conducted; place of business and capital; capital contribution of each partner; his share of the profits and losses; his special duties, if any, and any salary or drawing account arrangements; provision for keeping books, and for periodic inventories and accountings; any restrictions of the authority of the partners; provision for settling differences among the partners; the duration of the partnership; and any special provisions operative upon dissolution, unless contained in a collateral agreement.

THE TWO FUNDAMENTAL TYPES OF PARTNERSHIPS

The general partnership. The ordinary type of partnership, in which each partner devotes his entire time to the furtherance of the firm's business, is known as a general partnership. This is the most common form, and is typified by the fact that each partner has full authority to act for the firm within the regular scope of the business and by the fact that each partner is fully liable for the obligations of the partnership. The rights and liabilities of partners in a general partnership are more fully discussed in the two chapters immediately following.

The limited partnership. The second fundamental type of partnership is known as the limited partnership. This type, being unknown to the common law, can be organized only when permitted by special statute. A majority of the states, however, have enacted such statutes, many of them adopting, with local variations, the Uniform Limited Partnership Act. This is a model Act prepared some years ago by the Commissioners on Uniform State Laws and recommended to the states for enactment.

This model statute defines a limited partnership as "a partnership formed by two or more persons under the provisions of Section 2, having as members one or more general partners and one or more limited partners. The limited partners as such shall not be bound by the obligations of the partnership." That is its first characteristic. The second characteristic of this form of partnership is that it requires two kinds of partners, general and limited. The general partners conduct the business of the firm, and in so doing they act for themselves as principals and for the other partners as general agents, assuming unlimited liability for the firm's obligations. Thus, their rights and liabilities correspond to those of ordinary partners in a general partnership.

The rights and liabilities of the limited partners, however, must be sharply distinguished from those of the general partners in the limited partnership. A limited partner (often referred to as a special partner), has the right to full information about the affairs of the partnership and to an accounting, but he takes no part in the management of the business. His surname may not appear in the partnership name unless it is also the surname of a general partner or unless it was a part of the partnership name before he became a limited partner. He contributes a specified amount of capital to the enterprise, and unless he exceeds his restricted sphere as a limited partner, his liability for the obligations of the partnership is limited to the amount he has contributed. His contribution cannot be withdrawn, however, until all of the demands against the firm, except those of the partners themselves, have been satisfied. He is entitled to his specified share of the profits, and it is im-

portant to note that upon a dissolution, his share of the profits and his contribution have priority over all funds going to the general partners.

The limited partner's interest is personal property and is assignable. If assigned, the assignee may become a substituted limited partner with the consent of the other partners. If the assignee does not become a substituted limited partner, he has neither the right to information about the affairs of the partnership nor access to the books and records. He is entitled merely to his share of the profits, and, upon dissolution, to the assignor's contribution. On the death of a limited partner, his executor or administrator has all the rights of a limited partner for the purpose of settling the estate, including, of course, the power to assign the limited partnership interest of the decedent. *Thus it is of great significance that the death of a limited partner (as contrasted to that of a general partner), does not dissolve the limited partnership.*

Curiously enough, the statute also provides that one person may be both a general partner and a limited partner in the same partnership at the same time. A person occupying this dual role has the status of a general partner, except that in respect of his contribution he has the rights of a limited partner against the other partners. Therefore, as a general partner, his death automatically dissolves the partnership; but as a limited partner, his estate is entitled to the repayment of his contribution ahead of all distributions to the general partners.

The third outstanding characteristic of a limited partnership is the statutory requirement that a sworn certificate be filed for record in a public office setting forth details as to the name and term of the partnership, the character and location of the business, the names and residences of each of the partners and his designation as general or limited partner, the amount of capital contributed by each limited partner, his share of the profits, and other appropriate data of a similar nature. The statute usually requires also that a copy of the certificate or a notice containing its substance be published in local newspapers for a period of weeks.

The subject of limited partnerships has been dealt with at

some length here for the reason that it will not again be discussed in detail. Limited partnerships are numerically few as compared with ordinary or general partnerships, and the problems involved on the death of a general partner in a limited partnership are so similar in nature to those involved on the death of a partner in an ordinary partnership that separate treatment would be largely repetitious. Before leaving the subject, however, one point should be emphasized. On the death of a general partner in a limited partnership, the surviving general partners occupy a less favorable position than would be the case had they been partners in an ordinary partnership. In either case, the partnership is automatically dissolved, and unless alternative measures have been set up in advance or can be quickly improvised, the affairs of the enterprise must be wound up promptly and the deceased partner's share of the remaining assets must be paid over to his executor or administrator. When this winding-up process (which is discussed in detail later) has been completed in the ordinary partnership, the surviving partners and the estate of the deceased partner share the remaining assets without precedence. But in a limited partnership the assets remaining after the firm has been liquidated and the creditors of the business satisfied, are first used to pay the limited partners their profits and to return their contributions. Last in line come the general partners and the personal representative of the deceased general partner, who divide what remains. The general partners in a limited partnership, therefore, have an even greater need for a solution of the problems brought about by the death of a general partner than is the case when a death occurs in an ordinary partnership. This should be kept in mind as these problems and their solution with respect to the ordinary partnership are developed in subsequent chapters.

CHAPTER 2

Property Rights in a Partnership

THE PRIVATE OWNERSHIP OF PROPERTY, ONE OF the fundamental institutions of our free society, forms the basis and constitutes the subject matter of almost all business transactions. This property ownership has assumed many different patterns to suit the varied and ever changing needs of commerce, each form of business organization requiring for its efficient functioning its own particular kinds of property rights. For example, the development of the corporation brought with it the ownership of assets by a distinct legal entity, the corporation itself, and created the special type of ownership evidenced by the stock certificate. Another example, and the one with which we are immediately concerned, is that of the partnership. The evolution of the partnership method of conducting business has been accompanied also by the development of its particular pattern of property rights, including such novel types of ownership as the partnership interest and the tenancy in partnership. A working knowledge of all of these partnership rights is necessary to a clear understanding of the true nature of a partnership.

The principles set forth in this chapter are based on the Uniform Partnership Act. This is a model statute drafted in 1914 by Professor William Draper Lewis under the auspices of the National Conference of Commissioners on Uniform State Laws. Its adoption, with various minor changes to suit local conditions, in more than half of the states, comprising over 60 per cent of the population of the United States, has brought about a gratifying standardization of partnership law in these

jurisdictions. In large measure this statute is a codification of the common law, although new rules were made in certain particulars, notably in respect of the real property owned by a partnership.

ASSETS OF THE PARTNERSHIP

The corner grocer is the firm of King & Gay. Who is it that owns that can of beans on the shelf? Probably the wholesaler sold it to the partnership as such. Therefore, title is in the partnership itself, which fact of ownership is both legally possible and customary. Mr. King and Mr. Gay jointly own the beans as "tenants in partnership." As such a co-owner each has an equal right to possession, but only for partnership purposes. Neither can alone assign his individual share of ownership. Only a creditor of the firm can attach his individual ownership rights. If Mr. King dies first, his ownership in the beans and in all other specific property of the partnership automatically goes to Mr. Gay, who then owns all of the assets of the firm as a liquidating trustee. This includes any real property, the title to which was vested in the partnership and which, under the Uniform Partnership Act, is not subject to dower rights. (In those jurisdictions where partnerships are subject to the common law, the rule is that dower, *et cetera,* attaches to the deceased's share of the firm realty on dissolution after the firm creditors are satisfied.)

THE PARTNERSHIP INTEREST OF EACH PARTNER

In addition to, and distinguished from, his property rights in specific partnership assets, each partner owns what is known as his "partnership interest." This consists of his share of the profits and surplus, and is intangible personal property. A short digression for a moment into the field of inheritance taxation will serve to illustrate the nature of this property right.

In the United States Supreme Court case of *Blodgett v. Silberman,* 277 U. S. 1 (1928), Robert B. Hirsch was a general partner in the firm William Openhym & Sons, organized and doing business in New York under the New York Limited Partnership Act. Among the assets of the firm were land, buildings and

other tangible property located in New York and in Connecticut. Hirsch died a resident of Stamford, Connecticut. His will was probated in New York, the Federal and New York Estate taxes were paid, and then the will was probated in Connecticut. Blodgett, Connecticut Tax Commissioner, included in the Connecticut inheritance tax computation the value of Hirsch's partnership interest of approximately $1,700,000 on the principle that this interest was intangible personal property and hence, under well established rules of law, had as its situs for taxation the domicile of the owner. Silberman, Hirsch's executor, unsuccessfully challenged this tax in the Connecticut courts, then appealed the case to the United States Supreme Court, which upheld Connecticut's right to tax. Taxation of other types of property was also involved in the case, but details have been omitted here as irrelevant to the nature of a partnership interest. The Supreme Court held that:

> the interest of the decedent in the partnership of Wm. Openhym & Sons was simply a right to share in what would remain of the partnership assets after its liabilities were satisfied. It was merely an interest in the surplus, a chose in action. It is an intangible and carries with it a right to an accounting. . . . It thus clearly appears that both under the partnership agreement and under the laws of the State of New York the interest of the partner was the right to receive a sum of money equal to his share of the net value of the partnership after a settlement, and this right to his share is a debt owing to him, a chose in action, and an intangible. We concur with the Supreme Court of Errors that as such it was subject to the transfer tax of Connecticut.

Blodgett v. Silberman stands as warning, to those not trained in the law, of the law's complexity: taxation under the Connecticut inheritance tax was the basic issue; the New York Partnership Law (following the Uniform Partnership Act and the Uniform Limited Partnership Act) was applied to ascertain the nature of the partnership interest; and the common law rule of *mobilia sequuntur personam* (movables follow the person) was the basis for the holding that the situs of the partnership interest was at the domicile of the partner in Connecticut.

Under the Uniform Partnership Act a partnership interest is

assignable and an assignment does not of itself dissolve the firm. The assignee, however, has neither the right to interfere in the management of the business nor the right to information about its affairs. Unlike the partner's co-ownership in specific partnership property, his partnership interest may be reached by an individual judgment creditor of a partner. On death, the partnership interest goes to an executor or administrator, who is entitled to receive from the surviving partner, for distribution to the heirs, its value in cash as the deceased's share of any profits and surplus remaining after the winding up of the firm's affairs.

THE RIGHT TO PARTICIPATE IN THE MANAGEMENT

The third property right of each partner is his equal right to participate in the management and conduct of the business. By agreement of the partners, however, restrictions and delegations of authority may be made.

EACH PARTNER A PRINCIPAL AND A GENERAL AGENT

As a result of the foregoing property rights, each partner in the performance of his business duties acts with respect to himself as a principal having a joint interest in the partnership property, and as a general agent with respect to each other partner. As a general agent, he can bind the firm in any transaction that comes within the ordinary scope of the firm's business. He is restricted, however, from doing certain acts unless authorized by all his associates. For example, he has no authority alone to make an assignment of all of the assets, to sell the good will of the business, to confess a judgment, to submit a partnership claim or liability to an arbitrator or referee, or to do any other act which would make it impossible to carry on the ordinary business of the firm.

PROPERTY RIGHTS IN PARTNERSHIPS UNIQUE

The foregoing highlights dealing with property rights in a partnership show them to be unique. They differ from those encountered elsewhere in the business world. Perhaps the best

way to emphasize their uniqueness and to obtain a clearer picture of them is by contrast. Most of us are reasonably familiar with corporations, hence a few comparisons may be fruitful.

CORPORATION AND PARTNERSHIP PROPERTY COMPARED

If our corner grocer were incorporated, the corporation undoubtedly would have both full title to and ownership of the can of beans, because the corporate business unit is a separate legal entity. In the case of the partnership we had just enough "legal entity" to put title to property in the firm name, but not enough to put ownership there. Consequently our partners held the rights of ownership under the peculiar species of joint ownership known as "tenants in partnership."

To carry our comparison further, if one of the stockholders in the grocery corporation should die, his death would have no immediate effect on the ownership of the beans; they would still be an asset of the corporation itself. In the absence of any special arrangement, the ownership of the deceased's shares of stock passes through his estate to his legatees under his will, or, if no will exists, to his distributees as provided in the intestate laws. The new stockholders have voting powers at stockholders' meetings and the right to receive dividends declared on the stock by the board of directors, but they have no right to demand from the corporation that its assets be liquidated and that the value of their shares of stock be paid to them in cash.

How different the property devolution is when a co-partner dies! Co-ownership in the specific partnership property automatically ceases, the surviving partner or partners becoming vested with the ownership — as liquidating trustees in the absence of a continuation agreement. The deceased's partnership interest goes into his estate. *But the firm is automatically dissolved on the occurrence of the death, and in the absence of a continuation agreement this interest is restricted to the right to the cash value of the deceased partner's share of the assets of the firm upon liquidation, accompanied by the right to demand that the survivor wind up the partnership with all possible dispatch and render a proper account.*

CHAPTER 3

Liabilities in a Partnership

A STUDY OF ALL OF THE LEGAL RAMIFICATIONS OF partnership liabilities belongs in the law school. Nevertheless, a knowledge of the broad underlying rules is required by the life underwriter if he is to grasp the full significance of the problems created by the death of a partner. Most underwriters are familiar with the basic general rule, which may be stated as follows:

> Each partner is fully liable for any contract, wrongful act, or omission, whether the liability is created by himself or by any other partner, while acting in the ordinary course of the business of the partnership or while acting with the authority of his co-partners.

To illustrate, let us look once more at the corner grocer, the partnership of King & Gay. Inquiry brings out the fact that the can of beans was ordered from the wholesaler by Mr. Gay along with a large shipment of other canned goods, costing $800 and billed to King & Gay at 30 days net. Obviously, this was a transaction in the ordinary course of the firm's business; hence partner King is equally liable with partner Gay for the payment of the invoice. But suppose that King dies before payment is made. Gay now owns the stock-in-trade and of course, remains liable for the payment of all of the obligations of the business. What, if anything, happens to King's liability?

The law provides that the individual property of a deceased partner shall be liable for all of the obligations of the partnership incurred *while he was a member, but subject to the prior*

payment of his separate debts. King's executor can legally enforce a demand that Mr. Gay, as the surviving partner, apply the partnership property to discharge its liabilities. If this property should prove insufficient, however, the executor will have to contribute out of King's separate estate his share of the deficit, provided there are sufficient funds in the estate to do this after the individual creditors have been satisfied.

If the firm's assets were insufficient and survivor Gay insolvent, then King's executor would be liable for all of the unpaid obligations of the partnership to the extent of King's estate after the payment of separate debts.

On the other hand, if King's estate did not have enough assets after payment of separate creditors to pay in its share of any deficit, Mr. Gay would have to pay all of the deficit out of his own personal savings.

CHAPTER 4

Dissolution of a Partnership

THE OUTSTANDING NEED FOR A PLAN WHICH WILL assure continuation of the partnership business lies in the facts and circumstances surrounding the dissolution, winding up, and termination of a firm. To know accurately these facts and circumstances is to know the urgency of the need for the solution that the life underwriter has to offer. There are thousands of partners throughout the country whose knowledge in this respect is rudimentary at best. Consequently, life underwriters who aspire to sell any substantial volume of partnership insurance must inform themselves thoroughly on the subject in order that they may appreciate properly the need and purpose for their product and thus become qualified to portray the true facts to the partners. These facts, to the extent that they relate to our subject, will be set forth in this and the following chapter.

DISSOLUTION, WINDING UP, AND TERMINATION DISTINGUISHED

Much confused thinking is caused by lack of precision in the use of terms, particularly in the use of the words "dissolution" and "termination." Dissolution is the status of the partnership that comes into being automatically when any partner ceases to be associated in the carrying on of the firm's business. It is defined by the Uniform Partnership Act as "the change in the relation of the partners caused by any partner ceasing to be associated in the carrying on *as distinguished from the winding*

up of the business." "Winding up" needs no special definition. It is the final process in the life history of a partnership, the performing of the acts necessary to the liquidation and closing up of its affairs. "Termination" denotes the end of the firm; it no longer exists.

WHY A DISSOLUTION TAKES PLACE

Dissolution of a partnership takes place the moment any partner becomes disassociated from the firm. Why is this true? The explanation goes to the core of the partnership relation itself. This is an intimate, confidential, *voluntary,* contractual business relationship in which each partner can act for the others and can subject them to unlimited liability. From the very nature of this important but potentially hazardous business association, it is not surprising to find that a right to choose one's own partner, the *delectus personarum* (choice of the person), has always been a basic tenet. No one can choose a partner for another, nor choose to be the partner of another. It is therefore logical to find a correlative rule that the disassociation of any partner dissolves the relationship and gives each surviving member a new "choice of the person."

It does not matter why the partner ceases to be associated in the business of the partnership. For example, the cause may be the expiration of the term of the partnership, the agreement of all of the partners to dissolve, or the resignation of a partner at any time, whether it is permitted under their agreement or in contravention of it. As stated by Judge Andrews in *Cahill v. Haff,* 248 N.Y. 377, 382, regarding a clause in a partnership agreement permitting termination upon sixty days' written notice:

> Notwithstanding this clause, however, either might repudiate it at any time. Then it ended. No agreement can prevent this result. No one can be forced to continue as partner against his will. He may be liable for breach of contract. Nothing more.

Other causes of dissolution stem from such events as the death or bankruptcy of a partner, from any event that would make

the business illegal, or from a court decree of dissolution based upon any one of a variety of causes, such as the incapacity or business misconduct of a partner, or the inability of the firm to earn profits, *et cetera.*

GENERAL EFFECT OF DISSOLUTION

In the absence of a contrary agreement, dissolution terminates the authority of the remaining partners to act for the partnership except to the limited extent necessary to wind up the firm, including the completion of transactions already begun but not finished. Outstanding contracts are performed, bills receivable are collected, assets are converted into cash for what they will bring, liabilities are paid, and the residue is distributed to the erstwhile partners or their representatives. This winding-up procedure is summed up well as follows in the leading partnership case of *McClennen v. Commissioner,* 131 Fed. 2d 165, dealing with Massachusetts law:

> The survivors have the right and duty, with reasonable dispatch, to wind up the partnership affairs, to complete transactions begun but not then finished, to collect the accounts receivable, to pay the firm debts, to convert the remaining firm assets into cash, and to pay in cash to the partners and the legal representative of the deceased partner the net amounts shown by the accounts to be owing to each of them in respect of the capital contributions and in respect of their shares of profits and surplus.

If there is a deficit, each must contribute his share as a minimum, or up to the total amount of the deficit as a maximum, if the others are unable to pay.

CHAPTER 5

Winding Up and Termination of Partnership on Death of Partner

As we have seen, the dissolution of a partnership is brought about by any cause that results in the severing of a member's association with the firm. The principal cause in which the life underwriter is interested, however, is the dissolution and winding up of a partnership because of the death of a partner, for it is in this situation that the plan he has to offer can perform seeming miracles in extending the life span of an established business. We have discussed in a broad way what happens to the firm's business on dissolution if the law is allowed to take its course; but there remain several important phases of winding up which need further analysis. Outstanding among these is the status of the surviving liquidating partner.

SURVIVING PARTNER AS LIQUIDATING TRUSTEE

We have noted that on the death of a partner, the surviving partner (or partners) succeeds to the ownership of the firm's assets as a liquidating trustee. The full significance of his fiduciary status is of great importance to all partners, and, consequently, to all life underwriters soliciting business insurance. A realization of its implications will make it a major motivating factor in the purchase of partnership insurance. It is a formal trust relationship only in a few states where special statutes have so designated it. In practically every jurisdiction, however, the relationship between the surviving partner and the estate is recognized as fiduciary in nature, particularly with respect to

remedies available if there has been a breach of this trust. A brief excursion into a few of the leading law cases on the subject bears this out.

Joseph v. Herzig. Two brothers had conducted a partnership under the name of Herzig Brothers. One died and the survivor accounted in the Surrogate's Court for the physical assets of the firm, made settlement for them with the deceased's estate, and continued to do business under the same firm name. The executor of the deceased brought this action against the survivor for an accounting for the use of the firm name and good will. New York's highest court, 198 N. Y. 456; 92 N. E. 103 (1910), held that the surviving partner must account for *every* asset of the partnership. The following is quoted from the opinion of Chief Judge Cullen:

> A surviving partner has no right, in the absence of some provision in the partnership articles, to appropriate the firm assets for his own use, although he is willing to pay the value thereof. As to the estate of the deceased partner he is a trustee, bound to liquidate the partnership and dispose of its assets like other trustees. So far as he has disposed of or collected the assets, he must account for their proceeds. If, at the time of the accounting, any of the assets have not been disposed of, or if any partnership property subsequently comes into his hands, he is bound to account to the estate of the deceased partner for its share of what may be realized thereon. . . .

Anderson v. Droge. At his death deceased owned a one-third interest in a partnership. Plaintiff, his sole heir, was told by the surviving partners that, although the business had been prosperous in the past, it had suffered a slump in recent years and they doubted if the deceased's estate would realize anything from it. Plaintiff was later referred to the administrator. The administrator had a board of appraisers appointed and they appraised the value of the deceased's interest at $900, in spite of the fact that a financial statement showed capital and surplus of about $37,000 and a bank balance of approximately $26,000. Then the plaintiff received a letter from the administrator stating that the partnership had been sold under court order and bought in by the surviving partners for $950, and

enclosing check for $306 net for the one-third interest. Three years later plaintiff filed this suit against the surviving partners for an accounting. The court gave the plaintiff judgment for approximately $8,000, the opinion, 216 Iowa 159, 248 N. W. 344, (1933), stating in part:

> Our reason for reaching this conclusion is in accord with that of the District Court, that the surviving partners had a right to continue this business for the purpose of winding it up, and on the death of Thayer they became trustees of the property and business of the co-partnership for his legal heirs and representatives. The law required of them the utmost good faith in their dealings with those entitled to share in his interest and property left in trust with them. It was their duty as trustees to make a full and fair disclosure of the exact nature and extent of his interest in the partnership and to conceal nothing. They have failed in this duty; they have concealed from the plaintiff the nature and extent of the interest of the deceased in that concern and the value thereof. They have sought by concealment to use the court to defraud the plaintiff out of a valuable right in the concern. In the sale by the administrator only the tangible property was in fact valued, and the interest of the deceased in the other partnership property and as a going concern was not included or sold. They also failed to take into consideration the fact that the business was a going concern and had a good will.

In Re Ducker's Estate. The utmost of good faith and fair dealing will not save a surviving partner who chooses not to obey the mandate of the law to liquidate the firm on the death of a member.

Sol Ducker and one of his sons had conducted a partnership, and on the father's death the son and a friend of the father, as co-executors, decided to carry on the business rather than liquidate it. After operating it about a year under the firm name, they formed a corporation, and continued the business for about seven years more. During most of this time profits were plentiful and the business paid to the heirs, a brother and three sisters of the son, in all about $65,000. In addition, the son drew $75 a week as his share. Then came the depression; the corporation could not weather it, and became insolvent. When the account

of the executors was rendered, the brother and the three sisters of the surviving partner filed objections to it on the ground that the partnership should have been liquidated on the death of their father and the proceeds invested in legal securities under the provisions of his testamentary trust. The referee appointed by the court held unqualifiedly that the executors had acted throughout in good faith. He also found that the share of the objectants on liquidation of the partnership at death would have been $33,000.

The court held that the executors must reconstitute this entire sum, even though the plaintiffs had already received, in the years since their father's death, earnings from the business five times the amount they would have been paid in interest at 5 per cent had the trust fund been originally set up. They had already received about $65,000 and the decree set up $33,000 more for them, a total of $98,000. Had the surviving partner liquidated the partnership on the father's death, as the law prescribed, the objectants would have received principal in trust of $33,000. Interest at 5 per cent on this sum for the eight years would approximate $13,000, making a total of $46,000. Furthermore, the court pointed out that if the principal had been set up in trust promptly on the death of the father, it would undoubtedly have been diminished by the universal shrinkage of security values that occurred during the subsequent period. The opinion of the court, found in 146 Misc. 899, 263 N. Y. S. 217 (1933), stated in part as follows:

> Since *Williams v. Whedon,* 109 N. Y. 333, 16 N. E. 365, 4 Am. St. Rep. 460, it has been familiar law that partnership assets as such are not owned by the estate of the deceased partner, and that legal title thereto is completely vested in the surviving partner. The estate had the right only to receive, after liquidation of the firm business, the net value of the share of the deceased partner. . . . The survivor is entitled to the possession and control of the assets and has the right "within the limits of good faith" to dispose of the assets and close the partnership affairs. . . . It is apparent from the record that the accounting son of the deceased with his co-executor, a personal friend of the deceased, unwisely determined to carry on the business of the former co-partnership so as to provide a livelihood for

> the family of the deceased, four of whom are now attacking the determination. That this decision so to carry on the business exposed the accounting parties to a surcharge has been found by the referee and confirmed by Mr. Surrogate O'Brien. . . . The referee has found . . . that the brother and sisters of this accounting son . . . are in truth invoking the utmost rigor of the law against their brother.

Burden of proof on surviving partner. No one familiar with these and similar cases can doubt the fact that the surviving partner is a liquidating trustee and is "on the spot" whether or not he has acted in good faith. Because of his fiduciary status, he is held responsible to the estate as a trustee of the partnership assets; but this is only part of the story. Because of his superior knowledge of the partnership affairs, he is usually held to the burden of proving that he has not acted in violation of that trust when his conduct is challenged by the personal representative. The rule that the surviving partner is held responsible to the estate was applied by the Appellate Division of the New York Supreme Court in the case of *Bauchle v. Smylie,* 104 App. Div. 513, 93 N. Y. S. 709. In that case, one of three equal one-third partners had died and his widow was named executrix and residuary legatee in his will. Four months later she sold the decedent's interest to the survivors for $42,500. Not long thereafter, the widow brought an action to have the sale set aside on the ground of fraud. The lower court rendered a decision in favor of the surviving partners, upholding their purchase of the deceased partner's interest on the ground that the widow had not proved that the transaction was unfair to the estate. On appeal, the Appellate Division reversed the decision and sent the case back for a new trial, stating regarding the first trial:

> The action was tried upon an erroneous theory, viz., that the burden was upon the plaintiff to establish the transaction as unfair, whereas the burden was in fact upon the surviving partners to show that it was in all respects fair, and such as a court of equity would sanction and approve.

The opinion continued in the following words to stress the fiduciary position of the surviving partners, which placed this onerous burden on them:

> The relation which a surviving partner holds to the representative of a deceased partner has been clearly defined, and is generally understood. It is a fiduciary relation, involving trust and confidence of the highest character, which absolutely prohibits the surviving partner acquiring any benefit from the deceased partner's interest at the expense of his representative. [Authorities cited]. It is a relation stronger and more exacting than that which exists between the partners themselves, inasmuch as the law commits to them, to the exclusion of others, the care and management of the deceased partner's interest for the payment of debts and distribution. He is not a mere agent, but a trustee, and by reason of such relationship the same remedy exists on behalf of the representative of the deceased partner against the surviving partner as exists between a trustee, strictly so called, in behalf of a cestui que trust.

In short, on the death of a partner we find the surviving partner in the position of trustee of the firm's assets as to the estate of the deceased. In this fiduciary role he must make a fair and complete disclosure of all facts, present or prospective, affecting those assets. He must account for all property values, tangible or intangible. Moreover, if anything goes wrong between him and heirs unfamiliar with the partnership affairs, he will have the burden of proving that his trusteeship was carried out in exact compliance with the high standards of responsibility required of trustees. Lack of good faith and fair dealing will result in disaster; yet good faith and fair dealing will not save him if he departs, as in the Ducker case, from the strict mandates of the law governing the winding up of partnerships. Obviously, therefore, the surviving partner stands in great need of a different plan of procedure; he needs a plan that will relieve him of this oppressive fiduciary status.

ECONOMIC EFFECTS OF WINDING UP THE PARTNERSHIP

In a typical partnership we see two capable business men combining their diverse talents from day to day in carrying on a modest but successful enterprise. One has knack of merchandising; the other has the knack of efficient over-all management and

supervision. Together, they constitute an effective team, making enough profits to rear their families and enjoy the ordinary comforts and pleasures of life. With the business running smoothly due to their joint efforts, and with orderly plans already developed for the future, they consider themselves "all set." Then without warning, one of them suddenly dies. Gone now is the comparative tranquility of the business day. Gone are the orderly plans for the future of the enterprise. In their stead are the strange and onerous duties of winding up a heretofore thriving business. We are now tolerably familiar with those duties; next let us examine the economic havoc that often follows:

Shrinkage of partnership assets on liquidation. Among the first duties of the surviving partner as liquidator is the collection of accounts receivable. In performing this task he will undoubtedly learn the truth of the statement made by The Retailers' Credit Association that "It is almost impossible to collect a 'dead man's' bills. People simply will not pay after a store has changed hands. A 50 per cent collection is unusual; 25 per cent is much nearer actual figures." If the firm owned any real estate the surviving partner will be at the mercy of the prevailing market, if any market currently exists. There will be an inventory to dispose of for cash. Bates on Partnerships, S 743, says in part "the forced conversion of a large stock into money is almost sure to be attended with the most ruinous consequences, not only to the surviving partners, but to the estate of the deceased." Then there will be equipment of various kinds that will have to be converted into cash with reasonable promptness. In this undertaking he may find the statement of The Central West Distributors' Adjustment Bureau to be only too accurate; "These items, which usually must be disposed of through second-hand dealers, are sold only for a fraction of their original value; the purchaser usually feels they ought to be thrown in with the stock and will pay little for them." It is therefore evident that when the surviving partner has completed the liquidation of the tangible property of the firm he will be lucky to have realized fifty cents on the dollar in cash.

But what about the intangible assets, the going-concern value and the good will? In those few fortuitous instances where the

business may be sold "in bulk," some portion of these values may be salvaged, but in most cases these assets evaporate with the liquidation of the tangible assets. Their loss is total.

Income to the family from the business stops. Up to the day of his death the deceased partner drew out of the partnership a reasonably steady income. The needs and comforts of his family are geared to this income; their standard of living has been erected upon it. Can the family compel the surviving partner to continue these payments or any part of them? No, the survivor is devoid of any authority to make advances to the estate or to the heirs until he has closed out the business. In fact, with creditors of the firm pressing him for payment and without authority to obtain new credit for the firm, he cannot be expected to have any funds for the purpose. During the winding-up period the family must rely on the proceeds of the deceased's personal life insurance or on advances that his executor may be able to make from his personal estate. Consequently, immediate hardship will result if the personal sources of income are inadequate. Needless to say, this sudden interruption of the normal family income, followed by a drying up of the source because of drastic liquidation shrinkages brought about by the forced sale of assets, breeds dissatisfaction and suspicion in the minds of the heirs of the deceased partner. Once again we are confronted with the need for a better solution of the partnership problems that arise upon the death of a partner.

Administration of personal estate may be delayed. The executor or administrator of the deceased partner, as the legal representative of his personal estate, has the duty either under the will or under the intestate laws, as the case may be, to wind up the deceased's personal affairs, pay his personal debts, and distribute the remainder to those entitled to it. Under the Uniform Partnership Act he cannot interfere with the liquidation of the partnership unless, or until, there has been misconduct on the part of the surviving partner or there has been an unreasonable delay. If either has occurred, the legal representative can petition the court to have a receiver appointed to take over the winding up. *State v. The Vanderburgh Probate Court*, — Ind. —, 121 N.E. 2d 723 (1954). Otherwise, he must wait until liquidation has been completed by the surviving partner. In

the meantime, the executor cannot complete his own duties. He cannot fully appraise the estate or file his estate tax schedules until the partnership has been liquidated and the value of the deceased's share ascertained. Any advances to the widow may be made at his own peril, for there may be an ultimate shortage of assets; and it is in those estates where the assets are meager that executors are hardest pressed to make advances. If it finally develops that there is a cash sum coming to the estate on the termination of the partnership, he is responsible for its delivery to the proper heirs. If there is a deficit, he must contribute the deceased's share out of the assets of the personal estate. If he turns all the personal assets over to the heirs prematurely, he will be surcharged. Thus, if the law of partnership liquidation is allowed to take its course, we find the orderly administration of the deceased's personal estate delayed, with a disgruntled legal representative and frustrated heirs as inevitable consequences.

Surviving partner's business career jeopardized. If the surviving partner has carried out his legal mandate, he has brought the business of the partnership to a standstill, liquidated its property for whatever sum it would bring at forced sale, paid its debts, and divided the shrunken residue between the estate of the deceased partner and himself. In the process he has lost a substantial portion of his investment in the business. Nevertheless, the importance of this sacrifice is overshadowed by what may indeed result in disaster. In liquidating the business he has liquidated his job, and with it all his plans for the future. Small wonder it is, then, that so many surviving partners choose to make any deal that opportunity offers at this late date to acquire the deceased partner's interest, even at great risk of subsequent lawsuits and adverse judgments. In the extremity of the situation he will welcome almost any plan that promises to save his business life. Starting his business career all over again is often out of the question. But reliance on the hope of making a satisfactory and conclusive deal with the heirs in the face both of their naturally suspicious attitude and of the strict rules of the law of trusteeship is foolhardy. The surviving partner can least afford, of all the parties concerned, to let the law of partnership liquidation take its course.

Part II

PLANS ATTEMPTED TO AVOID LIQUIDATION ON DEATH OF A PARTNER

CHAPTER 6

Alternatives to Liquidation Improvised After a Partner's Death

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WE HAVE SET OUT IN SOME DETAIL THE SACRIFICES and losses suffered by everyone concerned in the liquidation of a partnership on the death of a partner. The extent of these sacrifices has plainly shown the vital need for a more practical solution than that of allowing the law to take its course, and has caused the parties to improvise various alternative schemes in an attempt to keep the business running and thus by-pass these losses.

MERE CONTINUANCE OF THE BUSINESS

Often a surviving partner will keep on operating, in the hope that he will later be able to come to an agreement with the deceased's heirs, or that they will acquiesce in his conduct. An example of the costliness and futility of this alternative is vividly portrayed in the Ducker case, in which the son operated the business with outstanding success for several years after his father's death to the great profit of the deceased partner's family, the son's own brother and three sisters, only to have "the utmost

rigor of the law" enforced against him. The results in that case seem harsh, but the court was merely applying the regular rule, that if a dissolution occurs and the business is continued without any settlement of accounts or any contrary agreement being entered into, the legal representative of the deceased is entitled to receive for the heirs the amount of the deceased's interest at date of death, plus his choice either of the interest on it or of the profits attributable to the use of the property after that date.

Only one case has interpreted the Uniform Partnership Act to call for a different rule. In *Blut v. Katz,* 13 N.J. 374, 99 Atl. 2d 78 (1953), the Supreme Court of New Jersey held that there was a choice between interest and a share of profits only when the partnership business was continued with the consent of the estate, and that where there was a continuance without the consent of the executrix of the deceased partner, she had no option to take a share of the profits but was entitled only to the value of the interest of the deceased partner at time of his death plus interest thereon to the date of judgment. Two judges, including Chief Justice Vanderbilt, vigorously dissented from this interpretation of the statute, stating that "on the plainest principles of equity and justice the surviving partners should account for the profits ensuing from their unauthorized use of the deceased partner's capital. The principle of unjust enrichment has peculiar application in such circumstances." The result is that except in New Jersey, the general rule appears to be as stated in 68 Corpus Juris Secundum 805:

> The estate of a deceased partner is entitled to a proportionate share of any advantage gained by the surviving partner while continuing the business. If the continuance was unauthorized the representatives may elect between interest on decedent's capital or a proportionate share of the profits.

Lest the impression be left that what the surviving partner loses as a penalty for continuing the business constitutes a gain to the heirs, the case of *Alsworth v. Packard,* 181 Minn. 156, 231 N. W. 916 (1930), will be discussed. For a long period of years A. D. Packard and his son carried on a co-partnership. After the father's death, the son continued to operate the business for

about six years, when his sister, as administratrix, brought suit for an accounting on the ground that he should have wound up the partnership affairs promptly. In the lower court a judgment for $66,000 plus a substantial amount of interest was rendered against the son. On appeal, Minnesota's highest court held that although the son was liable, a new trial was necessary to correct certain errors. The following illuminating comment is found in the opinion:

> There must be a new trial. We might say so and stop. We are tempted to go a bit further. A history of the affairs involved, extending over a period of forty years, is possible. The law has the machinery and there is enough time to hunt up early transactions and investigate facts and come to as correct a conclusion as human means can reach on disputed testimony after so long a time. The effort used and the time consumed largely will be wasted effort and time. It is not the fault of the law. It comes because of the shortcomings and delays and faults of the people concerned. The necessary money doubtless can be found to carry on the quarrel. The beneficiaries are well along in years. If the money and property could be had now they would have some enjoyment of it for quite a while. If active in litigation they will probably be able to get their controversy at an end so that one has all, or each has a part, or none of them has anything at all before the end comes.

The conclusion is inescapable that surviving partners and heirs alike usually suffer heavy losses if the business is improperly continued, and that this irregular procedure offers no alternative solution to the problems of liquidation.

NEW PARTNERSHIP WITH HEIRS

Sometimes, rather than face disastrous liquidation, the surviving partner forms a new partnership with the heirs. This alternative, however, is seldom resorted to because of the well-nigh insurmountable obstacles, both legal and economic, that block its path.

Legal obstacles. The first obstacle is the executor or administrator. Legally, the heirs cannot enter a new partnership with

the surviving partner with respect to the partnership property until the administration proceedings have been closed, for the heirs have no right to possession or control of such property until it comes to them by the accounting of the administrator, who, in turn, is charged with the duty of receiving and accounting for the value of the deceased's interest in the partnership in cash. (*Taylor v. Lint,* 338 Mich. 673, 62 N.W. 2d 453.) Therefore, this expedient is eliminated at the outset except in those isolated situations in which the executor or administrator and the sole heir are one and the same person. Even then, the deceased's creditors and the tax authorities must first be satisfied.

A further legal obstacle is the fundamental rule that no one can choose to be the partner of another. If, in spite of all the impediments, the surviving partner wishes to continue the business with the heir, he cannot do so unless the heir also wishes to do likewise rather than to receive the value of the deceased's interest in cash. On the other hand, the desires of the heir to form such a partnership are of no avail if the survivor prefers to liquidate.

In spite of the legal obstacles involved, a surviving partner sometimes will continue the business by forming a new partnership with the widow of his deceased partner even though she is not the sole heir. That this can be a costly mistake is well illustrated by a 1951 case, *Spivak v. Bronstein,* 367 Pa. 70, 79 Atl. 2d 205.

Spivak v. Bronstein. Jules Bronstein and Jacob Spivak were equal partners conducting a taproom and restaurant business. Spivak died in 1943, survived by his wife and infant son. Spivak left no will and his widow was appointed administratrix. Under the intestate laws of Pennsylvania, the child was entitled to one-half of his father's estate. Without the consent or approval of the probate court, the widow and the surviving partner entered into a new partnership agreement within a month. This agreement recited that the widow executed it on her own behalf and as administratrix, and also as guardian of her minor son (although she could not be the child's guardian under Pennsylvania law). The deceased partner's interest was valued in the agreement at $4,000. Bronstein was required to conduct the

business and to pay the widow $40 a week, but he was given an option to purchase the business.

The new partnership continued for three years; then the widow individually and as administratrix sold her interest (recited to be one-half) to Bronstein for $8,500. However, she reserved any right that she might have to an accounting for the profits from the date of death of her husband. A month later she sued for an accounting, alleging that her share of the profits amounted to far more than $40 a week paid her and that she had been fraudulently induced to sell.

The lower court, finding no fraud or mismanagement, decided that the widow as an *individual* was not entitled to any accounting, because of her agreement with the surviving partner. But the survivor must account for the one-half share in the deceased partner's interest which the minor son owned, and must pay the value of that share as of the date of death, together with the profits attributable to the retention of that share in the business, or interest at 6 per cent in lieu of profits. As a credit, the survivor was allowed one-half the amounts he had paid to the widow, and on the accounting a judgment for $10,045.81, including interest from date of termination of the partnership with the widow, was entered against the surviving partner. On appeal, the Supreme Court of Pennsylvania affirmed, ordering that the $10,045.81 be paid to the widow as administratrix and that she assign it to the legal guardian of her son.

Thus the surviving partner paid the widow a total salary of about $6,000 during the three years of the partnership; then paid her $8,500 for her interest — and he finally wound up after five ensuing years in the role of a defendant with a judgment against him for an additional $10,000. All this for a partnership interest agreed to be worth $4,000! The courts exact strict justice when legal obstacles are disregarded.

Economic obstacles. From an economic standpoint, a new partnership with the heir is usually sheer folly. Unless the new partner has been active in the management of the business in the past (this is seldom the case, for the heir is usually the deceased partner's widow), the survivor carries almost all of the load for an incommensurate share of the profits. He finds himself in

the position of trying to support both his own family and that of the deceased partner. More hopeless still, however, is the clash of basic objectives of the parties. The surviving partner's solicitude is for the future of the business. He wants to plow back for development and expansion any profits beyond a modest current income. The widow as a partner is interested in current income to replace that lost on the death of her husband. She will expect to derive at least as much as he formerly took out of the business, notwithstanding the fact that most of his profits were the result of the personal labor, skill, and experience that he contributed to the firm but that she is not able to contribute. The history of attempts to carry on such partnerships (typified by the Bronstein case) shows that the immediate consequences of this divergence of interests are wrangling and dissension, and that the ultimate result is dissolution and the winding up of the new firm. The exceptional case is the one in which the deceased is survived by a son who has been active and competent in the affairs of the business and is sole heir and administrator. In such a case, a new partnership composed of the surviving partner and the son can be arranged if the parties so desire, and should prove successful. Nevertheless, if such favorable circumstances do exist, formation of the new firm is not safely left to improvisation after the death of the father. Adequate provisions for the future partnership should be set up in advance.

From the above it is readily apparent that a partnership with the heirs is almost impossible to arrange after death occurs, is devoid of opportunity for successful operation in the overwhelming majority of cases because of the unequal sharing of the burdens and the conflict of objectives and is, therefore, rarely attempted.

PURCHASE OF SURVIVING PARTNER'S INTEREST BY HEIRS

Once in a while the heirs desire to purchase the interest of the surviving partner. Such a plan is seldom consummated because of its many drawbacks. In the first place, the surviving partner is under a legal duty to liquidate the firm, and can be relieved of

that duty only by the consents of the executor and administrator and of all the heirs. Heirs who are minors are unable to give consent; some other heir may be unwilling to. And unless all creditors can be satisfied, the legal representative will not concur. Then too, in carrying through with the plan, the survivor is selling himself out of a job and has to start out in business all over again. The heirs are buying a business strange to them and are required to manage it successfully without the guiding hand of either the deceased partner or the surviving partner.

The unsolvable dilemma. Furthermore, the heirs must withstand the withering competition of the survivor, a man who knows all the details of the business, unless they can obtain a special agreement from him not to establish himself again in the trade or industry in that locality. Without such a restrictive agreement, the heirs have no real chance of success. Restricted by such a negative agreement, the survivor is not only out of a job, he is deprived of his career. Only a surviving partner who is ready and wants to retire can afford to sign a contract of this nature. Thus, with a negative covenant essential to the heirs but fatal to the future business career of the surviving partner, the use of this plan runs into an unsolvable dilemma. It must be discarded as a solution to the problems of liquidation.

PURCHASE OF DECEASED'S INTEREST BY SURVIVING PARTNER

The remaining alternative that may be improvised by the parties after the death of a partner to avoid the sacrifices and losses implicit in liquidation of the partnership affairs is the purchase of the deceased partner's interest by the surviving partner. Here again both economic and legal obstacles stand in the way of a satisfactory solution.

The financial barrier. The chief financial barrier is the inability of the survivor to obtain the necessary cash with which to pay for the deceased's interest. If he does not have ample personal wealth, the surviving partner must borrow the purchase price or contract to pay the debt over a period of years. The instalment purchase plan will hang a millstone around the neck

of the enterprise for years to come. In trying to borrow the cash, the survivor will find that the banks are far more likely to demand a reduction in the line of credit than to grant a new loan. In fact, being cognizant of the fiduciary position occupied by the surviving partner, most financial institutions will avoid becoming involved in any way with the situation. Resort must therefore be made to individual funds. These are not usually available unless the prospects for the future of the business are exceptionally favorable, and then only if the surviving partner takes the money lender into partnership with him or forms a corporation to effect the purchase, giving the lender shares of stock to cover the amount of the loan. Normally then, the raising of the necessary purchase price requires that the survivor go into business and divide the management and profits with an untried, inexperienced, and often incompatible associate.

The legal barriers. The towering obstacles to this plan, however, are legal in nature. First, the deceased's executor or administrator can peremptorily demand that the business be liquidated. Even if willing to sell, he will be unable to do so unless the heirs consent. And, unless it is a cash sale, the creditors may block the transaction if they are not paid off.

Second, an almost insuperable barrier is the surviving partner's task of making a contract that will be able to stand up under any subsequent legal attack by dissatisfied heirs. We saw such an attack made in *Bauchle v. Smylie* (see page 141 herein) and the resultant burden thrust upon the surviving partners to show that the contract was above reproach. His status as a fiduciary lies at the root of this great difficulty. He is a trustee trying to purchase the subject matter of his trust from the beneficiaries. (If, perchance, the surviving partner is also the executor of the deceased's estate, he is precluded from making a binding sale to himself unless authorized by special statute. As stated in *Donnelly v. Ritzendollar*, 14 N.J. 96, 101 Atl. 2d 1 (1953), "It is beyond dispute that a fiduciary cannot purchase from himself. [Authorities cited.] Even in the absence of fraud such a sale would be set aside.") In many states he cannot make such a contract with another as the legal representative without consent of the beneficiaries of the deceased's estate, no matter

how much he offers for the deceased's interest. Michigan's highest court, in *Grigg v. Hanna,* 283 Mich. 443, 278 N. W. 125 (1938), had this to say:

> The surviving partner, as a fiduciary, is in effect the trustee of the assets of the deceased partner. . . [citing case] As such trustee, he may not be interested directly or indirectly as a purchaser in his own behalf of the trust property without consent of the *cestui que trust. 1 Perry on Trusts and Trustees,* 6th Ed. s. 195.

The opinion also quoted the following paragraph from *Kelsey v. Detroit Trust Company,* 265 Mich. 358, 251 N. W. 555, 556:

> A trustee has no right to act when duty is opposed to interest, fidelity to cupidity, honesty to the desire for personal gain. To act as trustee for a dead man, carries with it the duty to exercise honesty, good faith, and active diligence; the duty to disclose to the beneficiaries and account for the estate, and, stringent as the law is in prohibiting trustees acting in violation of their trust, the rules of law should be more stringent rather than be relaxed.

In a majority of states, however, the surviving partner is allowed to purchase the deceased's interest, provided the terms square with his fiduciary obligations. The leading case expounding this rule is *Cotton v. Stevens,* 79 N. H. 224, 107 Atl. 602 (1919), in which the surviving partner was successfully sued by his brother's widow and his purchase of his deceased brother's interest declared void because based upon inadequate inventory values. The opinion stated:

> In some cases it has been held that a trustee could not purchase the trust property, but in *Perry, Trusts, s. 428* it is said: "The better opinion, however, is, that a trustee may purchase of the *cestui que trust,* or accept a benefit from him, but the transaction must be beyond suspicion; and the burden is on the trustee to vindicate the bargain or gift from any shadow of suspicion, and to show that it was perfectly fair and reasonable in every respect, and the courts will scrutinize the transaction with great severity."
>
> . . . The surviving partner cannot place the representative of the deceased partner at arm's length and seek to obtain a profitable bargain for himself. Having generally a superior knowledge of the assets and their value, it is his

> bounden duty, in purchasing the interest of the deceased partner, to acquaint his representative with full information as to the assets, and the facts from which their value may be estimated or inferred. It is not sufficient that he does not withhold or conceal such information, but it is incumbent on him to disclose voluntarily all within his possession or knowledge from which a sound judgment as to the value of the interest may be formed. He cannot remain passive, but must make a frank and honest disclosure. *Tennant v. Dunlop,* 97 Va. 234, 244.

An excellent summary of the law is given in the case of *Steinmetz v. Steinmetz,* 125 Conn. 663, 7 Atl. 2d 915, (1935):

> While the principal contention of the plaintiff is that the judgment is not as comprehensive as he claims it should be, error is also assigned as to the included provision that the defendant must not directly or indirectly bid in the property at less than its fair market value, which imports that, with this restriction, he, although the surviving partner, might become the purchaser of the partnership property. A surviving partner holds the assets as a quasi trustee for the estate of the deceased partner. *Casey v. Hurley,* 112 Conn. 536, 538, 152 Atl. 892. Therefore he cannot speculate upon the partnership property for his own advantage and in disregard of the interests of or under the deceased partner. It is generally held that if he acts with the high degree of good faith which is required by the former partnership relation and his fiduciary relationship to the estate of the deceased partner, he may validly purchase the interest of the latter. *2 Rowley Op Cit.* p. 856; 47 C. J. 1067; *Didlake v. Roden Grocery Co.,* 160 Ala. 484, 491, 49 So. 384, 22 L. R. A. (NS) 907, 177 N. E. 629, 80 A. L. R. 1028, 1033, and cases in note, p. 1034; *Valentine v. Wysor,* 123 Ind. 47, 55, 23 N. E. 1076. A few pertinent cases evince a less favorable attitude toward purchase of the partnership property by the surviving partner at a sale by him or in his behalf. Some hold definitely that a surviving partner cannot validly buy the property of the firm at his own sale, either directly or indirectly, whether the attempt be made by means of public auction or private sale, and regardless of adequacy of the purchase price, his duty as seller and his interest as purchaser being held to be in irreconcilable conflict. *Valentine v. Wysor, supra,* 55; *Mosher v. Lee,* 32 Ariz. 560, 570, 261 Pac. 35; *Joseph*

v. Herzig, 198 N. Y. 456, 462, 92 N. E. 103; *Kimball v. Lincoln,* 99 Ill. 578, 585; Parsons, *Partnership* (3rd Ed.) p. 442; 47 C. J. 1068. The most liberal view entertained is that if the surviving partner attempts to take over the partnership business by selling the partnership property to himself or to someone acting for him the transaction is voidable by or at the instance of the representative of the deceased partner. *Didlake v. Roden Grocery Co., supra,* 490; *Rowell v. Rowell,* 122 Wis. 1, 11, 99 N. W. 473; Crane, *Partnership,* p. 379; see also *Dewey v. Chapin,* 156 Mass. 35, 37, 30 N. E. 223. Therefore the inclusion in the judgment of the provision which impliedly authorizes the defendant to purchase absolutely, although at not less than the fair market value of the property, is unwarranted in law.

Keeping in mind that these cases deal with situations wherein no agreement to purchase had been entered into by the partners prior to death, the opinions show that even in those jurisdictions where the most liberal rule prevails with respect to the purchase of the deceased partner's interest by the surviving partner, his duty of full and fair disclosure of all facts relating to the business is so great and the burden of vindicating the disinterestedness of his action in purchasing such interest for himself so onerous that most survivors left without advance authority to buy might better suffer the losses entailed in liquidation of the firm than assume the risks.

The foregoing analysis includes the various plans that have been improvised by the surviving partners and the heirs and legal representatives for the purpose of continuing the business and of thereby avoiding the liquidation losses on the death of a partner. The inevitable conclusion is that any scheme formulated after a death occurs eventually creates losses even more disastrous than would have resulted from immediate liquidation. Such alternatives are conceived too late.

CHAPTER 7

Alternatives to Liquidation Set Up Prior to a Partner's Death

A PLAN SET UP BEFORE A DEATH OCCURS IS NECESSARY

EXAMINATION OF THE PERNICIOUS RESULTS THAT often ensue from arrangements originated and entered into after the death of a partner for the purpose of by-passing the destructive effects of liquidation has demonstrated the necessity of establishing a plan before a death occurs. Various devices have been contrived during the lifetime of the partners; some by one partner acting alone, others by the partners acting in concert. An investigation of these devices and of the attendant results accomplished should lead us to the plan that will solve the problems brought about by the death of a partner.

PLANS MADE BY ONE PARTNER ACTING ALONE

Provision in will for continuance of the business. Sometimes a partner acts alone through provisions inserted in his will in an attempt to forestall liquidation. For example, he may provide in his will that the business be continued after his death, with his share of the capital left in the enterprise as an investment. At first glance this plan seems advisable, especially if the profits of the enterprise have been large, but actually such a provision damages rather than improves the lot of the heirs. A primary objection is that in legal effect he merely gives the surviving partner an option to continue or to liquidate, no matter how mandatory the terms of the will may

be. *Slater v. Slater,* 208 App. Div. 567, aff'd 240 N. Y. 557, is ample authority for this conclusion. In that case, clause "FIFTH" of the will read: "It is my will and desire but I do not so direct that the business now carried on by my brother James and myself as co-partners be continued for the benefit of my Estate so long as it may be practicable and profitable so to do." The opinion, referring to this clause, stated: "The aforesaid paragraph is the only reference in the will to the testator's business, and even had the testator directed his personal representatives to continue the partnership business, they could neither have been compelled to do so by the surviving partner nor could such personal representatives have compelled the surviving partner to admit them as partners." If the survivor elects to liquidate, the provision will be a nullity; the liquidation losses will not be avoided. Ordinarily, the survivor will choose to liquidate, for he will not welcome the prospect of doing all of the work for only a fraction of the profits. On the other hand, if he elects to continue, the testamentary provisions of the deceased partner will take from his heirs the protecting remedies that they would otherwise have. For instance, we saw in the Ducker case that where the business was continued without authority, and finally, after several years of attractive profits, became insolvent, the heirs were entitled to keep the profits and were awarded the value of the deceased's interest. Had there been no profits, or had there been nothing but losses, the heirs would have been entitled to the value of the deceased's interest, plus interest on it, for the period during which the business was continued. However, if the continuance of the business had been authorized by the will of Sol Ducker, the heirs would have received their share of the profits, but would have lost $33,000, the value of their portion of the partnership interest.

The futility of will plans that authorize the surviving partner to continue the business at the price of supporting two families is further illustrated in *Western Shoe Company v. Neumeister,* 258 Mich. 662, 242 N. W. 802 (1932). There the deceased partner, Neumeister, had bequeathed to his widow all his interest in the partnership of Neumeister & Schultz for the

balance of her life, and at her death, to Schultz. Schultz was to control and manage the partnership business at a reasonable salary and was obligated to pay the widow $200 a month, plus one-half the profits. After Neumeister's death the business was continued for eight years, and then the surviving partner went bankrupt. The Western Shoe Company, a creditor of the continuing business, sued the widow on the ground that she had been made a partner. Michigan's highest court held that she was not a partner, and therefore, was not personally liable for the debt. The opinion stated in part:

> It was the evident intention of the testator to secure for his wife an income from the partnership business, and to accomplish that purpose he gave possession and control of his interest to Mr. Schultz to be kept and used in the business subject only to certain profits and monthly payment to Mrs. Neumeister. But if he had intended to create a partnership relation between them, it could not be accomplished without their consent and there is no evidence that either of them ever consented.

Thus, to his widow, the result of this seemingly salutary scheme in the deceased partner's will, eight years after his death, was the total loss of the value of his partnership interest, accompanied by the legal attempt by the creditors of the continuing business to reach her other property. To the surviving partner, the result of the double burden of work for one-half the profits was bankruptcy.

The net effect of a provision in the will directing the survivor to continue the business is to furnish a dangerous option to the survivor at the expense of the heirs of the will maker. The heirs either receive the liquidated value of the partnership interest or have their funds placed in a highly speculative investment, at the choice of the survivor. The surviving partner has the option of sharing in the liquidation losses or of trying to support two families. Surely, this is not the solution for which we are looking.

Directive in will to form new partnership with heirs. Sometimes a partner directs in his will that his executor or one or more of his heirs be taken into partnership with the survivor,

and that the business be continued by the new firm. Here again, we have a provision that may be a nullity, for no one can choose a future partner for another. The survivor may, therefore, disregard the provision and proceed to liquidate, since if he follows the direction of the will, he will be embarking on a new partnership venture with an untried associate. We have discussed the disadvantages of such an arrangement in a previous chapter (p. 148). It is rarely attempted, and seldom successful, because of the unequal sharing of burdens and the conflict of objectives between the survivors and the heirs. Whatever the choice of the surviving partner, then, such a provision in the will of the deceased partner will probably fail to produce a desirable solution.

Provision in will for sale to survivor. A partner sometimes provides in his will that his partnership interest may be purchased by the survivor. This provision enables the surviving partner to buy in those states where he could not otherwise do so because of the rule preventing a trustee from purchasing property entrusted to him. In those states that allow a surviving partner to buy the deceased's interest, this provision in a will adds nothing unless it gives further powers. Unless the will stipulates a definite sale price or a specific valuation formula, the transaction is looked upon with suspicion by the courts, and the survivor, as a fiduciary, has the burden of proving that his dealings have been above suspicion. If the will does provide for the sale price, a definite step forward has been made, for then the shackles of the fiduciary relation have been removed from the survivor so long as he proceeds to make the purchase in exact compliance with the offer contained in the will.

In spite of this distinct accomplishment, however, other drawbacks condemn the plan. The survivor cannot rely on it because the provision in the will may be changed at any time prior to death, or the will may be held invalid for other reasons. Furthermore, even though the will remains unaltered and outlives probate, the survivor still has the problem of raising the necessary purchase price. The will maker cannot rely on it because the survivor is not bound in any way to make the purchase, and may exercise his right to liquidate the business.

Thus, we shall have to extend our search for a satisfactory solution beyond the scope of the unilateral contrivances set up by one partner, into the realm of bilateral arrangements made by all of the partners.

PLANS MADE BY THE PARTNERS ACTING TOGETHER

A successful plan requires joint action by all partners. It is now clear that the plan which will best solve the problems brought about by the death of a partner must be found among contractual plans entered into prior to death by all of the partners.

Agreement for continuance of the business. Several varieties of such plans have been tried out. One of the simplest was that contained in the partnership articles involved in the case of *Stewart v. Robinson,* 115 N. Y. 328, 22 N. E. 160, and in its companion cases of *Delamater v. Hepworth,* 115 N. Y. 664, and *Butcher v. Hepworth,* 115 N. Y. 328; and further involved in the cases of *Colwell v. Garfield National Bank,* 119 N. Y. 411, and *Bell v. Hepworth,* 134 N. Y. 442. The partners, Colwell and Hepworth, provided in their partnership agreement as follows:

> In the event of the death of either, the business shall be continued by the survivor until the expiration of five years from the first day of February next succeeding such death; the estate of the deceased partner to have the same share and interest in the profits, and to bear the same share of losses of the business, as would have been received and borne by the deceased partner had he lived; provided, however, that if the survivor shall think it necessary to employ an additional clerk in consequence of the death of the deceased partner, in such case the expense shall be charged to and shall be borne by the share in the profits of the deceased partner.

Partner Colwell subsequently died, leaving the value of his partnership interest, $50,000, in the business. Surviving partner Hepworth continued to run the business for a period of approximately five years as provided in the agreement, during

which time $35,000 of additional funds were loaned by the executors and trustees of Colwell to the business. At the end of this time, Hepworth was insolvent to the extent of about $500,000, and he then made an assignment for the benefit of creditors.

In the *Stewart v. Robinson* case, certain unsatisfied creditors of the continued business, learning that Colwell's estate had funds, sued his executors and trustees on the ground that the agreement, by providing that the estate would share in the profits and losses, had made the deceased's estate liable for the debts of the continuing business. The opinion pointed out, however, that neither the personal representatives nor the heirs had taken any part in the business with the survivor, that they had not been designated as partners, that an estate as such could not be a partner, and that in fact no new partnership had been formed. The court then applied the rule that only the clearest and most unambiguous language to that effect would have made the estate liable beyond the funds remaining in the business; and held that since such positive language could not be found in the agreement, the estate of the deceased partner was not liable beyond the funds left in the business.

In the *Delamater v. Hepworth* case, other creditors sued the surviving partner and the executors of the deceased partner, and, after declaring that no partnership existed between Hepworth and the executors, tried to reach the funds in the deceased's estate on the same ground that had been urged by the creditors in *Stewart v. Robinson*: that the agreement, by its wording, had made the estate liable for the debts of the business. The court decided against the creditors, without opinion, basing its decision on that of *Stewart v. Robinson.*

In the *Butcher v. Hepworth* case, the plaintiffs, who had been appointed receivers of the business, sued the surviving partner and the executors of the deceased partner to reach the assets of the deceased on the distinct ground that the business had been conducted by Hepworth and the executors as a new partnership. Here again it was held that no such partnership existed; that the agreement did not continue the old partnership nor call for a new one to be formed; that the executors had not

acted as partners; and that the agreement did not involve the general assets of the deceased partner or the personal assets of the executors, but only the funds left in the business.

But the troubles caused by this continuation agreement have not yet been fully explored. In the *Stewart v. Robinson* case the creditors had succeeded in having a receiver appointed for the estate of the deceased partner, pending the outcome of the litigation. After the creditors had lost the decision in the lower court, they were somehow successful in having the receivership continued. When the creditors finally lost the *Stewart v. Robinson* case in New York's highest court, the receiver in the case of *Colwell v. Garfield National Bank* sued the bank to recover a debt owed by that institution to the estate of the deceased partner. The court held that a receiver *pendente lite* had no authority to sue in behalf of the estate he represented after a judgment had been rendered against the party at whose instance he was appointed. The court held further that the order continuing the receivership after the lower court had rendered judgment was invalid. Thus this case reveals that, to add to their misfortunes, the executors of the deceased partner were ousted from their duties for an extended period.

Following the above cases, the surviving partner and the executors of the deceased partner seem to have had a brief interlude of non-litigious quietude. It appears that shortly after Colwell died, the surviving partner had borrowed several thousand dollars from a Mr. Bell and, with the consent of the deceased partner's executors, had given Bell a mortgage on property of the business as security. In *Bell v. Hepworth,* the mortgagee sued to foreclose his mortgage, joining the deceased's executors with Hepworth as defendants. The executors in defense of their suit, apparently somewhat "groggy" from the successive legal blows they had received, contended vainly that the lien of the estate of the deceased partner for the amount he had left in the business was superior to that of the mortgage; that the agreement contained in the partnership articles was invalid because it was testamentary in nature and was not executed with the formalities of a will; and that the agreement to continue the business violated the rule of perpetuities in that

it suspended the power of alienation of property for a period of five years. To all these contentions, the court's answers were adverse, and the mortgage was duly foreclosed.

Since each of these five cases was litigated in two lower courts before reaching New York's highest tribunal, the surviving partner and the executors of the deceased partner were called upon to defend themselves legally at least fifteen times as a result of the seemingly innocuous paragraph of the partnership agreement requiring continuation of the business. In the end, the survivor lost everything. The deceased partner's estate lost the $50,000 value of the partnership interest left in the business, most if not all of the $35,000 subsequently loaned to the business by the executors, and thousands of dollars in the legal expenses of defending the balance of the estate from the creditors of the continued business. Admitting that this cluster of cases is an extreme example, it is obvious, nevertheless, that any arrangement that can lead to such litigious and financially disastrous results for the surviving partner and estate of the deceased partner must be classed as highly undesirable.

AGREEMENT FOR NEW PARTNERSHIP BETWEEN SURVIVOR AND HEIRS

A binding agreement may be entered into by the partners and their heirs, providing that on the death of a partner the survivor will form a new partnership to continue the business with specified heirs who are parties to the agreement. Even if all the persons concerned are signatories to such a contract however, the arrangement has one legal weakness that cannot be surmounted: it cannot be specifically enforced by court action. True, if the surviving partner refuses to carry on the business with the designated heir as a new partner, he is liable to damages for breach of contract. And likewise, if the nominated heir refuses to perform, his refusal will subject the deceased partner's estate to damages for breach of contract. But the fact remains that a court will not compel any person to enter or carry on the partnership relation with another. The scheme is therefore tinged with uncertainty and still leaves the possibility of liquidation with its attendant losses as the final outcome.

Willingness to go ahead with the new partnership can by no means be assured. Obviously, unless the heirs who are selected to become future partners are active and experienced in the business, the plan will have small chance of success. The surviving partner usually finds himself left with an inexperienced and uninterested prospective partner whose primary objective is to receive current income to replace that lost on the death of the original partner. Such an objective conflicts ruinously with the surviving partner's long range objectives for the future development and expansion of the business, a fact that may well be proved in operating losses if the scheme is carried through.

The plan is feasible only in the exceptional case in which the heir is already a capable employee of the original partnership and an individual whom the survivor would like to take in as a future partner. For example, the partners might have talented sons employed by the firm. If an agreement to continue the business with a son who has attained his majority meets with the favor of all concerned, it should prove satisfactory. Certain precautions, however, must be carefully observed. If a partner's interest constitutes the bulk of his property, his wife should waive any rights that she might otherwise have in the partnership interest. In replacement, such a partner should own sufficient personal life insurance payable to his wife to guarantee her proper maintenance, support and well-being. An alternate plan calls for the purchase by the son of all or part of the father's partnership interest at his death. The purchase should be financed by insurance owned by the son on the father's life, the insurance proceeds to be paid over by the son to the father's estate for distribution to the other members of the family under the terms of the father's will.

It is readily apparent that the existence of the precise circumstances required for the success of a new partnership between the survivor and the heirs is so infrequent that the plan can rarely be set up. Thus it affords a desirable solution only in a few isolated instances.

Agreement giving survivor option to buy deceased's interest. It is not unusual to find partnership articles which contain a provision allowing the surviving partner an option to buy the deceased partner's interest. That such a plan has an inherent

and incurable weakness, which makes it undesirable, is revealed by cases that have dealt with such plans.

A familiar case is that of *Denholm v. McKay,* 148 Mass. 434, 19 N. E. 551 (1889), which involved what probably was the largest department store in Worcester, Massachusetts. William A. Denholm and William C. McKay operated the store as a partnership, the articles providing in part as follows:

> And it is further agreed, that, if either partner shall die during the continuance of this agreement, the other party shall carry on the business in the same manner until next stock-taking, and the survivor shall then have the option of taking the assets himself, at such price and terms as may be agreed upon by the legal representatives of the deceased and himself, or put the business into liquidation for the benefit of both parties, such liquidation to be as speedy as possible; or if agreed upon by the survivor and the representatives of the deceased, the business may be carried on until the expiration of this agreement; provided always that the party so carrying on the business shall at all times disclose his acts, the affairs of the firm, the books, and the account of stock, to the representatives of the party so deceased.

McKay subsequently died, leaving a widow and minor children as his heirs. He had named Denholm, together with two other individuals, as his executors. Denholm immediately had a careful inventory taken by the personnel of the store. This inventory showed McKay's portion to be worth about $82,000, and Denholm then purchased the deceased's interest from the other executors for that sum, the widow being cognizant of all the details. The facts show that the executors, in making the sale, were not guilty of any actual fraud, that their intent was to act fairly, and that they thought the price was a reasonable one. However, when the executors filed their accounting for the deceased's estate three years later, the widow challenged the sale and claimed that they should account for the profits made since McKay's death.

The court held that the agreement was voidable as to price because of the fact that the surviving partner had acted as one of the executors, and sent the case to a master to ascertain and

report the full value of the deceased's interest. But because the price paid was not much less than the probable true value, and because it would be practically impossible to segregate the profits that had been derived from the deceased's interest since his death, the surviving partner was held accountable for the true value, plus the interest on it, from the date of McKay's death.

The case revealed the several serious weaknesses involved in the plan. In the first place, the option arrangement gave no assurance to the widow and minor children that they would receive the full value of the deceased's interest, even though this was the final outcome. If the option had not been taken up by the survivor, they would have received only the liquidated value after a forced sale of the assets of the store. The court stated in the opinion that "The great object of this provision in the agreement apparently was to avoid the necessity of putting the business into liquidation by a sale, and thus stopping the whole concern." Here, the option was exercised, and the widow and children, after court action, fortunately obtained the full value. In the second place, the failure to stipulate a definite price or valuation formula in the agreement left the survivor in a fiduciary position so that his every act would be viewed with suspicion by the courts. In the third place, by designating the survivor as one of his executors, the deceased disabled the survivor from entering into a binding transaction as to price.

The last two weaknesses could have been eliminated by proper care; the first weakness is inherent in the option plan itself. The uncertainty of knowing whether or not liquidation losses will have to be suffered by the estate left for the support of the family of a deceased partner makes the option plan undesirable in the vast majority of cases.

AGREEMENT FOR SURVIVOR TO PURCHASE DECEASED PARTNER'S INTEREST

With one outstanding exception, we have now analyzed every scheme, plan, or contrivance that has been used to circumvent liquidation of the affairs of a partnership on the death of a partner. Most of these schemes have culminated in more

destructive consequences than would have been the case had liquidation taken place. Each has proved faulty in some vital function. One major plan remains to be analyzed: that calling for a binding contract among the partners whereby the surviving partner or partners agree to purchase the partnership interest of a deceased partner at a price stipulated in the agreement or to be ascertained by the application at time of death of a definite valuation formula contained in it.

A simple agreement of this nature was the bone of contention in *Murphy v. Murphy,* 217 Mass. 233, 104 N. E. 466 (1914). There the partners had agreed that in the event of the death of one, the survivor would pay his widow or legal representative $3,000, and that thereupon the survivor would become the sole owner of the partnership business. The firm, consisting of two brothers, Bartholomew and Patrick Murphy, conducted a liquor business. Upon Patrick's death, Bartholomew tendered the widow and administratrix $3,000 in accordance with the terms of the agreement, but she refused to go through with the transaction. Bartholomew then brought this suit, asking that the widow be compelled to carry out the contract. Massachusetts' highest court held that the agreement was binding and must be specifically performed. The widow as administratrix was required to accept the purchase price of $3,000 that had been stipulated by the partners in the contract and to release the interest of the deceased partner in the partnership to the surviving partner. As this is a leading case, we shall quote freely from the opinion.

> Partnership agreements which provide for the conduct of the business after the death of one or more of the partners, and for the disposition of the interest of partners in the partnership in such event, are frequent. See *Williams v. Brookline,* 194 Mass. 45, 79 N. E. 996. When fairly made, without any illegal purpose and without intent to evade the statute of wills, they are not open to objection. . . . There are sound reasons why a fair agreement entered into by partners, as to the disposition of partnership property in the event of the death of one or more of the partners, should be sustained. The terms of such an agreement made by those most familiar with the real character and

> value of the property are quite as likely to be just as an arrangement made after the decease. . . . The contract at bar was executed upon a valid consideration, and having been found expressly not to have been intended as a testamentary disposition, must be upheld.
>
> . . . The plaintiff as the surviving partner, in the absence of any term in the articles of co-partnership covering the matter would take as owner the legal title to firm property. *Holbrook v. Lackey,* 13 Metc. 132, 46 Am. Dec. 726; *Hewett v. Hayes,* 204 Mass. 586, 592, 90 N. E. 985, 27 L. R. A. (N S) 154. He would take it, however, subject to the duty to pay the firm debts, settle the partnership accounts, and account to the personal representatives of the deceased partner. In a certain sense he would hold it as trustee, partly for the benefit of the estate of the deceased partner. There is no reason in equity why the defendant should not be required to release this beneficial obligation which, but for the contract, would exist in her favor. *Maddock v. Astbury,* 32 N. J. Eq. 181.

The Murphy case finally brings us close to the ideal plan we have long been searching. A comparison of the results here with the weaknesses brought out in *Denholm v. McKay* makes this readily apparent. In the Denholm case the surviving partner had an option to buy. Therefore, the choice between purchase and liquidation was his, and there could be no certainty in advance that liquidation, with its consequent losses to all concerned, would be avoided. In the Murphy case there is a binding agreement of purchase and sale that, being upheld by the court, eliminated all possibility of liquidation losses. In the Denholm case the purchase price upon exercise of the option was left open, to be agreed upon between the survivor and the executors of the deceased partner. Then, to make matters worse, the survivor was named as one of the executors, thereby disabling him from entering into a binding agreement as to price and leaving him in a fiduciary position with respect to the whole transaction. In the Murphy case the price was exactly agreed upon in advance, with the result that the survivor never acquired the status of trustee with its attendant burdensome obligations and strict accountability. Furthermore, as the buyer of unique property (the partnership interest of the deceased partner), he

was entitled to specific performance of the transaction, rather than to damages, on the refusal of the estate to carry out its part of the contract. The outcome was that the surviving partner owned the entire partnership business and was free to go ahead with whatever future plans he may have had. The estate received in payment for the sale of the deceased partner's interest exactly the amount agreed upon by the partners as the proper price.

PURCHASE AND SALE AGREEMENTS BETWEEN PARTNERS GENERALLY UPHELD

The decision in the Murphy case, upholding the agreement between the partners providing for the purchase of the partnership interest from the deceased partner by the survivor upon the death of the first to die, probably represents the law in every state. Reference to some of the cases in other jurisdictions will bear this out.

One of the leading cases in the State of Pennsylvania is that of *Kaufmann v. Kaufmann,* 222 Pa. 58, 70 Atl. 956 (1908), which involved the large firm of Kaufmann Brothers. The four partners had agreed that on the death of one, the surviving partners would purchase the partnership interest of the deceased partner at a price arrived at by the application of a specified formula that included a valuation of the good will. On the death of one of the partners, Jacob K. Kaufmann, his partnership interest, by the applying of the valuation formula agreed upon, was valued at $288,750, including $38,750 for his share of the good will. His legal representatives tried to enjoin the carrying out of the purchase and sale agreement on the ground that at the time of Jacob's death his share of the good will was actually worth $1,750,000. The evidence showed that although the agreement had been amended from time to time during the eleven years it had been in force, the valuation clause had not been changed. The court upheld the agreement of the partners, saying in part:

> Though the most elaborate proof has been submitted by the learned counsel for appellants, the case, after all, is within a narrow compass and absolutely free from doubt and difficulty. The agreements, which are self-interpreting,

> were made by persons sui juris. The one as to the purchase of a deceased partner's interest is not an unusual one, and was fair alike to each of the four partners. If the representatives of Jacob are now disappointed that they cannot get more than the survivors offer them, the law cannot help them, for it was so written by him in his agreement with them.

The court, in *Casey v. Hurley,* 112 Conn. 536, 152 Atl. 892 (1931), had this to say about the agreement of the partners:

> While more precise and definite language might have been used to express the intent of the parties, that intent, it seems to us, is unmistakable, and we are unable to perceive any ground upon which it could be held that the contract is not a valid and enforceable one. The agreement between partners that, upon the death of one, the survivors should be entitled to take the interest of the other in the partnership assets at a price named in the agreement, or to be determined thereafter by some method specified therein, rests upon the consideration of the mutual promises of the partners, is enforceable, and relieves the surviving partner of the obligation to account. *Murphy v. Murphy,* 217 Mass. 233, 104 N. E. 466; *Kaufmann v. Kaufmann,* 222 Pa. 58, 70 Atl. 956; *Warren v. Warren,* 169 App. Div. 97, 154 N. Y. S. 458; *In re Orvis,* 223 N. Y. 1, 119 N. E. 88, 3 A. L. R. 1636, and see note in *L. R. A.* 1918B, p. 907.

It is now well established that partners may enter into a binding contract for the purchase of the partnership interest of the deceased by the survivor. Furthermore, the courts generally grant specific performance of these contracts in those cases in which their validity is challenged. This means that the partners may set up such agreements with full confidence that their arrangements will be carried out to the letter.

SURVIVORSHIP TYPE OF AGREEMENT HAS BEEN UPHELD BY MANY STATES

The survivorship type of agreement, providing that the interest of the deceased partner, immediately upon his death, or upon payment therefor, shall vest in and become the property of the

surviving partners must be distinguished from the standard type of agreement calling for the purchase and sale of a partner's interest upon his death. The survivorship agreement has been upheld in such cases as *McKinnon v. McKinnon, Coe v. Winchester,* and others. It has been declared a valid contract in the majority of states, but in a few jurisdictions there may still be some doubt as to its validity. For a period of years, Rhode Island was in that category. The Supreme Court of Rhode Island, in *Ferrara v. Russo,* 40 R. I. 533, 102 Atl. 86 (1917), held ineffective an agreement which provided that in the event of the death of Carmine Ferrara his interest in a certain printing establishment operated by him jointly with Russo would become Russo's property in consideration for a payment of $275 to Ferrara's heirs. The opinion stated in part:

> The agreement only provides and directs what was to be done after the death of Carmine. An agreement or instrument of this kind is held to be testamentary in character. The essence of such definition is that it is a disposition to take effect after death. And the form is not material, if its substance is testamentary.

The Ferrara case was severely criticized and undoubtedly led to the enactment in 1932 of new legislation (now Section 10, Chapter 428, General Laws of Rhode Island, 1938, which provides that a written partnership agreement, disposing of the assets, firm name, or partnership life insurance policies or proceeds upon the death of a partner, shall not be deemed testamentary in character or for that reason invalid or unenforceable.

The opinion in *McKinnon v. McKinnon,* 56 Fed. 409, a Missouri case, stated:

> There are many cases to be found in the books, some of which have been called to our attention and are evidently relied upon in the present case, where an instrument which was intended by the grantor to be a conveyance was held not to be operative as such, because it did not pass any present interest, and to be void as a will, because not executed in conformity with the statute of wills, *Hester's Executors v. Young,* 2 Ga. 31; *Turner v. Scott,* 51 Pa. St. 126; *Roth v. Michalis,* 125 Ill. 325; *University v. Barrett,* 22 Ia. 73. The distinction between a deed and

> a will is elementary, and is well understood. The former must pass a present interest, although the right to possession and enjoyment may not accrue until some future time; whereas an instrument which does not pass any interest until after the death of the maker is essentially a will, and must be executed with all due formalities. But we fail to see that these authorities, or the principles which they enunciate, have any proper application to the case at bar. The partnership articles involved in the present controversy were neither intended as a deed or a will. They constitute an executory agreement, which determines the rights of the parties inter se, and provides what disposition shall be made of the partnership property on the happening of a certain event. In the state of Missouri, where these articles were signed, and where both partners at the time resided and carried on business, it is as well settled, as it is in any state of this Union, that an agreement by a person, upon a valuable consideration, to give another the whole or a part of his property at the promissor's death, will be specifically enforced in equity, both as to real and personal property, if the consideration is duly rendered by the promisee . . .

In *Normand v. Normand,* 90 N. H. 548, 11 Atl. 2d 816 (1940), the opinion stated:

> It is not uncommon, however, for articles of partnership to provide the method by which the partnership affairs shall be settled, and when such provisions exist they must prevail. Parsons, *Partnership,* 4th Ed. s 344. Partners "may agree that upon the death of any of their number, the survivors shall become the absolute owners of the firm assets, with a personal liability to pay the deceased partner's representatives for his interest." Burdick, *Partnership,* 3rd Ed. 148. In such a situation the right of the representative is to have the value of the deceased partner's interest ascertained in the method prescribed by the agreement, and paid by the survivors in the stipulated manner. Id 149.

A 1949 case upholding a survivorship type of agreement is *Michaels v. Donato,* 4 N. J. 570, 67 Atl. 2d 911. The agreement provided that upon the death of a partner the surviving partner should pay the legal representative of the deceased partner $1,000, "that said sum shall represent the deceased partner's

entire interest in the partnership and that upon such payment the surviving partner shall become the sole owner of the partnership business." As in the McKinnon case, the decision turned on the distinction between a contract and a will. On this vital point, the opinion stated in part:

> A contract creates a present, enforceable and binding right over which the promisor has no control without the consent of the promisee, while a testamentary disposition operates prospectively. 57 Am. Jur., Wills, Sec. 40, Page 67. An instrument which does not pass any interest until after the death of the maker is essentially a will. But not every instrument which provides for performance at or after death is testamentary in character. If the instrument creates a right in the promisee before the death of the testator, it is a contract. "A will is dispositive; a contract is promissory. A will is gratuitous; while a contract * * * requires consideration." 1 Page, Wills, Lifetime Ed., Sec. 83, Page 179.

Turning to the agreement before the court, the opinion quoted 73 A.L.R. 980 to the effect that "a provision in a partnership agreement that on the death of one of the partners his interest in the partnership shall become the property of the other partners is not invalid as testamentary in nature, and therefore inoperative because of failure to conform to the requirements of the Statute of Wills." The quoted statement was then backed by the following imposing array of cases and authorities: *McKinnon v. McKinnon,* 56 Fed. 409; *In re Howe's Estate,* 31 Cal. 2d 395; *Faggelle v. Marenna,* 131 Conn. 277; *Casey v. Hurley,* 112 Conn. 536; *More v. Carnes,* 309 Ky. 41; *Murphy v. Murphy,* 217 Mass. 233; *Hale v. Wilmarth,* 274 Mass. 186; *Kavanaugh v. Johnson,* 290 Mass. 587; *Ottaviano v. Lorenzo,* 169 Md. 51; *Ireland v. Lester,* 298 Mich. 154; *In re Mildrum's Estate,* 108 Misc. 114 (N.Y.); *In re Eddy's Estate,* 175 Misc. 1011, aff'd 262 App. Div. 1015, aff'd 290 N.Y. 677; *In re Karlinski's Estate,* 38 N.Y.S. 2d 297; *In re Eisenlohr's Estate,* 258 Pa. 438; 1 A.L.R. 2d 1265; 50 Yale Law Review (1940), Page 202; Rowley, *Partnerships* (1916), Sec. 638; Story, *Law of Partnerships,* 7th Ed., Sec. 199.

A 1953 case, upholding a survivorship type of partnership

agreement, is *Silverthorne v. Mayo,* 238 N.C. 274, 77 S.E. 2d 678. The opinion stated in part:

> Agreements between partners providing that in the event of the death of one of the partners during the existence of the partnership, the surviving partner or partners shall pay a certain amount to the legal representatives of the deceased partner, or to specified persons, and upon the payment thereof the surviving partner or partners shall become the sole owner or owners of the partnership business, are frequent, and when fairly made, for a valuable consideration and without any illegal purpose, such agreements are not open to objection and will be upheld. 40 Am. Jur., Partnership, Sec. 311, page 347; Page on Wills, Volume 1, Sec. 84, page 180, et seq; *McKinnon v. McKinnon,* 8 Cir., 56 F. 409; *Murphy v. Murphy,* 217 Mass. 233, 104 N. E. 466; *Ireland v. Lester,* 298 Mich. 154, 298 N. W. 488; *Warrin v. Warrin,* 169 App. Div. 97, 154 N. Y. S. 458; Anno. 73 A. L. R. 991; Anno. 1 A. L. R. 2d 1265.
>
> It appears to be well settled that a provision in a partnership agreement to the effect that on the death of one of the partners his interest in the partnership shall become the property of the surviving partner or partners is not testamentary in nature, and the fact that the agreement is not executed according to the requirements of the law governing the execution of wills does not render it invalid and unenforceable. Such an agreement is enforceable if supported by fair and adequate consideration. 40 Am. Jur., Partnership, Sec. 312, page 347; *United States v. Stevens,* 302 U. S. 623, 58 S.Ct. 388, 82 L.Ed. 484; *Hale v. Wilmarth,* 274 Mass. 186, 174 N. E. 232, 73 A. L. R. 980; *Green v. Whaley,* 271 Mo. 636, 197 S. W. 355. See Anno. 1 A. L. R. 2d, page 1197, et seq., where cases from thirty-six states are cited in support of this view, including *Fawcett v. Fawcett,* 191 N. C. 679, 132 S. E. 796.

ADDITIONAL CITATIONS

Among other prominent cases upholding agreements of the partners for the disposal of the interest of a deceased partner to the survivor, or agreements similar in nature, are the following:

In re Orvis' Estate, 223 N. Y. 1, 119 N. E. 88 (1918); *Lockwood's Trustees v. Lockwood,* 250 Ky. 262, 62 S. W. 2d 1053

(1931); *Coe v. Winchester,* 43 Ariz. 500, 33 Pac. 2d 286 (1934); *Garratt v. Baker,* 5 Cal. 2d 745, 56 Pac. 2d 225 (1936); *First National Bank of Rome v. Howell,* 195 Ga. 72, 23, S. E. 2d 415 (1942); *Rankin v. Newman,* 114 Cal. 635, 46 Pac. 742 (1896); *Hermes v. Compton,* 260 App. Div. 507, 23 N. Y. S. 2d 126 (1940).

An Iowa case involved an agreement that would have had the effect of disinheriting a deceased partner's widow, and must be considered on its peculiar facts. In *Fleming v. Fleming,* 194 Iowa 71, 174 N. W. 946 (1919), rehearing denied, 194 Iowa 71, 180 N. W. 206 (1920), mod., 194 Iowa 71, 184 N. W. 296 (1921), error dis., 264 U. S. 29 (1924), mod., 211 Iowa 1251, 230 N. W. 359 (1930), the partnership survivorship agreement between four brothers was held in effect a contract to make wills in favor of the survivors and subject to the widow's statutory share in the estate of the deceased. The court pointed out that "there were no creditors except those paid by the surviving partners."

FINANCING THE PURCHASE AND SALE AGREEMENT

A study of some of the actual cases has shown that if a binding purchase and sale agreement has been entered into by the partners, then upon the event of a death, the surviving partner, on tendering the stipulated purchase price of the deceased partner's interest to his executor or administrator, is entitled to a release or conveyance of that interest. If at the time of death, however, the survivor should be financially unable to tender the purchase price, the plan would fall through in spite of any court action that might be brought by the deceased partner's estate. Therefore, the only remaining hazard to such a plan is that the surviving partner may not have the funds with which to carry out the transaction when a death occurs. In some instances a death will not occur for a number of years; in others it will occur in a matter of days. The surviving partner will require a specified amount of cash at an unpredictable time in the future, that is, whenever his partner dies. Obviously therefore, his need for funds will be exactly matched by the obligation of an insurance company to pay over funds under a life insurance policy carried on the life of the deceased partner in the amount of the purchase price.

Part III

THE PARTNERSHIP PURCHASE AND SALE AGREEMENT FINANCED WITH LIFE INSURANCE

CHAPTER 8

The Insured Purchase and Sale Agreement— General Considerations

LIFE INSURANCE ASSURES CARRYING OUT OF PURCHASE PLAN

EXTENDED EXAMINATION OF THE VARIOUS PLANS contrived to perpetuate partnership businesses demonstrates that definite assurance of the continuance of the business on the death of a partner can be had only by means of a contract in which the survivor agrees to purchase the interest of the deceased at a stipulated price. From the nature of the transaction, however, such assurance can only be as certain as the ability of the surviving partner to tender the purchase price at time of death.

Life insurance on each partner in the amount of the purchase price is not only necessary to remove the danger that the money to consummate the purchase will not be on hand when needed, but it also offers to the partners the most convenient and attractive method of financing that purchase.

Methods of financing the purchase other than with life insurance. The alternatives to the life insurance plan of financing the purchase are few. If the partners are wealthy, their ability to produce the cash may be conceded, but the survivor will have to put up one hundred cents on the dollar, perhaps at a time highly inconvenient to him. On the other hand, the life insurance contract calls for premiums in instalments that seldom total the face amount. If the partners are in ordinary financial circumstances, which includes the vast majority, three choices are possibly open to them: to build up the purchase price in advance through savings; to provide in the agreement for payment of the purchase price in instalments; or to borrow the purchase price at time of death.

Attempts to build up the purchase price in advance through ordinary savings plans are impracticable because the money might be required in ten days or in ten years; exactly when, no one can foretell. Certainty that the plan will be completed cannot be attained by this method.

A plan by which all, or substantially all, of the purchase price is to be paid in instalments after death is also unworthy of serious consideration because it mortgages the partnership business and the future of the surviving partner, while at the same time it leaves the family of the deceased dependent upon the survivor's success for their money. Moreover, the survivor may find himself in an impossible position to perform.

Assume that two partners each receive $20,000 from the partnership. They set a value of $100,000 on each of their interests and agree that in the event of the death of one the survivor will purchase the interest of the deceased by paying five annual instalments of $20,000, with 5 per cent interest. If the partner destined to be the survivor has a wife and a dependent child and ordinary deductions of $2,000, his current federal income tax, based upon a joint return and 1954 rates, will be $3,988, leaving him a net spendable income of $14,012. But look at the picture after the death of his associate. The survivor will undoubtedly have to hire a new assistant and pay him approximately $5,000 a year. On the assumption that the partnership will continue to yield $40,000 annually, an income of $35,000

will be available for the survivor. After his ordinary deductions of $2,000 as before and the deduction of $5,000 interest on his indebtedness under the agreement, his net income will be $28,000, his federal income tax will be $7,746 and his net spendable income will be $20,254. If we deduct from this figure his previous spendable income of $14,012 as necessary to the maintenance of his established standard of living, only $6,242 remains with which to pay the first instalment of $20,000. Conversely, if we deduct the first instalment from his spendable income of $20,254 only $254 remains for him to live on. Obviously, the survivor cannot carry out his bargain under such ordinary circumstances as those depicted. An agreement spreading the payments over a greater number of years is no answer, for the family of the deceased partner would then be left dependent upon the survivor's success over a dangerously long period.

Since the ability of the surviving partner to borrow the purchase price cannot be assured beforehand, the ultimate completion of this plan is shrouded in uncertainty. This lack of assurance that the plan will function properly overshadows the fact that, even if the survivor is successful in arranging a loan at time of death, he mortgages his future and he will finally have to pay the loan back at one hundred cents on the dollar, probably plus a substantial amount of interest.

The life insurance method of financing the purchase agreement. The life insurance method of financing, on the other hand, guarantees the successful completion of the purchase plan. It is, in effect, an advance instalment method of paying the purchase price for the deceased partner's interest. These advance instalment payments are in the form of convenient premiums, usually amounting annually to only three or four per cent of the total price with the customary proviso that these premium payments cease at death, no matter how few have been made. Rarely do premiums aggregate the face amount; in fact, the total amount actually paid is often only a fraction as some of the following case examples will show, and hence the purchase price is obtained with discounted dollars.

By this plan of financing, the event that causes the obligation to mature and become payable is also made to furnish the

money with which to discharge that obligation. By this plan, the survivor owns the entire business, paid for in full; and the deceased partner's estate receives the full amount of the purchase price, in cash, "on the barrel-head." If the life insurance contract had not been devised previously, it surely would have been devised to finance partnership purchase and sale agreements, because it so exactly fulfills the requirements.

VALIDITY OF THE PURCHASE AND SALE AGREEMENT FINANCED WITH LIFE INSURANCE

The validity of agreements for the purchase and sale of partnership interests, financed with life insurance, rests upon a legal basis no different than that of similar agreements that do not include this financing arrangement. If the agreement is properly drawn to contain the elements of a sound contract, it is binding and enforceable. The cases that involved no insurance which are discussed or cited in Chapter 7 as upholding agreements of this type are also authority for the validity of the complete form of agreement, which includes life insurance financing. Nevertheless, it will be of interest to refer specifically to a few of the cases dealing with agreements that used life insurance.

Coe v. Winchester. One of the most interesting of these cases is *Coe v. Winchester,* 43 Ariz. 500, 33 Pac. 2d 286 (1934). Ranny V. Winchester and Tasso Coe conducted as partners a merchandise brokerage business in Tucson, Arizona, under the name of Winchester-Coe Company. In the Spring of 1926 the partners each purchased $10,000 of life insurance, and entered into an agreement that functioned both as Articles of Partnership and as a Survivor Agreement covering the partnership interest of the first to die. This agreement, which Coe testified on the trial that he had typed while Winchester "more or less" dictated, is unique at least for its brevity. Here it is:

> We, Tasso Coe and R. V. Winchester, doing business as Winchester-Coe Company, agree to operate a merchandise brokerage business, dividing the profits equally.
>
> We agree that neither of us shall sign bonds, or endorse any notes unless done jointly.
>
> As a result of a ten-thousand dollar life insurance policy

taken out by each of us, Coe's with the Aetna and Winchester's with the Pacific Mutual Life, premiums on which are to be paid by Winchester-Coe Company. In event of Coe's death, his wife or heirs is to receive the face of this policy, and Winchester receives Coe's interest in the business. In the event of Winchester's death his wife or heirs to receive the face of the policy and Coe receives Winchester's interest in the business.

Signed by us this 8th day of May, 1926.

[signed] Tasso Coe
[signed] R. V. Winchester

In the Spring of 1930, only four years later, almost to the day, Winchester died. Myrtle Winchester, who was the widow and executrix of the deceased partner, after receiving the $10,000 life insurance proceeds, sued for an accounting. Her principal contention was that, Arizona being a community property state, the agreement covered only her husband's share of the community interest in the partnership, but not her community interest; in other words, that the surviving partner was entitled to only one-half of Winchester's one-half interest by reason of the agreement, and should account to her for the value of her community interest of one-fourth. She also challenged the validity of the agreement, and argued further that it was unfair to her.

Arizona's highest court held the agreement valid, that it entitled the surviving partner to the entire business, and that the arrangement was not only fair to the widow but advantageous to her and "was an admirable one."

The opinion brought out several points worthy of note. In upholding the validity of the contract, *Murphy v. Murphy*, 217 Mass. 233; *Matter of Borden's Estate,* 159 N. Y. S. 346; and *McKinnon v. McKinnon*, 56 Fed. 409, were cited, and the quotation from the McKinnon case, which we have set out on pages 172-173, was quoted. The court had some difficulty in arriving at the decision that the agreement covered the entire community interest of the Winchesters, because of lack of clarity of the wording used. Winchester, however, seems to have been better at writing letters than in dictating agreements, for it was by means of a letter that he had previously written to

Coe, which was fortunately admitted in evidence, that the court settled the point as the partners had intended. This letter read in part as follows:

> . . . My idea of the proposition is as follows: In case of my death my policy would be paid to my estate, you to receive the entire business. In case you died your policy would be paid to your wife and I would receive the entire business, the two policies to be paid by the firm.
>
> I think this is an excellent proposition and think we should go on with it.

In holding that Winchester had the right to sell the entire community personal property, the court had this to say:

> The partners were married and their contributions to the partnership were from the marital community of each. While the wives of the members of the firm were not actually or nominally partners, therein, because the assets of the firm were community property they had a direct contingent interest in such assets. Under the community law of this state the spouses own their common property and the wife's interest is equal to that of the husband. Such being the rule, the assets of the partnership belonged in equal parts to the partners and their wives. The wife, however, during coverture has no power of disposition of the community personalty. The law, for reasons of convenience and expediency, places that power exclusively in the husband, who may exercise it in any way he chooses, except that he cannot make a testamentary disposition of his wife's interest or dispose of it in fraud of her rights. *La Tourette v. La Tourette,* 15 Ariz. 200, 137 Pac. 426, Ann. Cases, 1915B, 70. These are the only limitations on the husband's control or disposition of the community personalty.
>
> We are satisfied that the agency of Winchester over the community personal property vested him with full and complete power to make a contract in the nature of the one in question . . .

With respect to the advantages of the arrangement, the opinion is also worth quoting:

> The contract was certainly beneficial to the wife of the partner who died first, for the reason that she obtained

> $10,000 cash instead or her husband's one-half interest in the business worth only $19,819.39, itemized $11,819.39 in personalty and $8,000 "good will." Without the insurance arrangement the appellee's share would have been a little over $5,000 of the tangible assets and one-half of whatever might have been realized for the partnership "good will" upon a falling market in 1930 and since. It is apparent that the reason which prompted the partners to reduce their contract to writing was not that they feared each other, or that they wanted a written memorial of their agreement, but that their primary purpose in doing so was that the wife of the one who should first die would be provided for as well or better than if she took her deceased husband's one-half interest, and the survivor would have the business without having forced upon him a partner not of his own choosing or some one unfit or incapable of contributing the necessary skill to make the business successful. . . . The arrangement certainly was an admirable one and was made by the two partners to provide for their wives when they could no longer do so . . ."
>
> . . . Nor can it be said that the contract was not most advantageous to appellee. She received $10,000 cash instead of one-half interest in a $19,800 business subject to immediate liquidation. . . . We concur in Winchester's opinion of the arrangement wherein he says: "I think this is an excellent proposition and think we should go on with it."

Considerable space has been devoted to *Coe v. Winchester* because this case illustrates several important phases of our subject. In the first place, it proves the old adage that "when a person acts as his own lawyer, he has a fool for a client." Had the partners engaged the services of a competent attorney to draft their agreement, the case probably would never have gone to court. Unambiguous language would have made it clear that Coe was to get the entire business, and having the wives also sign a properly drawn agreement (which is advisable in community property states even though not held necessary in this particular case in which only personal property was involved), would have left Mrs. Winchester with no plausible ground on which to bring suit. In the second place, the facts show that

not more than five years of premiums could have been paid on the life insurance. Therefore, the purchase was financed by Coe through insurance premiums at only a small fraction of the price actually paid over to Mrs. Winchester. In the third place, the case shows that enlightened court opinion not only upholds such agreements, but applauds their use.

Lockwood's Trustee v. Lockwood. The facts of this case, 250 Ky. 262, 62 S. W. 2d 1053 (1933), show that John W. Lockwood and his son, William, conducted the partnership of J. W. Lockwood & Son. On October 30, 1931, when the father was age 67, they entered into a partnership purchase and sale agreement, financed by $10,000 of insurance on each life. On November 9, 1931, only 10 days later, the son died. The case came to court because the agreement was poorly worded, two of the clauses being in conflict on the amount that was to be paid to the estate. The court upheld the particular clause that awarded the full amount of insurance in payment of the partnership interest.

The case had three interesting facets that merit our attention. First, the validity of the agreement as such was not questioned. Second, there would have been no dispute had the agreement been properly drawn, a fact which emphasizes that this is a task for a competent and experienced lawyer. Third, the case illustrates again the superiority of the life insurance method of financing such agreements. In the normal course of events, the father would have died first, yet it was the son who died just ten days after the purchase and sale agreement had been executed. Only a small amount could have been paid out in premiums; nevertheless, the estate of the deceased received the full purchase price of $10,000. The all-important reason for using the life insurance method of financing is that it guarantees the completion of the plan by making certain that the purchase price is in the hands of the purchaser when it is needed.

It is impossible to avoid the conclusion that life insurance is the most efficient method of financing when it is considered purely from a dollars and cents standpoint. The risk of having to pay the purchase price in a few days or in a few years because of the premature death of a partner is ever present and should

be transferred to a life insurance company whose prime economic function is to neutralize such risks by the application of the law of averages to large numbers. John Lockwood and his son acted wisely in doing this.

First National Bank of Rome v. Howell. In this case, 195 Ga. 72, 23 S. E. 2d 415 (1942), the partners conducted a grocery business in Rome, Georgia. Each partner was insured for $10,000, and unusual cross agreements were entered into, obviously not drawn by an attorney, as follows:

> State of Georgia, County of Floyd.
>
> This agreement made and entered into at Rome, Ga., this twenty-third day of October, 1934, provides as follows: Irma T. Howell, of Rome, Ga., agrees to accept for her full and complete equity of the Howell Grocery Co., No. 2 the proceeds of one insurance contract issued by the Metropolitan Life Insurance Company of New York City, on which she is named beneficiary, Policy No. 6546835-A for ten ($10,000) thousand dollars, on the life of Elbert B. Howell, premiums on this insurance is being paid out of the profits of the Howell Grocery Co. No. 2, and the intention of said insurance is for the full purpose of purchasing from Irma T. Howell her full and complete interest of said Howell Grocery Co., No. 2, in case of prior death of Elbert B. Howell. This contract shall be binding upon the parties hereto, their heirs, executors and assigns.

These cross agreements were supposed to have embodied all the terms of a prior complete oral agreement entered into between the parties.

On the death of partner Elbert B. Howell, his widow received the proceeds of the insurance as beneficiary, but his estate refused to release his partnership interest on the ground that the agreement was not binding. The agreement was challenged on two main points: first, that it was testamentary in nature, and hence was void because not executed with the formalities of a will; and second, that because the premiums had been paid by the partnership, each partner had in effect paid the same amount of premiums, and hence their situation was equal and there could be no consideration passing between them to support the contract.

Georgia's highest court affirmed the lower court judge in overruling a demurrer by the bank as executor and trustee of the deceased partner, and held that under the allegation of the petition of the surviving partner he was entitled to reformation of the written contract to include the terms of the complete oral contract and to specific performance.

In holding agreements of this nature valid, the opinion quoted from *In Re Orvis' Estate,* 223 N. Y. 1, as follows: "An agreement between partners to constitute, from undivided profits, a fund for continuation of the business, which shall be the property of the survivor upon the death of either, rests upon mutual and equal consideration, and is enforceable." The opinion also quoted from the now familiar *Murphy v. Murphy,* 217 Mass. 233, and then made the following quotation from 40 *American Jurisprudence,* p. 347, ss. 311, 312:

> Agreements between partners that in the event of the death of one before the termination of the partnership, the survivor shall pay a certain amount to the legal representatives or heirs of the deceased partner and that thereupon he shall become the sole owner of the partnership business, are frequent, and when fairly made, for a valuable consideration and without any illegal purpose, such agreements are not open to objection. Provision in a partnership agreement that on the death of one of the partners his interest in the partnership shall become the property of the other partners is not testamentary in nature, and the fact that the agreement is not executed according to the requirements of the statute of wills does not invalidate it. It is enforceable if supported by sufficient consideration.

On the specific question of consideration, the opinion stated:

> In the instant case, the payment of the insurance premiums out of the firm assets, and the benefit flowing to each of the partners as a result of the plan, constituted sufficient consideration.

This case added Georgia to the long list of states whose highest courts have upheld agreements of this type. Furthermore, this unanimous decision of the seven justices of the Supreme Court of Georgia is deserving of special praise be-

cause of the complications brought on by the incompleteness of the written agreement.

We now turn to Michigan and to the case of *Ireland v. Lester,* 298 Mich. 154, 298 N. W. 488 (1941). Clyde Ireland and Cleveland J. Lester were partners in the sand and gravel business. In April, 1936, they entered into a purchase and sale arrangement. The purchase price in the agreement was set at $50,000 and was never changed. It was partially covered by life insurance that was to constitute the initial payment upon death; the remainder was payable at the rate of $1,000 per year. The agreement was prepared by an out-of-town attorney whom "the partners never saw, the data being furnished by the insurance agent." As originally drawn, it was provided that the deceased's estate should receive the money. However, before its execution the partners erased the word "estate" and inserted the word "wife" with respect to the initial payment, but by oversight they did not do so with respect to the subsequent payments. The agreement was signed by the partners and their wives.

Ireland died in December, 1939, without leaving a will, and was survived by his widow and two children by a former marriage. The surviving partner was ready to perform, but the question arose: Who should receive the money? The widow brought suit to have the instrument reformed to accord with the terms intended by the parties and for an order directing the money to be paid to her. The two children intervened, contending that the contract was invalid as testamentary in character and that the estate was entitled to the value of the partnership interest, in which case they would receive their intestate shares as heirs at law.

Michigan's highest court affirmed the decision in favor of the wife, holding that the contract was not testamentary in character, but that it was "a bilateral contract consisting of mutual promises to sell or buy, to be determined in the future by an event sure to occur." It was held "a valid and binding agreement, not testamentary in effect," the court declaring that the lower court had jurisdiction to reform it, regardless of whether the money was payable to the estate or the widow, and that there was no reason why the administrator could not carry out the

terms of the agreement. The court also pointed out that the widow was a third party beneficiary under the agreement, and that by reason of a special Michigan statute her rights under it had vested at the time it was signed.

In distinguishing the contract from a testamentary instrument, the opinion said:

> The fact that the death of one of the parties is to determine the time of performance does not of itself make the agreement testamentary. It is as proper to set death as a date for performance as any other time that could be stipulated.
>
> An instrument that is testamentary in character operates only upon and by reason of the death of the maker. Till then, it has no effect or force, and it is this ambulatory quality which is a characteristic of wills. A valid contract does not fall into the testamentary class simply because it is performable after the death of one of the parties, for to so hold would overlook the fact of the complete revocability that is a further characteristic of a will.
>
> . . . But the instrument in the instant case was operative from the day it was signed, and there came into existence contractual obligations and rights which the parties were entitled to have performed. There was a present transfer of a chose in action, performance of which was set for a future date. It was not intended nor was it necessary to have a present transfer of the partnership interest. It is this element of present existing contractual rights that distinguishes this case from those where the instrument has been declared testamentary in character.

Then the opinion went on to state:

> In the absence of any showing that a contract of this nature was for the purpose of evading some statutory provision or to offend public policy, there is no reason why a person cannot as well use this method of disposing of his property as by will or deed. The contract was made for an adequate consideration, and the obvious purpose of the agreement was to enable the surviving partner to take over the business and not have to dissolve it.
>
> Similar cases have come up in other states and it has been decided in practically all of them that such agreements between partners, when made without any ulterior

motives, are valid contracts. [Citing *Murphy v. Murphy, Hale v. Wilmarth,* and *Coe v. Winchester.]*

In summary, the cases involving partnership purchase and sale agreements financed with life insurance have universally upheld these agreements, based upon the earlier authorities, outstanding among which are the Murphy and McKinnon cases. We have found no case that has held such a contract void by nature. On the contrary, we have seen that the courts are upholding these agreements in spite of inept draftsmanship, which demonstrates their conviction of the inherent legal soundness of the underlying transaction.

COURTS REQUIRE PARTNERSHIP PURCHASE AGREEMENTS TO BE SPECIFICALLY PERFORMED

From time to time, reference has been made in the text to the fact that the courts grant specific performance of agreements for the purchase and sale of a partnership interest. This was done by the courts, for example, in the leading cases of *Murphy v. Murphy* and *McKinnon v. McKinnon.* Before the matter is discussed further, however, the significance of a decree of specific performance should be made clear. Perhaps this may best be done by contrasting it with the judgment rendered in the ordinary contract action at law.

In the case of the breach of an ordinary contract, the person aggrieved will sue for, and if successful receive, a judgment entitling him to money damages. Because the other party failed to perform his part of the contract, the plaintiff is awarded a sum of money in the amount of the pecuniary loss caused by this lack of performance; and he then must recontract with someone else if he wants to have the contract terms carried out.

In the case of the breach of certain special types of contracts, however, money damages are obviously not an adequate remedy, and in such cases courts of equity will require the parties to carry out what they have agreed to do. In other words, a decree of specific performance is granted. Among these special types of contracts, as we have seen, is the agreement for the purchase

and sale of a partnership interest. Money damages would not be just to the surviving partner. He has contracted to buy the deceased partner's interest, and if that particular transaction is not carried through, he must liquidate the business, and with it, his job. Justice can be done him only by requiring the estate of the deceased partner to transfer the deceased's interest in the partnership to the survivor on receipt of the purchase price.

This was the decree in the Murphy case, and it was also the decree in *Rome v. Howell,* in the Lockwood case and in many others that we have reviewed. But what of the deceased partner's estate? Can the executor or administrator of the deceased partner require the survivor, by court decree if necessary, to carry through his obligation to buy so that the estate may be sure to avoid liquidation losses? The following case shows that the surviving partner may also be made specifically to perform his part of the contract.

Kavanaugh v. Johnson. Thomas J. Kavanaugh and George W. Johnson conducted The Graphic Press, as partners. They entered into an insured purchase and sale agreement in which the survivor was obligated to purchase the deceased partner's interest at a valuation based upon an inventory to be made at time of death by three appraisers, but the minimum valuation was further stipulated to be the amount of life insurance on the deceased subject to the agreement. The facts show that insurance was purchased by the partners from time to time. Insurance was last taken out on Kavanaugh in 1931, at which time Johnson was found to be uninsurable and an "income bond" was issued on him. In 1933, no doubt because of adverse business conditions, $9,000 of insurance on each life, all subject to the agreement, was allowed to lapse. Then on January 12, 1934, the insurable partner, Kavanaugh, died. There was $13,266.67 of business insurance in force on his life, $6,008.51 of it being subject to the purchase and sale agreement. All of this insurance was made payable to the surviving partner. When an appraisal revealed that the physical assets of the partnership at the time of Kavanaugh's death were $5,273.92 less than the liabilities, the survivor refused to pay over the insurance pro-

ceeds on the ground that one-half the net liabilities, or $2,636.96, should be subtracted. The executrix of the deceased partner brought this suit in equity, *Kavanaugh v. Johnson,* 290 Mass. 587, 195 N. E. 797 (1935), to reach the insurance proceeds.

The court decreed specific performance, ordering the surviving partner to pay $6,008.51, the full amount of life insurance proceeds made subject to the agreement, with interest from the date the inventory had been taken, and ordering the executrix thereupon to release her rights in the partnership.

Thus we see that the estate, as well as the surviving partner, is entitled to have these agreements carried out to the letter. The court followed the general rule that, if the property is such that the court would have given specific performance to the buyer if he had sued for it, the seller may have specific performance. The rule has ample justification in these cases because there is no open market for a deceased partner's interest.

Before leaving *Kavanaugh v. Johnson,* it will be worth while to emphasize a few of its interesting aspects. First, it was the insurable partner, Kavanaugh, who died. Furthermore, his death occurred only three years after he was last insured, and less than a year after $9,000 of insurance on his life had been allowed to lapse. The insurance obviously showed considerable profit, but it was unfortunate that some insurance had to be dropped only a few months before Kavanaugh's death. Second, in view of the settled state of the law in Massachusetts, few words were written by the court regarding the validity of the agreement. The opinion merely stated on this point:

> It is apparent that one of the main objectives of the agreement was to provide a method for the disposition of the interest of a deceased partner without disrupting the business as a going concern. Such an agreement when not made with intent to evade the statute of wills is valid. *Leach v. Leach,* 18 Pick. 68, 75; *Murphy v. Murphy,* 217 Mass. 233, 235, 236, 104 N. E. 466; *Hale v. Wilmarth,* 274 Mass. 186, 189, 174 N. E. 232, 73 A. L. R. 980.

Third, the agreement should have stated that the survivor was to assume the partnership debts upon the purchase. This omis-

sion in all probability brought the case to court. On this point the opinion reads:

> In the light of all the facts the plaintiff should receive under clause 4 the full amount obtained by the defendant on the policies covered by the agreement, without deduction for debts. The principle that in the absence of agreement partners share losses equally, *Lavoine v. Casey,* 251 Mass. 124, 127, 146 N. E. 241, is overcome by the principle that where one partner takes all the assets and continues the business only slight evidence is necessary to warrant the inference that the partner also assumed the debts of the firm, *Shaw v. McGregory,* 105 Mass. 96, 102. This construction is supported by the uncontradicted evidence that the policies and "income bond" of 1929 and 1931, which were not within the terms of the agreement, were taken out for the purpose of providing the surviving partner with cash to pay the debts and carry on the business, because in all probability there would be a good many debts and the partners felt that "whoever survived would need the cash to pay those debts and go on with the business as survivor."

Finally—and we repeat for emphasis—the decision shows that the courts will grant specific performance to the deceased partner's estate if there is the ability to perform on the part of the survivor, in other words, if he is able to pay. It is a rule in equity never to make a futile decree, but it is submitted that if there are life insurance proceeds in the amount of the purchase price in the hands of the surviving partner, or better still, in the hands of a trustee, with which to carry out a purchase and sale agreement, such agreement when brought to court will be ordered performed to the letter. In short, a properly executed purchase and sale agreement of the partnership interest, financed with life insurance, definitely assures the continuance of the partnership business.

CHAPTER 9

Specific Benefits of the Purchase and Sale Agreement with Life Insurance

INTERSPERSED THROUGHOUT THE TEXT HAVE BEEN discussions and examples that have revealed the advantages to be derived from an insurance-financed agreement between partners for the purchase by the survivors of the deceased partner's interest. For convenient reference, we shall devote this chapter to a recital of these advantages.

BENEFITS TO THE SURVIVING PARTNERS

Survivors' business future assured. The insured purchase and sale agreement, by replacing the ordinary course of the law on the death of a partner, which would require prompt liquidation of the partnership affairs, assures the continuation of the partnership business without interruption or loss of momentum, because the continuation plan includes provisions that will effect the purchase of the deceased partner's interest immediately, with the greatest smoothness and dispatch. The agreement to buy and sell has previously been set up, the price has been agreed upon in advance, and the purchase money with which to consummate the transaction is at hand. Nothing has been left over which to bargain or dicker. Consequently, the survivors take over the business as a running machine, with equipment, employee organization, customers and good will all intact; and they may go forward with their daily routine and future plans as entire owners of the business, free and clear of any debt to the

deceased partner's estate. Their future business careers have been assured.

Survivors avoid liquidating losses. The liquidation of a going business invariably results in substantial pecuniary losses, outstanding among which is usually total loss of good will. The insured purchase and sale agreement, providing for the uninterrupted and undisturbed continuation of the business by the surviving partners, completely by-passes these losses in business equities that often have been built up by years of hard work.

Survivors avoid becoming liquidating trustees. Without a purchase and sale arrangement, the surviving partners, on the death of an associate, become liquidating trustees of the partnership property and affairs. As such, they are held to the highest standards of conduct, and to the strictest accountability for every asset of the partnership in closing out the business. That this fiduciary status is burdensome and often costly has been amply demonstrated again and again by the cases examined. With a binding purchase and sale agreement all this is avoided; a fiduciary relationship between the surviving partners and the deceased's estate is never established. You will remember that in the case of *Murphy v. Murphy,* 217 Mass. 233, it was said:

> The plaintiff as the surviving partner, in the absence of any term in the articles of copartnership covering the matter would take as owner the legal title to firm property. *Holbrook v. Lackey,* 13 Metc. 132, 46 Am. Dec. 726; *Hewett v. Hayes,* 204 Mass. 586, 592, 90 N. E. 985, 27 L. R. A. (N. S.) 154. He would take it, however, subject to the duty to pay the firm debts, settle the partnership accounts, and account to the personal representatives of the deceased partner. In a certain sense he would hold it as trustee, partly for the benefit of the estate of the deceased partner. There is no reason in equity why the defendant should not be required to release this beneficial obligation which, *but for the contract,* would exist in her favor. [Emphasis added.]

If further proof is needed that such an agreement prevents this onerous fiduciary relationship between the survivors and the deceased's estate or heirs from arising, it may be found in *Hermes v. Compton,* 260 App. Div. 507, 1027 (New York, 1940),

from which opinion the following self-explanatory quotation is taken:

> . . . I do not believe that upon Hermes' death a trust was reposed in the surviving partners with respect to Hermes' share of the partnership assets. There was neither a trust reposed nor any property with respect to which a trust could be reposed. True, so long as Hermes remained a partner there was property with respect to which a trust reposed among the partners. But by the terms of the agreement, immediately upon his death all of Hermes' property rights in the partnership assets were extinguished and the trust relationship which theretofore existed terminated. Instead of dissolving the partnership and distributing the assets, it was agreed that the partnership was to be continued by the surviving partners, who were to retain all the assets; and in exchange for Hermes' share therein and in consideration therefor they were to make the specified payments to Hermes' estate based on a sum equal to a percentage of the profits, and such payments were to be "in full satisfaction of the interest of such deceased partner in the partnership and in full liquidation thereof. . . ." That there was a complete severance of the relationship of trust and confidence that existed prior to the death of Hermes is also clear, because the agreement further provides that nothing contained therein "shall be so construed as to constitute as a partner the estate of any deceased partner." In other words, Hermes' death effected not only a termination of the relationship of confidence and trust which theretofore existed, but also a sale to the surviving partners of his interest in the partnership assets. While after Hermes' death his estate was interested in the profits because the consideration of the sale was to be determined by the net income, it had no proprietary interest in the business or the profits. Hence, plaintiff has an adequate remedy at law and is not entitled to an accounting.

Thus, instead of being trustees, the surviving partners with a purchase agreement occupy the status of purchasers bound by a contract previously entered into, dealing with sellers also previously bound by the contract with respect to all the terms of the transaction. If the contract is properly drawn, no difficulty whatever should be encountered. No one can examine the host

of court cases dealing with the fiduciary relationship—many of them are contests arising years after the death of a partner and all placing the burden of proof of good faith and irreproachable conduct on the surviving partners—without being convinced that the survivors under a modern insured purchase and sale agreement are indeed in a fortunate position.

Courts will enforce carrying out of purchase contract, if necessary. Because the future business careers of the surviving partners are tied up with the purchase and sale arrangement, it is vitally important to them that the plan be carried through on the death of a partner. They cannot afford, therefore, to rely on any plan for the continuance of the firm's business that the courts will not specifically enforce if necessary. As we have seen, the insured purchase and sale agreement will be specifically enforced by the courts according to its terms.

With a carefully set up agreement, however, resort to litigation is rarely required. As a matter of fact, few of the many agreements of this type seem to have reached the courts. It is significant that of the five cases reviewed in Chapter 8, three were open invitations to lawsuits because of the agreements used. In *Coe v. Winchester,* the partners not only used the more frequently challenged survivorship type of agreement, but acted as their own lawyers as well. In *Rome v. Howell,* the insurance agent drafted the agreement. In *Ireland v. Lester,* the partners attempted to revise their agreement at the last moment and in only half doing so, compelled a suit for reformation. The remaining cases, *Lockwood's Trustee v. Lockwood* and *Kavanaugh v. Johnson,* were taken into court mainly because controversies arose over the meaning of the respective valuation clauses, undoubtedly the most important part of such an agreement and, consequently, the part demanding the greatest skill in draftsmanship. The lesson to be learned from these two cases is that the valuation provisions must be crystal clear. The Kavanaugh case also demonstrates the likelihood of a court contest when there is a gross difference between the value of a deceased partner's interest and the purchase price to be paid for it. In that case, the purchase price strongly favored the widow. In *More v. Carnes,* 309 Ky. 41, 214 S.W.2d 984 (1948), the converse was

true. That case involved an insured survivorship agreement under which on the death of a partner the survivor would automatically become the owner of the business and the insurance on the deceased partner's life would be paid to his wife as beneficiary. Because the appraised value of the deceased partner's interest was more than double the value of the insurance proceeds, the widow challenged the validity of the agreement. The court expressed regret over the resulting inequity, but held the agreement valid and enforceable. These comprise almost all of the available top court cases, and the ultimate decision in every instance enforced the agreement in the manner that the parties had intended when it was made.

BENEFITS TO THE DECEASED PARTNER'S ESTATE AND HEIRS

Estate receives payment in full, in cash, at once. The functioning of the *fully insured* purchase and sale agreement places in the hands of the executor or administrator of the deceased partner the full amount of the sale price of the decedent's interest in the firm, in cash, at once. There is no basis for acrimonious bickering and bargaining between the personal representative, usually the widow, and the surviving partners. Furthermore, by provision to that effect in the agreement, the amount of the proceeds may be set as a minimum price, thereby guaranteeing such proceeds as the minimum amount that the estate will receive. This is in striking contrast with the certainty that losses will be suffered through forced liquidation and the uncertainty of the amount that will finally be received in the absence of a purchase agreement.

Deceased's estate can be settled promptly and efficiently. If there is no purchase agreement effective after the death of a partner, the survivors are required to wind up the partnership with reasonable dispatch; but the process necessarily consumes considerable time—more than it will usually take the personal representative of the decedent to administer the decedent's personal state. But the personal representative, among other important duties, cannot complete his estate and inheritance tax schedules until he knows the liquidated value of the decedent's

share in the firm, nor is it usually possible for him to ascertain the respective amounts that are to go to various legatees. Therefore, in the normal course of settling the affairs of a deceased partner, the executor or administrator will find it necessary to hold open the estate until the partnership has been closed out and the share of the deceased partner has been received from the surviving liquidating partners, which delays the accounting and settling of the entire estate. This delay is eliminated by the insured purchase and sale arrangement, by means of which the executor or administrator promptly receives the value of the decedent's business interest in cash.

The executor has need for a substantial amount of cash with which to pay final expenses, outstanding bills, taxes, fees, and other probate costs. Furthermore, ready cash frequently enables him to take advantage of discounts offered for prompt payment of bills and taxes. New York, for example, grants five per cent discount on estate taxes paid within six months after death. To obtain the required cash, the forced sale of valuable estate assets at a sacrifice is often necessary. An insured purchase agreement eliminates any such loss, and since cash is immediately available, discounts may be saved.

In the ordinary course of liquidating a partnership on the death of a partner, a formal accounting procedure is called for between the surviving partners and the personal representative of the deceased. An insured business purchase agreement eliminates this time-consuming, costly, and often irritating procedure.

Where the agreement is properly set up—as discussed later—the purchase price will establish the value of the deceased partner's interest for Federal estate tax purposes. Because in the absence of such an agreement small businesses tend to be overvalued for such purposes, the benefit alone may save thousands of dollars in taxes.

In short, with ample cash immediately available from the purchase and sale agreement and with delays, uncertainties and costly procedures eliminated, the personal representative can carry out a prompt, efficient and economical administration of the deceased's estate.

The widow is relieved of business worries. Many different

plans not making use of insurance financing and under which the welfare of the widow has been made dependent upon the future success of the surviving partners over a period of years have been set up as an alternative to liquidation. *Hermes v. Compton* is typical of such arrangements. The agreement in that case fixed the purchase price as a percentage of profits to be earned by the surviving partners for the five years subsequent to death. Profits of the survivors were large the first year following Hermes' death, and his widow received a substantial payment; then the senior surviving partner retired, and payments were discontinued. The widow brought suit for an accounting, which suit was defeated in equity because of the agreement. The widow continued the litigation as an action at law, but here too, lost the decision. An insured purchase and sale agreement would have furnished the purchase price "on the barrel head," and the widow would have been relieved of the worries and losses consequent upon the provisions made in that case.

Under an insured business purchase agreement, the widow is entirely free from any future responsibilities in connection with the partnership. The estate receives payment in cash, which may be invested in the highest type of securities for her benefit. This is as it should be; for a widow to keep her money in a small business, no matter how successful its past record may be, is hazardous.

BENEFITS DURING THE LIFETIME OF THE PARTNERS

The partnership business is profitably stabilized. With an insured purchase and sale agreement, the future of the partnership business is assured. This fact has several important and valuable consequences of immediate benefit to the partners. The partners and their customers or clients, knowing that the business of the firm will continue in spite of the death of one of the members, are at liberty to enter into more permanent and farsighted dealings that will tend to stabilize the business on a more profitable basis. Employees, knowing that the continuance of the business has been assured, and with it, their jobs, are welded into a more stable and efficient organization. The firm's

bankers—knowing that the business will not be interrupted on the death of a partner; that the purchase price of a deceased partner's interest will be forthcoming automatically at the needed time from an outside source, the insurance company, without draining one cent from the business treasury; that the partners each year are building larger cash values in their business insurance policies; and that the firm's business and organization has been stabilized by the arrangement—will extend a more favorable line of credit over the years. All of these beneficial business factors, taken together, spell out more profits for the firm during the lifetime of all the partners.

An attractive saving medium is provided. The insured purchase and sale arrangement is in effect an advance instalment method of purchasing the interest of a deceased partner. Each premium paid on the insurance under such an arrangement represents a current saving for future benefit. As a savings plan, it has many attractive features. Perhaps most important is the fact that the accumulation program is automatically completed for the full amount needed on the death of the insured, no matter how little has been put in by way of premium payments. Among other desirable characteristics, the amount to be saved each year is convenient in size, is made regularly and has an element of compulsion, without which few savings projects are ever carried through to completion. After a few years, the policies contain guaranteed cash equities, which receive the highest degree of legal protection in some of the states, and which are available at once should a real financial emergency arise. In other words, it is a convenient, effective savings program focused directly on an objective vitally important to all the partners, assuring them that the money required to buy out the business interest of a deceased partner will be fully saved when needed.

The future of the partners is made predictable. An insured business purchase agreement enables each partner to predict what will take place in the event of the death of any partner. If fate decrees that he is a surviving partner, he knows that he will become owner of the business, paid for in full. On the other hand, he knows that if he should die first, his estate will

at once receive the full value of his share of the business in cash. Each partner, therefore, can freely give his best efforts to the promotion of the partnership affairs, secure in the knowledge that if he lives his career will be kept open and his property ownership enhanced; and that, if he does not survive his associates, the value of his estate will be enhanced by his hard work. Each partner, also, knowing that if he dies first his estate will have the cash benefit of a specified amount, is thereby enabled to plan his estate in an orderly manner for the support and welfare of his family. Contrast this picture with that of partners without a purchase plan, faced with the prospect of sudden termination of the business, trustee responsibilities, unknown liquidation losses, loss of careers, unknown estate values for the support of dependents, bickering and dissension between widow and survivors; and the conclusion is obvious that the partners, while all are yet living, derive substantial benefits from an insured purchase and sale arrangement.

CHAPTER 10

Selecting Type of Agreement

The two basic types of agreements. A partnership purchase and sale agreement may take either of two available forms: a buy-and-sell agreement, or a so-called "entity" agreement.

A buy-and-sell agreement is most commonly used. It is an agreement whereby the partners individually agree to purchase the interest in the firm of a deceased partner. Customarily, each partner owns insurance on the life of the other partners in an amount approximating his share of the purchase price should one of the other partners predecease him. The partnership is not a party to such an agreement.

In the case of a partnership composed of several partners, who desire to continue the partnership regardless of deaths occurring among their number, the use of an entity type of agreement has become increasingly popular. The partnership itself is a party to such an agreement, along with the partners. The agreement provides for the uninterrupted continuation of the partnership upon the death of a partner and the purchase of his interest for the account of the survivors from the partnership funds, furnished in whole or in part for this purpose by insurance on the lives of all partners. The policies are owned by, paid for by, and payable to, the partnership.

FACTORS DETERMINING CHOICE OF AGREEMENT

Equity of results. In the case of a buy-and-sell agreement, the insurance usually is arranged on the cross-purchase plan.

Each partner agrees that upon the death of a co-partner he will purchase a proportionate part of the deceased partner's interest at a price based upon its agreed value pursuant to the agreement, and each partner purchases and maintains insurance on the lives of the others in the approximate amount of purchase price he will be called upon to pay when a co-partner dies. Under this plan, the insurance is owned personally and does not enter into the purchase price. Assuming that the price set represents true value, the buy-and-sell agreement functions with complete equity among the partners—regardless of the variations in their ages or in their respective interests in the firm.

In the case of an entity purchase agreement, the payment of the premiums by the partnership is the same mathematically as if each partner had paid that portion of the premiums which is proportionate to his fractional interest in the firm. As contrasted with the arrangement under a buy-and-sell agreement, however, none of the insurance is owned by a deceased partner's estate as recompense for his portion of the premiums that have been paid by the partnership. Thus an entity agreement will not function equitably among the partners unless the purchase price paid to a deceased partner's estate takes into consideration the life insurance owned by the partnership to the extent of his fractional interest in the firm. Partial equity is obtained if the purchase price takes into consideration his share of the value of all the policies immediately before a death occurs. Substantially complete equity results if his share of the proceeds of the insurance on his own life is also taken into consideration. If the entity plan is to achieve this result and at the same time have the purchase price fully insured, however, additional amounts of insurance will be required.

Number of partners. In the case of partnerships composed of only two partners, buy-and-sell agreements are used most frequently. The arrangement is free from estate tax complications. By reason of the fact that each partner pays the correct cost of his benefits under the agreement, complete equity is attained.

In the case of partnerships composed of more than two partners, however, the plan whereby each partner maintains insurance on the life of each other partner becomes less convenient

as the number of partners increases. With three partners, the arrangement under a buy-and-sell agreement whereby each owns and maintains policies on the lives of the others—a total of six policies in all—is only slightly less convenient than is the case with the partnership owning and maintaining three policies under an entity type of agreement. But where there are nine partners, for example, there would be seventy-two policies under the usual buy-and-sell agreement, compared with only nine policies under an entity type of agreement. In such a case the buy-and-sell agreement could be insured with only nine policies: one on the life of each partner, with the other eight partners joint premium payers and joint and survivor owners. But the difficulties that might be encountered in the form of future adjustments and complications where there are so many joint owners and premium payers makes such a plan impracticable. Hence one must conclude that where there are a substantial number of partners, the entity plan, under which the partnership pays the premiums and owns a small number of policies, is simpler in operation than a buy-and sell plan, under which each of several partners owns and maintains a cluster of policies.

Ages and fractional interests of the partners. Where a partnership is composed of only a few partners who do not differ greatly in age or in respective fractional interests owned in the firm, these factors are neutral so far as choice of plan is concerned. Under either type of agreement, the financial load of premium payments is distributed in approximately the same proportion although in a different manner. But where there are large differences in the respective ages of the partners or in their respective fractional interests in the firm, these factors may favor an entity agreement. In such a firm, the younger partners customarily own the smaller interests, with the result that they may be unwilling or unable to pay the premiums required to maintain the insurance on the older partners with the larger interests in the firm. The indirect premium load under an entity type of agreement, on the other hand, rests largely upon the partners who are older and who own the larger interests. Thus the premium load is distributed according to ability to carry it. As previously noted, the plan will work

out equitably provided the purchase price under the entity agreement takes into consideration the deceased partner's share of the insurance values when a death occurs.

Status of insurance in relation to partnership. Under a buy-and-sell agreement, the insurance is owned personally by each respective partner. Under an entity type agreement, the policies and proceeds are partnership assets. The increasing cash values continuously contribute to the building up of the financial worth of the partnership—whereas the insurance personally owned under a buy-and-sell agreement build up the personal assets of the individual policy owners. The value of the policies owned by the partnership under an entity agreement will strengthen the financial statement of the firm, a result which the partners may desire. But such policies are at all times subject to the claims of the partnership creditors. Hence difficulties may be encountered in carrying out the entity agreement when a death occurs, unless the firm has ample funds, aside from the insurance proceeds collected at that time, to satisfy its creditors. In this connection, however, it is well to recall the fact that general partners have unlimited liability for partnership obligations.

Ratio of partnership interests desired among surviving partners. When a partnership retires a deceased partner's interest under an entity agreement, the surviving partners will share the ownership of the firm in the same ratio that their respective interests bore to one another prior to the death. If this ratio is not satisfactory, they will have to realign their interests by means of a supplementary purchase and sale transaction among themselves. The provisions of a buy-and-sell agreement, on the other hand, may specify that each survivor will buy whatever proportion of a deceased partner's interest is set forth therein—regardless of their current proportionate interests.

Federal estate tax factor. Where the insurance acquired to finance a buy-and-sell agreement is arranged on a cross-purchase basis, so that an insured will not possess any incidents of ownership in the policies on his own life, the value of the proceeds will not be subject to Federal estate tax. Subject to the tax, however, will be the value of the policies the deceased partner

owned on the lives of the survivors and the value of the deceased's partnership interest. If the agreement is drawn and set up properly, the value of that interest will be its purchase price in the agreement—as is brought out later in Chapter 15.

Where the insurance is owned by the partnership to finance an entity agreement, the discussion in Chapter 15 will show that it is not clear whether the value of the insurance on the life of a deceased partner will be includible *as insurance* in his gross estate. In the event that such value should be included as insurance proceeds, however, it will not be included again in valuing the deceased's partnership interest. In valuing that interest, the deceased partner's proportionate share of the value of the policies on the lives of the surviving partners, being partnership assets, will be taken into consideration. The only exception would be where the purchase price has not taken into consideration the insurance values and the purchase price is held to establish the value of the deceased's partnership interest for federal estate tax purposes. The discussion in Chapter 15 will show that there is no case or ruling directly on these facts.

Income tax status of payments. The sale of an interest in a partnership under a buy-and-sell agreement is treated as the sale of a capital asset, except as to payments received from the surviving partners for the seller's interest in the firm attributable (on the basis of relative fair market values) to unrealized receivables and to inventory items that have appreciated substantially in value. Unrealized receivables are uncommon in the case of a commercial partnership reporting its income on an accrual basis. They are typical of a personal service partnership reporting on a cash basis, such as a law firm. Where substantially appreciated inventory items exist, they are usually possessed by a commercial partnership. Such items are defined broadly and are considered to have appreciated substantially in value if their fair market value exceeds 120 per cent of their adjusted basis to the partnership and exceeds 10 per cent of the fair market value of all partnership property except money. Payments received that are attributable to unrealized receivables and to substantially appreciated inventory items are deemed

amounts realized from the sale of property other than a capital asset, with the result that any consequent gain or loss is ordinary income or loss [I.R.C., Secs. 741, 751].

In the case of a buy-and-sell agreement, this ordinary income or loss is computed first. In determining the amount, "a portion of such partner's adjusted basis for his interest in the partnership must be allocated, under regulations, to his share of unrealized receivables or substantially appreciated inventory items. The amount of basis to be so allocated shall ordinarily be his pro rata share of the partnership basis for such property with appropriate adjustments for any transferee basis with respect to him under section 743(b). This amount shall be subtracted from the basis of such partner's interest before computing his capital gain or loss on the sale of his interest under section 741." [83d Cong., 2d Sess., S. Rep. No. 1622, p. 401.]

Payments made by a partnership under an entity agreement to liquidate the interest of a deceased partner apparently receive the same tax treatment as above, where the entire liquidation payments are made within one taxable year of the partnership [I.R.C., Secs. 731, 751].

Where payments from the partnership are made in more than one partnership taxable year, they receive somewhat different tax treatment. First, payments are allocated, on the basis of relative fair market value, between payments in exchange for the deceased's partnership interest and other payments. Payments in exchange for the partnership interest do not include amounts paid for the deceased's proportionate share of unrealized receivables, and do not include amounts paid for good will except to the extent the agreement provides for reasonable payments with respect to good will. Payments in exchange for the partnership interest do include payments attributable to inventory items that have appreciated substantially in value, but are considered amounts paid for property other than a capital asset. First, an amount of the basis of the partnership interest being liquidated equal to the partner's share of the partnership basis for its substantially appreciated inventory items, with appropriate adjustments for any transferee basis with respect to him under section 743(b), is allocated to his share of

such items, and ordinary income results to the extent that his share of the fair market value of such items exceeds this allocated basis [83d Cong., 2d Sess., Conf. Rep. No. 2543, pp. 62, 65]. The remainder of the basis of the partnership interest is measured against the value of the liquidated partner's portion of the capital assets of the firm, including good will if payments for it are specified in the agreement, to ascertain the capital gain or loss on the liquidation of such interest [I.R.C., Secs. 736(b), 751(b)(1)(B); 83d Cong., 2d Sess., S. Rep. 1622, p. 404]. Any other payments received, including amounts received for unrealized receivables and unspecified good will, are usually ordinary income to the estate and are classed as income in respect of a decedent. However, if any of these payments are determined with regard to the income of the partnership they are treated as a distributive share of the partnership income and retain their character as ordinary income or capital gain, as the case may be.

It should be emphasized that under an entity agreement that spreads payments over more than one taxable year of the firm there is tax flexibility with respect to any payments for good will. If the agreement specifies that a reasonable amount is to be paid for the deceased partner's share of existing good will of the firm, such payments constitute part of the payments for the deceased partner's interest. As such, they get capital gains treatment in the hands of the recipient (usually resulting in no gain or loss) and are not deductible by the partnership. If the agreement does not specify payments for good will, any payments actually made for it are not considered paid on account of his partnership interest but are classed as other payments made which are deductible by the partnership and income to the recipient.

Income tax bases of the surviving partners. Upon the purchase of a deceased partner's interest under a buy-and-sell agreement, the basis of the partnership interest of each surviving partner is increased by the amount he has paid to purchase a portion of the deceased partner's interest. In such amount is included an amount representing the proceeds of the insurance he has collected on the life of the deceased partner.

The effect of the workings of an entity agreement upon the

bases of the interests of the partners is somewhat complex. The policies are owned by the partnership and payable to it. Ordinarily, the partnership will pay the premiums out of partnership income, charge off as expense that portion of the premiums not reflected in an increase in cash values, and carry the cash values as an asset. The portion of premiums thus charged off is a non-deductible expense, and as such does not reduce the distributive income of the partnership nor the taxable incomes of the partners. Nevertheless, such expense paid by the partnership reduces the bases of the partners' interests to the extent allocated to each. The net result is that the payment of premiums by the partnership, as contrasted with the withdrawal of a like amount of distributive income by the partners, increases the respective basis of each partner's interest by his share of the increase in cash values each year.

The insurance proceeds received by the partnership upon the death of a partner are excluded from its gross income. But it appears that the excess of the death proceeds over the cash value of the policy as carried on the partnership books increases the bases of the partnership interests of the partners [I.R.C., Section 705 (a) (1) (B)].

To sum up the effect under an entity agreement, the interest of the deceased partner (as always) gets a new basis at his death. But the basis of the partnership interest of each surviving partner should reflect his attributable portion of the cash values of all the policies owned by the partnership, plus his attributable portion of the nontaxable income of the partnership represented by the insurance proceeds collected on the life of the deceased partner. It may be that a provision allocating all of such nontaxable income to the capital accounts of the surviving partners will hold for basis purposes. Lacking that, however, a portion will represent the deceased partner's share. Therefore, amounts with respect to the insurance on the life of the deceased partner totalling less than the insurance proceeds will go to increase the bases of the surviving partners' interests.

Thus, partners have a substantial number of important factors to be considered in making their choice between an individual buy-and-sell agreement and a partnership entity agreement.

CHAPTER 11

Contents of the Purchase and Sale Agreement with Life Insurance

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Introductory. Agreement must be drawn by a competent attorney. A written purchase and sale agreement that includes provisions for life insurance financing is the basic legal medium used to assure uninterrupted continuation of the business of a partnership by the survivors, following the death of an associate. The agreement can be incorporated in the Articles of Partnership, but rather than add to the cumbersomeness of the Articles, the established practice is to execute a separate contract. The contract may take either of two forms: a buy-and-sell agreement in which the individual partners are the parties, or a so-called entity agreement in which the partnership itself is also a party.

A buy-and-sell agreement provides that on the death of a partner the surviving partners will buy the deceased's interest in the firm at a stipulated price, that life insurance will be carried on each partner to furnish the purchase money and that upon receipt of payment the personal representative will transfer the deceased partner's interest to the survivors. An entity agreement provides for the uninterrupted continuation of the partnership following the death of a partner and the purchase of his interest for the account of the survivors from the partnership funds, furnished in whole or in part for this purpose by insurance on the lives of all partners, owned by, paid for by, and payable to, the partnership. With the surviving partners depending upon their agreement for acquisition of full owner-

ship of the enterprise instead of having to liquidate their business and jobs, and with the deceased's estate and heirs relying upon it for prompt payment in cash of the full value of the deceased's interest in the firm instead of the shrunken, forced-sale value of his share, this document is obviously one of the most important contracts the partners will ever execute. Because of this, a competent attorney should be engaged to draft the instrument.

THE BROAD PATTERN OF THE AGREEMENT

The growing realization that the insured business continuation plan is the only method by which the partners can make certain that their objectives will be carried out has brought about the adoption of this arrangement by literally thousands of firms. And this, in turn, has brought about a modicum of standardization in the forms of agreements used. Furthermore, every agreement of this type, because it deals with like subject matter, must of necessity follow a similar broad pattern with which life underwriters must be familiar if they are to render intelligent and profitable service to partners. This broad pattern consists of the essentials that the insured purchase and sale agreement must accomplish. They may be itemized as follows:

1. A definite commitment on the part of each partner that he will not dispose of his interest in the partnership during his lifetime without first offering it for sale to the other partners at the contract price.
2. A definite commitment, not merely an option, on the part of all the partners in which they agree, binding their estates, that the surviving partners (or the partnership, in case of an entity agreement) will buy, and that the deceased partner's estate will sell and transfer to the survivors (or to the partnership), the partnership interest of a deceased partner.
3. A definite commitment as to the purchase price to be paid by the surviving partners (or partnership) for the deceased partner's interest.
4. A definite commitment by the partners (or partnership) to purchase and maintain under the agreement life insurance

policies in an agreed amount with which to finance the purchase, the proceeds of which policies are to constitute purchase-price money for the partnership interest when it is received by the deceased partner's estate.

5. A definite commitment as to the ownership and control of the life insurance policies made subject to the agreement and as to the disposal of policies on the lives of surviving partners.

6. A definite commitment with respect to the time and manner of paying any balance of the purchase price in excess of the insurance proceeds, and conversely, with respect to the disposition of any insurance proceeds in excess of the purchase price.

7. A definite commitment that the surviving partners will assume all obligations of the partnership and will save harmless and indemnify the deceased partner's estate therefrom.

CONTENTS OF THE AGREEMENT

Introductory. Since no two partnerships are exactly alike, no two insured purchase and sale agreements can be identical in form and content. The provisions of each such contract must be individually "fitted" by the attorney to the circumstances of each particular case. This "fitting" is made possible because various alternative methods are available to provide for such matters as, for example, establishing the purchasing price, designating the life insurance beneficiaries, and allocating premium payments. Nevertheless, since all agreements must deal with the same subject matter, that is, the buying and selling of a deceased partner's interest and the use of life insurance to supply the purchase money, the general structure and contents of such agreements are sufficiently delimited to make a somewhat detailed analysis practicable. Life underwriters should be reasonably familiar with the general provisions usually contained in them, and should be cognizant of the various alternative arrangements available. Accordingly, an inexhaustive topical analysis will be made of the principal provisions that are usually contained in a standard agreement, without, however, considering the technical legal wording to be used in setting out these provisions in the finished document, since that is the peculiar province of the drafting attorney.

The parties to the agreement. Preferably, all the partners, together with a trustee selected by them, are the parties to a buy-and-sell agreement. The partners, being the buyers and sellers, are necessary parties. The trustee is not a necessary party, but is recommended as an impartial "third party," to act as custodian and beneficiary of the life insurance policies during the lifetime of the partners, and, when a death occurs, to supervise the consummation of transaction. In the case of an entity type agreement, the partnership itself is a party along with the partners. A trustee is seldom a party, but may be desirable as an additional party in some instances.

In community property states, it is advisable, although held not necessary in Arizona under the facts present in *Coe v. Winchester* (see page 180), to include the wives of the partners as parties.

The purpose of the agreement. The preamble of a well-drawn agreement contains a recital of the purpose of the agreement. It should state that the partners desire to create a ready market for the interest of a deceased partner, and that the survivors desire to acquire such interest in order to be able to continue the business without the necessity for liquidation and an accounting. This preamble serves the purpose of clarifying the intention of the parties and might play an important role should ambiguities creep in elsewhere in the agreement.

The "first offer" commitment. In those instances in which any of the partners owns sufficient property to call for the payment of estate taxes upon his death, the purchase and sale agreement should contain a clause requiring any partner who retires to offer his interest in the firm for sale to the partnership or the other partners at the same price that governs on purchase in the event of a partner's death, before he can make any other disposition of it. Such a provision seems to be required if the price is to be binding on death as to valuation of the partnership interest in a deceased's estate under the Federal estate tax law (see case of *Claire Giannini Hoffman,* 2 T. C. 1160, discussed at pages 426 et seq. of the book on Corporations).

The commitment to sell and to buy. A buy-and-sell agreement should set out in unequivocal language that each partner, binding his heirs, personal representatives and assigns, agrees to

sell to the surviving partners, and that the surviving partners agree to purchase all right, title and interest which the deceased partner may have in the partnership at the time of his death. Where the agreement is of the "entity" type, the partners commit their estates to sell their interests to the partnership, and the partnership agrees to buy a deceased partner's interest for the accounts of the survivors.

The agreement should also show the present share of ownership each partner's interest represents, and if more than two partners are involved should clearly designate the portion of a deceased's interest that each survivor is to acquire.

The price to be paid, and valuation formula, if used. The purchase price to be paid for a deceased partner's interest must either be stated in the agreement in dollars and cents, or the agreement must set out a crystal clear valuation formula or procedure to be used at time of death to determine the price. A buy-and-sell agreement should further state that the proceeds of any life insurance made subject to it are not to be included in settling the value of a deceased's interest. An entity agreement, on the other hand, should directly or indirectly take into consideration the insurance values if it is to arrive at an equitable price.

If the purchase price is fixed in advance, the agreement should also provide that the parties may revise the stated figure annually or more often by endorsing the revised purchase price upon the contract. The chief disadvantage of this method is that the partners may neglect to keep the figure up-to-date. However, unless the stated price is so inadequate as to work a fraud on individual creditors or on statutory rights of heirs, the efficacy of the agreement will not be impaired. The method has several distinct advantages. First, it cannot be misunderstood. Second, each partner knows at all times the exact amount his estate will receive for the sale of his business interest in the event of his death, and can plan his estate and for the welfare of his dependents with an accuracy not otherwise possible. Third, knowing in advance the amount to be paid, the partners, by maintaining a like amount of insurance directly or through the partnership, may keep the purchase price fully insured, and in

this way eliminate any necessity for supplementary payments. In short, a stated purchase price simplifies and makes definite the whole arrangement.

If the purchase price is to be ascertained at death by formula, it is most important that, whatever the particular formula to be adopted, its details are incorporated in the agreement in the clearest possible words so that no controversy will arise over the amount due the deceased's estate. If the provisions are susceptible to more than one interpretation, then they should be rephrased by the attorney. The accountant for the partnership is the person usually best qualified to select the formula that will most accurately reflect the true value of the partnership interest, and the attorney is, of course, the proper person to draft the wording of the provision in the agreement. However, this provision is so vital that neither the accountant nor the life underwriter should hesitate to criticize the nomenclature used if its meaning is not entirely clear to them.

Any number of different valuation formulae are available. The simplest fixes the purchase price as the actual book value of the deceased's interest at time of death. Care should be taken to designate who is to make the necessary audit and appraisal. However, since this method does not include any valuation for good will except in the unusual case in which this item occurs in the balance sheet, a more adequate formula will include this. Sometimes a stated amount is agreed upon as the good will value. Quite frequently, a good will is valued by including a provision by which the average annual earnings in excess of a stipulated percentage of the book value will be capitalized. For example, such a formula might stipulate that the net earnings, averaged over the five years previous to death—after deducting a specified amount as equivalent to compensation for the personal services of the partners, and after deducting six per cent of the book value as earnings on invested capital—will be multiplied by five to ascertain the good will value to be added to the net ledger assets in arriving at the total value. A formula set up along these lines will probably establish a purchase price closest to the true value of the enterprise.

Where an entity agreement is used, the partners should keep

in mind in considering good will that if the agreement specifies a reasonable amount to be paid for good will, the payment will be treated as part of the purchase price for a deceased partner's interest. As such, it will not be deductible by the partnership and under ordinary circumstances will not create tax liability for the recipient. On the other hand, any payments made for unspecified good will are deductible by the partnership and taxed as ordinary income to the recipient [I.R.C., Section 736 (b)]. Any substantial payments to be made of the latter type should be spread over several taxable years of the recipient, in order to minimize the amount of income taxes involved.

Another formula requires that the value of the deceased's interest be fixed by a board of appraisers. For instance, a three-man board might be required, one to be appointed by the surviving partners, one by the deceased's personal representative, and the third to be selected by the other two.

Still another formula establishes as the purchase price the value fixed under the Federal estate tax for the deceased partner's interest. This plan is not recommended, however, because in most cases the consummation of the purchase would be considerably delayed by it.

These are only a few of the formulae that might be used, but they serve to illustrate this method of establishing the purchase price of a deceased partner's interest. If partners in a particular case desire to follow this method, their accountant should be called upon to prescribe the formula most suitable for that particular partnership. Before leaving this subject, however, attention is called to the readily apparent drawback inherent in every formula; namely, the purchase price is not ascertainable with exactitude until after a death occurs.

The financing of the purchase with life insurance. A recital should appear in the agreement definitely stating that the life insurance made subject to it is for the purpose of providing the necessary cash to consummate the purchase of a deceased partner's interest. The agreement should also definitely state that the proceeds of such insurance when received by the deceased partner's estate or heirs, whether received directly as insurance beneficiary or indirectly from the trustee or the survivors, shall

be credited to the surviving partners as payment on account or in full, as the case may be, of the deceased partner's interest in the partnership.

By making these statements in the contract in so many words any danger is removed that the estate or heirs will contend they are supposed to receive both the insurance proceeds and the value of the deceased's business interest.

Schedule of the life insurance policies. In the body of the agreement or in a schedule attached to and made a part of the instrument, there should appear a description of each life insurance policy made subject to it. Ample identification is provided if the agreement sets forth the name of the insured, the policy number, the insurance company, and the face amount of each policy. In addition, a schedule should be provided in which to record any future changes made in the insurance coverage by the adding, substituting, or withdrawing of policies, if the agreement permits such changes to be made.

Careful scheduling, so that the identity of all policies subject to the agreement is clear at all times, is important. It is not uncommon for the surviving partners to be designated as beneficiaries of the insurance made subject to a buy-and-sell agreement. Frequently, too, partners carry business insurance payable to the survivors in addition to the purchase money insurance coverage. In such a situation it is imperative that an accurate schedule of policies be maintained. Careful scheduling of policies is also advisable under an entity agreement.

Provisions for adding, substituting, or withdrawing policies. A partnership purchase and sale agreement will normally remain in effect over a period of years, during which time substantial changes are likely to occur in the value of the business. Therefore, the agreement should provide for the addition, substitution, and withdrawal of life insurance policies by the joint action of the partners.

Again, the precaution must be carefully observed to record in an attached schedule the details of any future changes made in the composition of the insurance policies subject to the agreement.

Adjustment to be made when the amount of insurance pro-

ceeds differs from the purchase price. When the death of a partner occurs, the amount of life insurance proceeds payable subject to the agreement may be exactly equal to the purchase price to be paid for the deceased partner's interest, or it may exceed or fall short of that figure. It cannot be expected that these amounts will coincide if a valuation formula is used to ascertain the purchase price. And even if the purchase price is a stated amount, a death may occur when, for one reason or another, the full amount of insurance is not carried. Hence, every agreement should contain provisions specifying the adjustments that are to be made when the insurance proceeds and the purchase price differ in amount.

When the insurance proceeds exceed the purchase price, it is usually provided in a buy-and-sell agreement that the full amount of such proceeds shall nevertheless be paid over as being the minimum purchase price. Although any other disposition of the excess proceeds that the partners desire can be provided for, the establishment of the insurance money as the minimum has the important advantage that it enables each partner to know the minimum amount his estate and heirs will receive. This is particularly valuable information if the purchase price is to be derived from the application of a formula after death. Where an entity agreement is used, it is customary to provide that any excess of insurance proceeds over the purchase price collected by the partnership on the deceased partner's life shall be retained as general partnership funds.

When the purchase price exceeds the insurance proceeds, it is customary to provide that the balance will be paid by the delivery of a series of interest bearing notes made by the surviving partners or the partnership, depending upon the type of agreement, and payable to the estate of the deceased partner. This series of notes may be specified to run for a few months or for a period of years, depending upon the circumstances of the particular case and the wishes of the partners. Some agreements leave the details of paying any balance entirely in the hands of the surviving partners and the personal representative of the deceased, to be agreed upon by them at the time of death. There are, however, two objections to this. First, it may lead to bicker-

ing and controversy and it may result in arrangements too harsh for the survivors, or, on the other hand, it may be too liberal for the best interest of the deceased's estate. Second, one of the basic requirements of a valid contract is that its terms be definite; and it is possible that some court might construe such a loose provision as too indefinite. Whether or not this danger is remote, it can easily be avoided; and at the same time the provisions can be made sufficiently flexible. For example, it may be provided that any balance of the purchase price is to be paid in instalments of a specified amount at specified intervals, thus allowing the number of instalments to vary with the size of the total balance. The partners usually know approximately how much a survivor or the firm, as the case may be, will be able to pay periodically without financial embarrassment. Therefore, this arrangement seems to afford the most satisfactory solution, supplying as it does, both definiteness and flexibility. Under any instalment arrangement, there should always be the privilege of accelerating payments.

Before leaving this topic, it should be emphasized again that maximum benefit can be obtained from an insured purchase and sale arrangement only when the partners keep the purchase price as fully insured as possible. Most partners realize this, with the result that in the great majority of cases the balances payable over and above the insurance proceeds are either non-existent or represent an insignificant part of the total purchase price.

The payment of premiums. The agreement should designate who is obligated to pay the premiums on each policy included under it. In the case of an entity agreement, the premiums are paid by the partnership. A buy-and-sell agreement usually provides that the premiums for each policy will be paid by the partners other than the insured in the same ratio that the interest of the insured will be acquired and shared between them upon the insured's death. However, because there are several other arrangements available for allocating premium payments among the partners, each requiring considerable explanation, discussion of the entire subject of premium payments is deferred until a later chapter.

Ownership of the insurance policies and restrictions on use

for other purposes. The agreement should state who will own the right to exercise the benefits, privileges, and advantages contained in each policy during the insured's lifetime. This will be the partnership, in the case of an entity agreement. The logical partners to own these rights in the case of each policy under a buy-and-sell agreement are the particular premium payers. However, an exception to this may well be made in a trustee beneficiary case, discussed under the following heading.

The agreement should further state that the rights in the policies shall be exercised by the respective owners only for the purpose of carrying out the terms of the agreement.

The insurance beneficiary arrangements. The purchase and sale agreement should definitely state who are to be designated beneficiaries of the life insurance policies made subject to it. This is another provision, however, that offers the partners and their attorneys considerable choice.

The agreement may stipulate that a specified individual or trust company, preferably the latter, be designated as beneficiary. However, a necessary antecedent to this is the selection by the partners of the trustee plan of administering the terms of the agreement and the preparation and execution of the instrument as a trust indenture. At this point, therefore, a brief word-sketch of the workings of the trustee arrangement will be drawn.

Under the trustee plan, the trustee selected by the partners (usually their own bank, if it has trust powers) becomes a party to the agreement. The contract is drawn up in the form of a business insurance trust agreement, the provisions of which follow the general purchase and sale contract form, modified and supplemented by the trustee provisions. These require, of course, that the life insurance policies be made payable to the trustee and that the policies be kept in the possession of the trustee. Ownership rights in the policies, that is, the right to exercise the benefits and privileges contained in the insurance contracts during the lifetime of the insured, may be retained by the partners (or by the partnership, if it is an entity agreement), or may be given to the trustee. Although funds with which to pay the premiums may be deposited with the trustee, customarily the partners themselves (or the partnership, under

an entity agreement) pay the premiums directly to the insurance company, and it is common practice in either event to have the dividends on any participating policies applied against current premiums.

It is after a death occurs, however, that the important provisions of the trustee plan begin to function. Under the beneficiary designation in the policies, the death proceeds are collected by the trustee. Then, if the agreement provides for the application of a valuation formula in order to ascertain the value of the deceased partner's interest, the trustee either applies the formula itself, or sees that it is properly applied, whichever is called for by the provisions. The value having been obtained, either from a clause in the agreement setting out a certain figure or from the application of the formula specified in the agreement, the trustee, after deducting its commissions, turns over to the deceased's executor or administrator as much of the insurance proceeds as is required to pay the purchase price of the deceased partner's interest, disposing of any excess of proceeds as stipulated.

If the insurance proceeds, however, do not equal the purchase price, then the trustee procures from the surviving partners or partnership, according to the type of agreement, a series of notes, as called for in the agreement, payable to the deceased's estate and aggregating the balance owed by the survivors; and it delivers these notes, together with the insurance proceeds, to the personal representative. Simultaneously with the payment of the purchase price, the trustee requires the delivery to it by the executor or administrator of a writing that transfers the decedent's partnership interest to the surviving partners (or the partnership) and waives any right to an accounting from them. The trustee then delivers the writing to the survivors (or partnership) and disposes of the insurance policies on the lives of the survivors as directed in the agreement, and the trust is terminated.

This brief resume of the trustee plan shows that the trustee functions as a disinterested, experienced, and responsible third party, carrying through the consummation of the purchase and sale with smoothness and dispatch, and relieving the partners of

most of the details and bother. By all odds, it is the preferred plan for the partners to use.

Instead of setting up an agreement under which a trustee is designated beneficiary for the life insurance, the partners may select any one of several other arrangements, each of which has its advantages. The space required for an adequate discussion of these other arrangements, however, makes it advisable to devote a separate chapter to them.

Disposition of insurance on the lives of surviving partners. The question of the disposition of the insurance policies on the lives of the surviving partners does not come up in the case of an entity type agreement that continues in force irrespective of the death of one or more partners. Also, this question does not arise on the death of a partner in a two-man partnership under such an agreement because the deceased partner's estate will be paid the value of his interest from the partnership funds, which include the proceeds of the insurance on the deceased partner's life, and the remaining business assets, including the policy on the life of the survivor, will belong absolutely to the survivor. Where there are more than two survivors, the policies on their lives continue operative under the entity agreement.

An individual buy-and-sell agreement should contain provisions relating to the disposition of the insurance subject to it on the lives of the survivors. The nature of these provisions depends upon whether the agreement is to continue beyond the first death, or is to terminate upon the purchase of the interest of the partner first to die. If the agreement is to terminate, as in the case of a death in a partnership composed of two partners, the agreement should contain provisions disposing of the policies on the life of the surviving partner and allowing him the option to take over the contracts if he so desires. Such an option is valuable to him for several reasons. Foremost is the possibility that he might not be insurable at the time of his partner's death. And even if he is insurable, new insurance would require a higher premium outlay to maintain. Furthermore, the policies that have been maintained on his life under the agreement have usually been in force a sufficient time to make them incontestable, and they often contain other privileges and benefits

on a more favorable basis than is the case with new policies. Because of these advantages to the survivor, and further, because the contracts usually have substantial cash values that have been created in whole or in part out of premiums paid by the deceased partner, the surviving partner should be required to pay the deceased's estate a reasonable sum for their acquisition.

Most buy-and-sell agreements provide that the estate will be reimbursed to the extent of the cash values created under the plan by premiums that have been paid by the deceased partner. For example, if there were only two partners and each had paid the premiums for the insurance on the life of the other, the premiums that have been so paid by the deceased partner have created the entire cash value in the survivor's policies; the agreement would provide that the survivor may acquire this insurance upon paying the deceased's estate the cash value of it.

It should be noted that, under this arrangement, the surviving partner can easily finance the taking over of these contracts, because he can always borrow from the insurance company the amount he must pay over. If two partners have contributed equally to the premiums, then the agreement would require the surviving partner to pay the deceased's estate one-half of the joint cash values of all the policies as of the day before the death occurred. It should be noted here, however, that, except in the case of equal ages, the cash values of the insurance taken over on this basis will be greater or less than the amount the surviving partner is required to pay over for the policies. It is apparent that either of these methods is also applicable if there have been three or more partners. Ordinarily the surviving partner is given at least thirty days in which to act, after which period the deceased's personal representative may surrender the insurance for the account of the estate.

A popular modification of the cash-value-reimbursement method is to require the surviving partner to reimburse the deceased's estate for the premiums paid, in the event that a claim occurs before the policies on the life of the survivor have been in force a sufficient period of time to contain cash values. This seems just, for in such a case the insurance gain of the survivor would be large, and he can well afford to refund to

the estate the premiums that the deceased partner has paid.

Occasionally, a buy-and-sell agreement provides that the policies on the survivor's life shall belong to him without reimbursing the deceased partner's estate for them. Of course, the partners can make such a stipulation if they wish, but it is not a fair arrangement unless the purchase price agreed upon has taken this into consideration. In the event of a death, the surviving partner profits to the extent that the amount of insurance proceeds payable exceeds the premiums he has paid, in other words, he realizes all the insurance gain, and the deceased partner's estate certainly should be reimbursed in some manner for the premiums the deceased has paid. This is done on a practicable basis when he is reimbursed to the extent of the cash values created by his premium outlay. The cash value basis of reimbursement is also entirely logical when the insurance method of financing the transaction is looked upon in its true light, as being an advance instalment plan of building up the purchase price. Each partner pays annual premiums for insurance on the life of the other to build up the fund with which to purchase the other's partnership interest upon his prior death. When one of the partners dies, the fund that the surviving partner has been building up automatically becomes self-completing for the face amount of the insurance carried. This particular fund has been accumulated entirely from the premiums paid by the survivor, and he is fully entitled to it all, for the purpose of buying the deceased partner's interest. The fund that was being accumulated by the deceased partner did not mature, but usually it has developed substantial cash values, entirely created by the premiums paid by the deceased partner. Clearly, his estate is entitled to the current amount of his fund, viz., the amount of the cash values in the policies on the life of the survivor.

As already indicated in the case of a two-man partnership, where a buy-and-sell agreement does not run beyond the first death, the agreement should grant the respective insureds an option to purchase the policies on their own lives owned by the deceased partner's estate. Where there are more than two partners and the agreement is to continue beyond the first

death, the surviving partners other than the insured in each instance are granted an option to purchase the insured's policy. Thus if Jones and Smith are the surviving partners, Jones will have an option to purchase from the deceased partner's estate its policy on the life of Smith; and vice versa. In this manner, all of the insurance on surviving partners subject to the agreement can remain subject to it on a cross-insurance plan, as long as the partnership operates. Such purchases will not subject the death proceeds of the policies to income tax as having been transferred for value, because policies may be transferred for value to a partner of the insured (or to a partnership in which the insured is a partner) under an exception to the transfer-for-value rule [I.R.C., Section 101 (a) (2) (B)].

Provision that the deceased's estate be held harmless from claims of creditors of business. In agreeing upon the value of their partnership, the partners will have in mind, not its gross assets, but its net worth: its assets, less its outstanding obligations. Therefore, when the deceased partner's interest is purchased at the agreed valuation, his estate receives payment based upon the net worth of his share in the firm. In other words, the deceased's share of the outstanding liabilities having been subtracted in arriving at the purchase price of his interest, his estate receives no money with which to pay these obligations. The deceased has in effect paid his share of the debts of the firm by accepting the valuation of his interest on a net worth basis. It clearly follows, then, that the purchase and sale agreement should contain a provision that the surviving partners should assume all the obligations of the partnership, and that the deceased's estate should be held harmless from the claims of the creditors of the firm.

Provisions for amending, revoking, or terminating the agreement. It is customary to include in the purchase and sale agreement a statement that it may be amended or revoked by a writing signed by all the partners. If a trustee is a party to the agreement, it is usually necessary to provide that no amendment may be made that will increase the obligations or reduce the rights of the trustee without its written consent.

It is customary, also, to include in the agreement a clause

stating that the agreement will automatically terminate upon the happening of such events as, for example, the lapse of insurance subject to the agreement, or the dissolution, other than by death, of the partnership. This clause should provide that upon termination of the agreement, each partner is entitled to acquire the policies on his own life after completing whatever financial adjustment is stipulated. For instance, if there were two partners, each of whom had paid premiums on the other's policies, then it could be stipulated that each partner could acquire the policy on his own life by paying the other the cash value of it.

The foregoing analysis has touched upon the principal provisions that should be contained in a partnership purchase and sale agreement. Sample forms of agreement have been omitted purposely. The inclusion of one or two would tend to narrow the discussions; the inclusion of an adequate number would be impracticable. They are readily obtained from the form books, from the legal departments of trust companies and insurance companies, and from the specialized business insurance services and trust services. However, lest the impression be left with those who are not familiar with such agreements that they are bulky and many-paged documents, it should be said that well-drawn agreements of this type are on the average only about eight or nine pages in length, if trustee arrangements are used, and are otherwise only about half that long. It is a reasonably concise instrument, but the mission it performs for the partners is so important that there must be no carelessness in its preparation. Such a possibility is remote if the partners engage an experienced attorney for the task.

CHAPTER 12

Who Should Pay the Life Insurance Premiums

THERE ARE A VARIETY OF WAYS IN WHICH payment of premiums for the life insurance made subject to a purchase and sale agreement may be allocated. Premiums may be paid by partners other than the insured under each policy, they may be pooled and paid pro rata by the partners, they may be paid by the insured partner in each case, or the partnership itself may pay them. In order that an intelligent choice may be made from among these methods, each arrangement will be discussed in this chapter.

Premiums paid by partners other than the insured. Where a buy-and-sell agreement is used, this is the logical arrangement. Keeping in mind that the true nature of the insurance method of supplying the purchase price is an advance-instalment accumulation plan under which the insurance premiums constitute the instalments, then it follows logically that the premium payer in the case of each policy under the plan should be the partner or partners to whose account the insurance proceeds payable on death will be credited as purchase money. Applying this basic principle, the premiums for each policy should therefore be paid by the partners other than the one insured under it, and such premium payments should be contributed by these other partners in the same ratio in which the interest of the insured will be purchased and shared between them upon the insured's death. Perhaps this allocation of premiums appears more complicated than it really is; a few examples may prove helpful.

If there are only two partners, each should pay the premiums on the insurance on the life of the other, for it is the survivor who will be given purchase-money credit for the insurance proceeds paid, and the survivor will take over all of the deceased's interest in the business.

If there are three equal partners, each should pay one-half of the premiums for the insurance on the lives of the other two; for in the event of the death of one of the others, each will receive purchase-money credit for one-half of the insurance proceeds, and each will acquire one-half of the deceased's interest in the firm. Exactly the same principle can be followed with a larger number of partners.

Again, this is the correct principle to apply if the partnership interests in the partnership are not equally divided, or if, the interests being equal, the partners desire unequal interests between the survivors in event of a death.

For instance, Jack, Jim and Joe are equal partners. If Jack should die, Jim and Joe desire to own the business equally between them; hence they will each contribute one-half the premiums for the insurance on Jack's life. If Jim or Joe should die first, however, Jack does not want to increase his one-third interest in the business; hence Jim will pay the entire premiums for the insurance on Joe's life, and vice versa, and in the event of the death of either, the other will own a two-thirds interest.

To illustrate further, Ben might have a one-half interest in a three-member partnership, with Bill and Bob each owning a one-fourth interest. They desire a continuation plan that in the event of a death will allow the interests of the survivors, after they acquire the interest of the deceased, to bear the same ratio to each other as before. In other words, the ratio of Ben's interest with each of the others is one-half to one-fourth, or two to one. To maintain this fixed relation he will have to acquire two-thirds of the interest of either Bill or Bob; hence he should pay two-thirds of the premiums for the insurance carried on each of them. However, the ratio between Bill and Bob is one to one, or equal; hence each would pay one-half the premiums for insurance on Ben's life.

The following exhibits in tabular form (in fractions of the

total premiums for each coverage) the premium allocation for Ben, Bill and Bob, based on the above facts:

PREMIUM PAYMENTS

	by Ben	*by Bill*	*by Bob*
Insurance on Ben's life	—	½	½
Insurance on Bill's life	⅔	—	⅓
Insurance on Bob's life	⅔	⅓	—

In cases in which there are three or more partners it is a simple matter to prepare and include in the agreement a schedule of premium allocations, worked out on whatever basis is decided upon by the partners. It is a simple matter, also, to arrange for the partnership to draw the premium checks, charging them to the accounts of the individual partners in accordance with the allocation schedule agreed upon.

Suggestions are outlined in Chapter 14 as to adjustments that may be made in the event that a partner holding a smaller interest is unable to pay all the premiums allocated to him.

Pooling of premiums. Although the foregoing method of allocating premium payments in the case of a buy-and-sell agreement is correct in principle, and is ordinarily used, other methods are also used. One such other method is to "pool" the entire premiums and require each partner to pay a part. If the partnership interests are equal and the partners' ages are close, rough equity is achieved among the partners by requiring equal contributions from them to the pool. If the ages vary considerably, however, the plan unduly favors the younger partners at the expense of the older ones. If the interests are unequal, then the pooling of the premiums merely "scrambles" the equities, regardless of the basis upon which the partners contribute to the pool. If there are substantial differences, both in the ages and in the interests of the partners, then by a pooling of premiums the equities of the individual partners in the financing arrangement might be said to have been beaten into an "omelet."

The pooling arrangement results in an equal sharing of the premium payments; but on principle they should not be equally shared except in the freak situation where both ages and in-

terests are equal. Moreover, if premiums are shared equally, then it logically follows that the resulting benefit in the event of a death should likewise be shared equally. In other words, it follows logically that the deceased partner's estate should be entitled to his aliquot share of any insurance profits made: insurance death proceeds received in excess of premiums paid. Of course, no such sharing of profits is provided for the practical reason that the balance of proceeds left to be credited against the purchase price would fall short of the amount required. The principle of the sharing of benefits, however, is usually applied partially, by giving the deceased partner credit for his pro rata share of the cash values of all policies as of the date of death. Sometimes he is also credited with his pro rata share of any death proceeds that may be in excess of the purchase price, but the fact remains that the pooling arrangement is a "share and share alike" method on the debit side only.

Premiums paid by respective insureds. Employing another method, a buy-and-sell agreement could specify that each partner pay the premiums for the insurance on his own life. It should not be necessary to point out that this is totally wrong in principle, for in effect each partner is maintaining the fund with which to purchase property that he already owns, his own partnership interest.

Premiums paid by the partnership itself. Under an entity type agreement, the premiums should of course be paid by the partnership. The firm will own the policies and the cash values will appear on the partnership books as assets. Mathematically, the payment of the premiums by the firm is the same as if each partner had contributed that part of the total premiums which is proportionate to his distributive share of the partnership income. Therefore, the purchase price set under this type of agreement should at least take into consideration the cash values of all the policies immediately before the death of a partner. Ideally, the purchase price should also take into consideration the excess of the death proceeds over the cash value of the policy on the deceased partner's life—as such proceeds collected by the partnership constitute partnership assets for which the deceased partner indirectly has contributed his proper share.

CHAPTER 13

The Life Insurance Beneficiary Arrangements

In chapter 11, it was pointed out that the partners and their attorneys are offered a considerable choice in the matter of the beneficiaries that may be designated to receive the life insurance proceeds payable under the insured partnership purchase and sale agreement. In that chapter it was also pointed out that an arrangement by which a trustee is made a party to the agreement to carry out its provisions as an impartial third party and is accordingly designated as the life insurance beneficiary, was to be preferred. However, cases frequently occur in which the partners, either because the amounts involved are comparatively small, or for other reasons, do not desire a trust plan. It is important, therefore, to know what other beneficiary arrangements are available to the partners and the relative merits of each arrangement.

Designation of the surviving partners as beneficiaries. If the trustee plan is not selected, then the designation of the surviving partners as insurance beneficiaries is probably the most logical alternative choice in the case of a buy-and-sell agreement. By the terms of the continuation agreement, the survivors have usually paid the premiums for the insurance on the deceased's life, and have owned it, subject to the necessary restrictions against its use for other purposes; and therefore it is not unreasonable to pay the death proceeds to those who have created and owned the fund. Furthermore, this designation logically puts the purchase money in the hands of the individuals who owe it.

This arrangement also tends to set up an equilibrium between the deceased's estate and the surviving partners after the insurance proceeds are paid to the beneficiaries. The surviving partners, who are obligated to buy and to pay the purchase price for the deceased's interest, hold these insurance proceeds. The executor or administrator, who is obligated to sell and to transfer the deceased partner's interest, holds the title to that interest. (The surviving partners also hold the specific partnership property, but no change in the title or possession of that property is required by the plan.) Hence this beneficiary designation results in a reasonably balanced situation, with each side of the transaction holding something that it is obliged to deliver over to the other side simultaneously upon receipt of something that the other side possesses. Accordingly, the consummation of the purchase and sale should go through smoothly, upon the survivors paying over the purchase price and receiving back a transfer of the deceased's interest in the firm. The possibility that a serious difficulty will develop is remote if all the parties concerned realize that, should one side balk at going through with the plan, the other side may demand and obtain, by court enforcement if necessary, specific performance of the transaction.

The trustee plan is superior in that, among other things, it segregates the insurance proceeds by having them paid to a disinterested third party as stakeholder; but there is no basic reason why a properly set up buy-and-sell plan that pays these proceeds into the hands of the surviving partners should not function satisfactorily.

The surviving partners should not be the beneficiaries of the insurance where an entity type of agreement is used.

Designation of the deceased partner's estate as beneficiary. The designation of the deceased partner's estate as beneficiary of the insurance policies placed under the purchase and sale agreement is another (but usually unsatisfactory) choice available to the partners and their attorneys.

If this designation is made, it is imperative that the purchase and sale agreement contain a clear and positive statement that the insurance proceeds thus received by the estate direct from

the insurance company are to be credited as payment on account or in full, as the case may be, of the purchase price for the deceased partner's interest. This is obviously necessary in order to preclude any possibility that the estate or heirs will contend they are entitled both to the insurance proceeds and to the value of the deceased's interest.

From the above comments, it is apparent that the designation of the insured partner's estate as the beneficiary does not result in a balanced situation after a death occurs, for the reason that the executor or administrator holds both the insurance money and the title to the partnership interest of the deceased partner. Consequently, delivery of everything, or almost everything (in case the purchase price had not been fully insured), that the personal representative is entitled to receive under the agreement has already been made before the parties are brought together, and there does not remain an equal exchange of values to be made between them. In other words, the parties do not meet on an equal footing to conclude the transaction. This arrangement creates an obstacle to the smooth functioning of the plan.

The designation of the insured's estate as beneficiary creates the possibility that the principle of the Legallet case will be applied so that the insurance proceeds will not be included in the income tax bases of the partnership interests of the surviving partners — or, in the case of a two-man partnership, in the basis of the assets acquired by the survivor. That case is discussed later. Suffice it to state here that the opinion in that case relied heavily on the Mitchell case (also discussed later), which involved proceeds payable to the insured's estate as beneficiary.

Proceeds paid to a deceased partner's estate as beneficiary are includible as such in his gross estate for Federal estate tax purposes. Therefore, with such a beneficiary there is the possibility that the Government will attempt also to include the value of the deceased partner's interest. Such an attempt at double estate taxation was made in the Mitchell case, involving close corporation stock. Although such attempts have consistently failed (*Estate of Ray E. Tompkins,* 13 T. C. 1054 (1949), involving a partnership interest), insurance arrange-

ments that make such attempts possible are usually to be avoided.

It should be pointed out that the designation of the deceased partner's estate as beneficiary is not suitable unless the agreement specifies that the insurance proceeds shall constitute the minimum price in the event the stipulated method of valuation produces a lesser amount. If the insured's estate is the beneficiary, the insurance proceeds become part of the taxable estate of the deceased partner, against which the personal representative is allowed to credit the value of the deceased's interest to the extent that the amounts overlap. Hence, if the insurance proceeds should be in excess of the value of the deceased's interest and if the agreement should call for a sharing of that excess with the surviving partners, the personal representative must persuade the Treasury Department that it is entitled to deduct the amount of excess paid back to the survivors. He thus creates another possible source of controversy over the amount of estate taxes due.

Designation of personal beneficiaries of the insured partners. Considerable demand has developed, particularly in connection with smaller partnerships, for an insured purchase and sale plan that will allow each partner to designate his personal beneficiaries to receive the proceeds of the policies on his own life in order to take advantage of the attractive instalment settlement options contained in the policies. Pressure for such a plan has been and is being exerted by life underwriters as well as by partners because of a laudable desire to reap double benefits from the insurance. The objective is to have the insurance proceeds function, first, as business insurance, to supply the purchase money for the deceased partner's interest, and second, as personal insurance, to have the purchase money remain in the form of insurance proceeds payable to the deceased's family in instalments under the policy options, which enables the partners to use it as part and parcel of their personal insurance programs.

Although there are double benefits to be derived from the successful working of such a plan, there remain a number of very serious obstacles in it that must be overcome. The partner-

ship interest of the deceased partner is an asset of his estate, and the insurance proceeds are the purchase money for it. Therefore, if the surviving partner is to have the undisturbed right to all of the assets of the partnership, it follows that these insurance proceeds must be made available for the payment of claims of creditors of the estate unless other funds are available to satisfy such claims. *Silverthorne v. Mayo,* 238 N.C. 274, 77 S.E.2d 678 (1953).

A second obstacle is the possibility that heirs of the deceased partner other than those designated as beneficiaries will claim rights in the insurance proceeds on the ground that these proceeds represent payment for the partnership interest and thus must be treated and distributed as estate assets.

A third obstacle is raised by the case of *Legallet v. Commissioner,* 41 B. T. A. 294, in which it was held that partnership purchase insurance proceeds paid direct to a deceased partner's widow as beneficiary could not be included in the cost basis of the assets of the business in the hands of the surviving partner.

A fourth obstacle inherent in the designation of personal beneficiaries is the danger that such beneficiaries will claim both the insurance proceeds and their share of the value of the partnership interest on the ground that the insurance was personal. This obstacle, however, may be disposed of at once by stating that whenever a personal beneficiary arrangement is set up, the wording of the agreement must leave no doubt whatever that the insurance proceeds are in lieu of any interest in the firm.

With respect to the first obstacle, various arrangements have been suggested for making sure that the claims of creditors of the deceased partner will be taken care of, so that these personal creditors, or the deceased's personal representative (whose first duty as estate fiduciary is to pay creditors' claims and who is subject to surcharge for any failure in duty) will not interfere with the full transfer of the deceased's interest in the partnership to the survivor.

One suggestion is simply to make sure that there will be ample cash from other sources in the insured's estate to pay the debts of the estate. This might be done, as a practical matter, if the particular partner has an estate other than his partnership in-

terest sufficient to pay all estate claims, including taxes, by making certain that he has a valid will to provide for these payments from this other estate property. This expedient is not sensible, however, if it results in the necessity for forced sale of other estate assets to raise cash, when such cash could have been provided from the partnership purchase and sale transaction. The net result would be that the partner, by setting up the partnership business purchase plan, has eliminated any loss from liquidation of his partnership interest; then, by designating personal beneficiaries for the partnership insurance, he has substituted the losses from the forced liquidation of other assets. If the cash that will be needed is much smaller in amount than the purchase price of his partnership interest, the dilemma of liquidation losses can be solved by the purchase of the required amount of additional personal insurance, payable in cash to his estate.

If, however, the amount of cash that will be needed by his estate cannot be closely predicted (which has often been the case in the past and will be the case even more frequently in the future because of the contingent nature of the marital deduction), or if the amount approximates the value of his partnership interest, then it is far better for him to set up the normal partnership purchase plan, under which the purchase price will be paid either directly or indirectly to his estate in cash, and to place all of his personal insurance under the settlement options.

Another suggested plan to make certain that the claims of creditors of the deceased partner's estate will be settled goes to the heart of the legal difficulties involved, and therefore appears to have real merit. Under this plan, the insurance on each partner is purchased, paid for, and owned by the other partners, but the agreement obligates the other partners to execute beneficiary designations as requested by the respective insured partner. The agreement provides further, however, that the proceeds payable to the beneficiaries thus designated must be held with the insurance company under the interest option until one year (sometimes two years is specified) after the insured's death, during which time all or any part of such proceeds may, if the estate is solvent, be withdrawn at the behest of his executor or

administrator, but they *must* be withdrawn if the estate is insolvent. Under this arrangement the insurance proceeds constituting the purchase price for the deceased partner's interest are made available to the personal representative if and to the extent that they may be needed during a period presumably sufficient to administer the estate.

Under the above modified personal beneficiary arrangement, the surviving partner (or partners) is usually designated as beneficiary and given the right of withdrawal during the period that the proceeds are held at interest in order to give the survivor constructive receipt of the proceeds in the light of the Legallet case, discussed later, the holding in that case constituting another serious obstacle to be overcome. If, however, it is considered desirable to have the funds under the control of a disinterested third party during the interest period, then some companies are willing to permit the designation of a trustee as first beneficiary. This trustee is given the right to withdraw and pay over cash to the estate if and to the extent required in its administration. After the expiration of the period, the proceeds can be made available to the personal beneficiaries of the deceased if they are previously designated as second beneficiaries in the policy to take over automatically at the expiration of the interest period, or upon proper relinquishment by the trustee of all interest in the proceeds.

It is apparent that the first obstacle encountered in naming personal beneficiaries is adequately overcome by this ingenious modification of the usual personal beneficiary provision in the case of policies of those companies that are willing to permit such provisions to be set up.

Various plans have been suggested also for overcoming the second obstacle: viz., that heirs of the deceased partner will claim rights in the insurance proceeds on the ground that these proceeds, representing payment for the partnership interest, must be distributed as estate assets. All of these plans have one common component, that is, that a will with coordinating provisions is to be executed by each partner, but before these suggestions are outlined, something more should be said about the underlying problems involved.

In the absence of a will, the intestate laws of each state pre-

scribe that the decedent's property is to go to specified classes of heirs in specified proportions. In New York, for example, the property of a man dying without a will and leaving a widow and children, goes one-third to the widow and two-thirds to the children and to the descendants of any deceased child. Therefore, if the widow is named as beneficiary of the partnership purchase insurance, and if there is no will, there is a possibility that one of the heirs who would otherwise have shared in the value of the business interest will claim that the personal beneficiary designation has illegally taken away his intestate share of the purchase price paid for that interest.

By means of a properly prepared will, the possibility of interference from heirs other than those who are given a right to renounce the benefits of the will and to take under statutory provisions, can be eliminated. But a problem may be presented by the fact that the laws of most states give certain heirs, ordinarily the widow and usually any children born after the making of the will and not mentioned in it or not otherwise provided for, an election to take against the will up to the amount they would have been titled to receive in the absence of a will. The widow, at least, usually has an indefeasible right to a share of a decedent's estate, will or no will, and she cannot be denied this right except by her own voluntary waiver in a formal manner commonly prescribed by statute. In this connection, it should be noted that insurance proceeds in any amount payable to her as a direct beneficiary do not defeat or reduce a widow's statutory rights in most, if not all jurisdictions, because her rights are in the property passing through the decedent's estate. Therefore, should she or any other heirs be designated as personal beneficiary of the partnership purchase insurance, will or no will, there is a possibility that the widow will attempt to upset the plan, unless a valid waiver has been obtained from her in advance.

An example of this is shown in *Buehrle v. Buehrle,* 291 Ill. 589, 126 N. E. 539 (1920). Two brothers, a few years after having inherited a wholesale liquor business from their father, insured themselves for $5,000 under a joint-life fifteen-year endowment policy, payable to the widow of the first to die, and they entered into an agreement stating that each would make a

will leaving his partnership interest to the other. They also agreed that on the death of one the entire business "shall belong to the survivor of said parties, provided said insurance policy above mentioned is kept in full force and valid and payable to the widow of such deceased party." On the same day the agreement was signed, the brothers also executed wills in conformity with the agreement and conditioned upon the policy being in full force and effect at the first death. Premiums on the policy were paid by the partnership.

Upon the death of one brother seven years later, his widow collected the $5,000 proceeds. However, an audit of the partnership books made the day after the death showed the assets to be worth $69,905.10. As soon as the widow learned of the contents of the will and the contract she renounced her rights under the will, elected to take her statutory share, and charged herself with the insurance proceeds. The surviving brother contended that the partnership interest passed to him under the terms of the agreement itself, but Illinois' highest court held that it was an agreement for the making of mutual wills rather than a survivorship contract and that the wife was entitled to her statutory rights in her husband's estate upon her renunciation and her election to take under the law. The court further held that, since the insurance premiums had been paid by the partnership, the proceeds would be considered as partnership assets. The case shows clearly the absolute necessity for proper waivers from pretermitted heirs if the plan adopted calls for the partnership interest to pass *by will* to the surviving partner.

Where the partnership interest of a deceased partner passes by the terms of purchase and sale in a buy-and-sell agreement, some courts have held that unless the purpose of the transaction was to evade a statutory provision or to offend public policy, an individual designated to receive the purchase price has proper legal right to it, as against everyone but unpaid creditors of the estate, as the beneficiary of a valid and enforceable third-party beneficiary contract. The Michigan Supreme Court so held in *Ireland v. Lester,* 298 Mich. 154, 298 N. W. 488 (1941). The facts of this case were reviewed in Chapter 8.

The Supreme Court of North Carolina arrived at a similar

decision in *Silverthorne v. Mayo*, 238 N.C. 274, 77 S.E.2d 678 (1953). In that case the partnership agreement specified that the purchase price for the deceased partner's interest was to be paid direct to his widow. She was to receive $1,500 in bonds immediately, and was to be paid the sum of $8,500 at the rate of $1,000 a year. The deceased partner left no will. The widow died after receiving only one annual instalment of the purchase price, and a legal controversy arose between the beneficiaries under her will and the distributees of the deceased partner's estate as to which group was entitled to the balance of $7,500. The court held that the widow had received the right to the purchase price as the designee of the payments in a valid third-party beneficiary contract; hence those taking under her will were entitled to the balance payable after the widow's death. The following quotation from the opinion shows that where a deceased partner's interest is sold under a buy-and-sell agreement and the purchase price is to go to the widow, the arrangement eliminates the problem of the deceased partner's heirs but does not eliminate creditors of his estate who are not paid from other funds:

> Ordinarily, a surviving partner, in the absence of a partnership agreement providing otherwise, is charged with the duty to pay the firm debts, collect the partnership accounts, and account to the personal representatives of the deceased partner. It naturally follows that a partnership agreement is not binding on the firm's creditors unless they assent. 68 C. J. S., Partnership, § 401(d), page 921. Furthermore, an interest in a partnership may be subjected to the payment of the individual debts of the partner. Therefore, the disposition of property by contract, enforceable at death, does not exempt such property from liability for the debts of the decedent any more effectually than if the property had been disposed of by will. However, it would make no difference in the instant case whether the balance due is paid to the executor of the last will and testament of Dorcas Jane Silverthorne or to an administrator of the estate of R. S. Silverthorne; provided there are no unsatisfied creditors of his estate. In no event would the distributees of R. S. Silverthorne, as such, take any interest in the balance which is due or to become due under the partnership agreement.

> Since there is no intimation on this record that any valid claim against the estate of R. S. Silverthorne is outstanding and unsatisfied, the judgment below is Affirmed.

We shall now discuss the various plans that have been suggested in order to overcome the problem presented by heirs of the deceased partner – keeping in mind that where the partnership interest passes by the agreement of the partners, rather than under the deceased partner's will, the problem largely is that of precluding futile lawsuits by disgruntled heirs. A few of these arrangements will be outlined briefly and their effects discussed. (It will be assumed that each such arrangement includes a modified personal beneficiary provision in which the proceeds are withdrawable during a limited period if needed by the estate. In this way our first problem, that of the claims of creditors of the decedent's estate, is already adequately solved.)

One suggested solution is a plan by which the wife of each partner is made a party to the purchase and sale agreement, is made the personal beneficiary of the life insurance under it, and is also the sole legatee of the partnership interest by specific bequest in each partner's will.

This plan appears to solve the problem of heirs without requiring statutory waivers from the partners' wives. The problem presented by the Legallet case will be discussed separately because it bears equally on all plans using the modified personal beneficiary provision. Weaknesses of the plan are as follows: It is dependent upon valid wills; it puts the decedent's widow in rather too full control; and its functioning requires the survivorship of a widow or, if there is no widow, probably that of a sole adult heir who has been made a party to the agreement and sole legatee of the business interest.

Another suggested plan contemplates a special survivorship agreement under which each partner agrees that, upon his death, his interest in the partnership shall immediately become the property of the surviving partners. By the terms of the agreement the other partners agree to purchase and maintain on his life a stipulated amount of life insurance made payable to his wife. Appended to this agreement is a certificate signed by the wives, stating that each has read the agreement, that

each agrees to accept the benefits accruing to her in lieu of any interest in the partnership belonging to her husband, and that she waives any statutory rights she might have in the partnership property in the event of her husband's death. Life insurance is purchased in stipulated amounts, with the wives named as beneficiaries, and wills are executed by each partner, confirming the agreement.

Aside from the appended waivers, this is the same type of agreement we have seen in such cases as *Coe v. Winchester* and *McKinnon v. McKinnon,* and is the same type successfully litigated in *Hale v. Wilmarth,* 274 Mass. 186; *In re Mildrum's Estate,* 177 N. Y. S. 563; *Matter of Orvis,* 223 N. Y. 1; *Matter of Karlinski,* 38 N. Y. S. 2d 297; *Faggelle v. Marenna,* 131 *Conn.* 277; *More v. Carnes,* 309 Ky. 41; and *Michaels v. Donato,* 4 N.J. Super. 570. Those cases show that such an agreement would be upheld against the heirs in many jurisdictions without any waivers; nevertheless, waivers are recommended in all states that have not passed upon such an agreement and in all cases, regardless of jurisdiction, in which the insurance proceeds are apt to be materially less than the value of the partnership interest. Had the Buehrle brothers kept to the survivorship provisions in their agreement instead of including further provisions for bequests by will of their respective interests to each other, probably the agreement would have been upheld; but without an appended waiver it would have been too much to expect that widow Buehrle, without a court battle, would have accepted the $5,000 insurance proceeds in lieu of the value of a partnership interest worth about $35,000. The object should not be to set up a successful lawsuit for the surviving partner, but to set up a plan over which no litigation is likely to arise.

In those jurisdictions that have upheld the survivorship type of agreement, the likelihood that heirs will object can be forestalled by suitable waivers.

A third suggested plan calls for a purchase and sale agreement containing the regular provisions for the sale of the deceased partner's interest by his personal representative, and for the crediting by him of the insurance proceeds against the purchase price. In fact, the standard agreement pattern is followed

except for the provision for modified personal beneficiaries. Life insurance is purchased as specified, and each partner executes a will in which he directs his executor to carry out the terms of the purchase and sale agreement.

Although the problem of heirs objecting to the arrangement might prove to be solved without waivers, it still seems prudent to obtain from the wives waivers of any statutory rights they might have in the partnership property in the event of a partner's death. Any problem of getting a transfer of the partnership interest of a deceased partner is definitely solved if the modified personal beneficiary arrangement is used. Because he has access to the insurance proceeds if they are needed to settle estate claims, the executor has no grounds on which to base a refusal to make the transfer.

A fourth plan sets up a trusteed purchase and sale arrangement with the modified personal beneficiary provisions outlined previously. Under this plan, the wills of the partners direct their personal representatives to carry out the transaction and to request of the trustee any portion of the insurance proceeds needed in the settlement of the estate. The principal difficulty with this plan is the reluctance on the part of many insurance companies to allow settlement options, even for a limited period, to be paid to a fiduciary.

We now come to the problem presented by the Legallet case (41 B. T. A. 294) as it relates to the modified personal beneficiary arrangement. In that case the partners originally executed a regular insured buy-and-sell agreement with $20,000 of life insurance on each partner, payable to the other as beneficiary. A few months later they each purchased $5,000 additional insurance. Three years later they substituted a new agreement for their standard agreement and made all of the life insurance payable directly to their wives as personal beneficiaries under the instalment income options. The new agreement included the wives as parties, each of whom agreed to accept the $25,000 insurance proceeds as first payment on the deceased partner's interest (valued in the agreement for the current year at approximately $55,936 each) with the balance payable in a series of fifty monthly notes of equal amount. Sev-

eral months later partner O'Neill died, and the purchase and sale transaction was consummated as agreed upon. Afterwards in the same year the surviving partner Legallet sold some accounts receivable and merchandise that had belonged to the former partnership of Legallet & O'Neill. In reporting the profit on the sale in his income tax return for that year Legallet used the full purchase price of $55,936 as the cost basis of the assets acquired by him from the deceased partner. However, the government assessed him an additional income tax of $4,680.04 on the sale, on the ground that the cost basis of the assets acquired did not include the life insurance proceeds of $25,000 and was, therefore, only $30,936, the amount of notes paid. Legallet then petitioned the Board of Tax Appeals to set aside the assessment, but was unsuccessful. The court stated:

> The $25,000 was not in fact received by him, but by O'Neill's wife, and was not in fact paid by petitioner to her. Is the effect, for the present purpose, as if he had so received and paid the $25,000 as purchase price of the partnership interest acquired? . . . Petitioner, in effect, contends that looking through form to substance, the insurance should be considered as received by petitioner as provided by earlier agreements between the partners, though not by the last agreement, that they were constructively received by him, and that the insurance proceeds when received by O'Neill's wife were impressed with a trust and subject to use as part payment of the purchase price of the partnership interest acquired by petitioner, in accord with the use in the contract of the expression "part payment."

The main body of the opinion of the Board is devoted to a line of reasoning grounded on the rule that property owned by a decedent acquires at his death a new income tax basis consisting of its value for Federal estate tax purposes. It reviews its own estate tax cases of *Boston Safe Deposit & Trust Co. Executors,* 30 B. T. A. 679; *M. W. Dobrzensky, Executor,* 34 B. T. A. 305; and *Estate of John T. H. Mitchell,* 37 B. T. A. 1, disapproving, as it had done in the Dobrzensky case, its reasoning in the first case, and approving its reasoning in the Dobrzensky and Mitchell cases in which it held that business-purchase insurance was to be included *as insurance* in the deceased's estate for tax purposes in all cases in which the in-

surance arrangement brought it within the gross estate, and the value of the business interest purchased was to be excluded to the extent that insurance proceeds were included. The Board stressed the fact that in those cases, and in the case being decided, the premiums had been paid by the business and charged equally to the partners. Then the opinion said:

> In all three of the above cases, and in this, the purpose was to provide a part of the purchase price of the partnership interest. If the insurance proceeds were insurance, to be included in gross estate in the cited cases, they would be such in the estate of O'Neill, and only the balance of the purchase price would be included in gross estate as from Legallet on the contract. Therefore, we think the petitioner can take as cost base only the latter amount. . . .

In other words, here, as in the Mitchell case, the insurance would be included in O'Neill's gross estate as such, and his partnership interest (or the purchase price paid for it) would be included only to the extent its value exceeded the insurance proceeds. This amount would be only $30,936; hence, it represents Legallet's cost and therefore the amount that he may allocate to the basis of the specific assets formerly owned by the partnership. As cost is the proper basis for a purchased asset, it would seem that there should have been added to Legallet's basis at least the one-half share of the premiums paid on O'Neill's policy by the partnership and borne equally by the partners as a nondeductible expense of the firm.

Legallet's argument that the insurance proceeds should be considered constructively received by him and paid over as part of his cost was answered, and the case decided upon the authority of the Mitchell case, as follows:

> Petitioner's argument that we should look to substance through form and find that the parties intended that petitioner be the beneficiary, as in previous transactions, is nullified by the mere fact that the parties, for reasons duly considered, deserted the older form of agreement and method of insuring with the other as beneficiary and adopted a different one. They wished a change of substance as well as form, for they wished a certain kind of distribution, and in order to obtain it, found it necessary

> to deviate from the old payment in a lump sum to the survivor. We cannot reasonably now say that the change was unintentional or ineffectual. Likewise the idea that the insurance proceeds was a trust fund for payments to the petitioner is, we think, not accurate. It was, as in the three cases above discussed, subject to a contract, but not by way of such trust as to dictate constructive receipt of the amount by petitioner. A mere contract entailing the elements here involved does not constitute constructive receipt.
>
> Upon the authority of the *Dobrzensky* and *Mitchell* cases, *supra*, above discussed, we conclude and hold that petitioner's cost basis does not include the $25,000 insurance proceeds received by the wife of his deceased partner.

As long as the Legallet case is followed, it obviously adds another primary difficulty to any plan that includes the naming of personal beneficiaries under partnership business continuation insurance policies. In fact, the only beneficiary arrangements that appear to raise no doubt as to whether the insurance proceeds will be included in the cost basis are, first, that which names the surviving partners as beneficiaries and, second, that which names a trustee beneficiary, both arrangements pursuant to a plan of policy ownership and premium payment that eliminates the insurance proceeds from the insured's taxable estate.

A modified personal beneficiary arrangement under which the survivors, or a trustee acting for them, may withdraw proceeds during the probate period should constitute constructive receipt of such proceeds. If, further, the insurance occupies a non-taxable status with respect to the estate of the deceased, the obstacle presented by the Legallet case should be surmounted. In this latter connection, however, it seems clear that the deceased may be held to possess an incident of ownership in the insurance on his life if by the terms of the agreement he could require the policyowners to designate personal beneficiaries of the policy as directed by him. Giving to the other partners, or the trustee, a free rein in the matter of naming second beneficiaries, if it's practicable under the particular circumstances, might well solve the problem.

From the foregoing analysis it is apparent that the matter of

designating personal beneficiaries in business insurance policies involves special problems. However, a workable plan can be set up under which personal beneficiaries may be designated in the modified form. Choice among the various plans depends upon the state of the law in the particular jurisdiction, the circumstances of the individual case, the wishes of the parties involved, and the beneficiary rules of the particular insurance company whose policies are concerned. It is also apparent, however, that such a plan will probably have to accept some disadvantages. Furthermore, the proper execution of such an arrangement will require the skilful selection and coordination of provisions best suited to the circumstances of the individual partnership. The conclusion seems evident, therefore, that the standard agreement with a trustee or the surviving partners as insurance beneficiaries (or the partnership in the case of an entity agreement) will prove the most satisfactory in the great majority of partnerships, and that a plan using personal beneficiaries should be adopted only in the exceptional case in which a qualified local attorney has approved it after a careful study of all the advantages and disadvantages of the plan in the particular situation.

Designation of the partnership itself as beneficiary. The partnership itself should be designated beneficiary of the insurance only in the case of an entity type agreement. Under such an agreement the policies are partnership property and are properly payable to the firm. Under a buy-and-sell agreement, on the other hand, the policies are owned by the individual partners, and needless confusion would result from naming the firm as beneficiary.

*

CHAPTER 14

Unusual Continuation Problems Discussed

THE DISCUSSION OF THE INSURED PARTNERSHIP business continuation plan has been based in general upon the circumstances found in the typical firm: namely, a partnership composed of two or more members, all of whom are insurable, and whose respective interests in the partnership are somewhere near equal. It is recognized, of course, that these typical circumstances do not always obtain and that unusual circumstances may call for appropriate modifications of the standard purchase and sale arrangement. Accordingly, a few of these abnormal situations will be pointed out and a few ways by which they may be met will be suggested.

PARTNERS WITH GREATLY DISPROPORTIONATE INTERESTS

Occasionally a partnership is encountered in which the respective shares of the members are greatly disproportionate to each other. A simple example would be our old firm of King & Gay, if we assume that King holds a three-fourths interest and Gay a one-fourth interest. The standard procedure would require Gay to purchase insurance on the life of King in the amount of his three-fourths interest and pay the premiums on it. If this can be done it should be done, for these premiums are the scientifically correct amounts that Gay should be called upon to pay for the acquisition of King's three-fourths interest upon the latter's death. But very often the problem of premium paying of the partner with the smaller interest is aggravated by the fact that

the other partner is considerably older. We shall assume this to be the case with King, with the result that it is financially impossible for Gay to pay the entire premiums for the insurance on King's life.

A satisfactory solution to Gay's premium paying problem could be worked out as follows: Gay will pay as great a portion of the premiums for the insurance on King's life as he is able. King will pay the remainder of the premiums for the insurance on his own life as a loan to Gay. A special schedule should be appended to the agreement on which to record and initial these loans as they are made, and the agreement should provide that these loans be repaid out of the first insurance moneys collected upon King's death. Of course, unless the amount of insurance carried on King's life is in excess of the purchase price of his interest, this provision will cause the proceeds to fall short, but the discrepancy will be absorbed by the usual note arrangement covering any balance of purchase price remaining after crediting the insurance proceeds received. Over the life of an agreement it very often happens that the partners will adjust their interests to a more nearly equal basis, in which event loans of this nature may be paid back before a death occurs.

Another solution, not so satisfactory, is for Gay to purchase insurance on King's life in the amount Gay is able to maintain, leaving the remainder of the purchase price to be absorbed by the usual instalment note arrangement.

A third solution would be to set up a partnership entity type of agreement, under which the insurance premiums are paid by the partnership and the firm is the owner and beneficiary of the policies. Such an agreement is particularly suitable to a partnership consisting of several partners, but it can be used in the case of two partners. Under this form of agreement, a partner with a large interest indirectly pays a proportionately large share of the premiums, but the plan works out equitably where all insurance values are taken into consideration when the interest of a deceased partner is acquired.

THE UNINSURABLE PARTNER

When we realize that, on the average, approximately one per-

son in every twenty who applies to the insurance companies for life insurance is unable to obtain a policy, we may expect that partners who desire to set up an insured purchase and sale plan will occasionally find that one of their associates is uninsurable. The problem is solved immediately if the uninsurable partner has sufficient personal insurance that he is willing to sell and assign to the partnership or the other partners to finance the purchase price of his interest. Where this cannot be done, the first reaction of the partners usually is to abandon their plan to execute a continuation agreement, but they need not and should not desert their purpose. We have gone to considerable lengths to demonstrate what happens to a partnership business when the law of partnership liquidation is allowed to take its course. The losses resulting are serious to everyone concerned, and they can be avoided even though a partner cannot be insured. In fact, if there were no such thing as life insurance it would still be advisable for partners to set up continuation agreements under which the surviving partners would finance the purchase of a deceased partner's interest with down payments accumulated in ordinary sinking funds and with a series of notes to cover the remainder of the purchase price. The "dog" is the purchase and sale agreement; the "tail" is the method by which the agreement is financed. With every partner insured for the value of his interest, we have a "wagging tail" to denote that everything is as it should be. But the tail should not be allowed to wag the dog. If it is impossible to set up the ideal insurance method of financing with respect to the interest of every partner, then it should be used for the insurable partners, and the sinking fund method should be used to finance the purchase of the uninsurable partner's interest.

The purchase and sale agreement is modified to provide that the partners other than the uninsurable member, instead of maintaining insurance on his life, will deposit annually into a segregated reserve fund an amount at least equal to the premiums that would have been paid by them had the partner been insurable. With the preferred trust plan, this sinking fund may be built up in the trust, thus affording a perfect segregation; otherwise it may be placed in a separate bank account, or in-

vested in government bonds. Another feasible method under certain circumstances is to build up the fund by means of discounted premiums paid in advance on the policies of those insured, provision being made for the reversion of the fund to the contributors upon the insured's death or upon the death of the uninsurable partner.

As a concomitant to the provision for a sinking fund, the agreement must allow the remainder of the purchase price to be paid in instalments spread over a period of time sufficient to avoid financial embarrassment to the survivors. This is taken care of automatically if the note arrangement suggested earlier in the text is employed, namely, that notes of a specified amount become payable at specified intervals; thus, the number of instalments will vary automatically with the size of the total remainder of the purchase price to be paid.

Where an entity agreement is used, a sinking fund may be built up in the form of discounted premiums or in a special reserve account. The partnership also may find it feasible to own key-man insurance on the insurable partners, in order to augment the sinking fund should any of the insurable partners predecease the uninsurable partner. It should not be assumed that because one of the partners is uninsurable, he will die first; in the case *Kavanaugh v. Johnson* it was the uninsurable partner who survived.

THE PROBLEM OF LARGE PARTNERSHIP LIABILITIES

The death of a partner does not free his estate from liability for the debts of the partnership. In the ordinary situation, however, if the firm's debts are largely composed of current liabilities, the regular provision in the purchase and sale agreement requiring the surviving partner to assume these debts and to hold the estate of the deceased partner harmless therefrom has proved satisfactory. Nevertheless, situations will be encountered in which a partnership has outstanding comparatively large liabilities not immediately due and in which the ordinary provision in the agreement will not be sufficient protection to the deceased's estate. Such a situation is not within the prov-

ince of the life underwriter to work out, but he should recognize that it does exist in certain cases, and he should know something about one or two of the remedies that might be used.

One possible remedy in a proper situation that life underwriters would naturally think of is a special joint policy of life insurance covering the partners in the amount of the deferred obligations. If there are only one or two large creditors such a policy can be made payable to them as their interests may appear, with any balance payable to the firm. If a trusteed partnership purchase plan is used, such a policy can be made payable to the trustee with instructions to apply the proceeds to the debts of the firm in whatever manner desired.

The proceeds of any life insurance arranged to pay off obligations of the partnership should be included in valuing the partnership interests under a purchase and sale agreement, for such proceeds increase the net worth of the business to the extent thereof.

Another possible remedy, if the partners are unable to maintain the amount of insurance required to retire the deferred obligations in full, is for them to purchase an amount of insurance sufficient to obtain releases from these creditors of the estate's liability.

A third possible remedy is the purchase of a surety bond by the surviving partner that would require the surety company to indemnify the deceased's estate for any loss resulting from the failure of the survivor to discharge the outstanding debts of the firm. The difficulty with this solution, however, is that it cannot be known in advance whether the survivor will be able to obtain the issuance of such a bond.

It should be evident from this discussion that because of the large amount of their deferred liabilities, some partnerships should postpone any continuation plans until they have achieved a more suitable ratio of liabilities to net worth. In other words, an insured purchase and sale plan cannot logically be set up in every situation. In a great majority of partnerships it will be of immense service to the partners and their families, but in a few firms the partners might better solve the outstanding liabilities problem first.

PROFESSIONAL AND PERSONAL-SERVICE PARTNERSHIPS

Because of the fact that a professional or personal-service partnership, typified by a law firm or a firm of accountants, differs in some material respects from the ordinary commercial partnership, there is need for a separate discussion of its continuation problems and their solution.

In the ordinary business firm, capital, in the form of such tangible property as real estate, fixtures, machinery, equipment, materials and supplies, and merchandise, is an important factor and represents a substantial portion of the purchase price to be paid on acquisition of a deceased partner's interest. In such a firm, going-concern and good-will value also account for a sizable part of the total valuation. In contrast, the usual professional or personal-service partnership interest represents only a small amount of capital in the form of tangible property and, in legal contemplation, little or no good will attributable to a partner that survives his death.

Nevertheless, from a practical economic standpoint, a considerable quantum of good will is actually created by a capable and well-established personal-service partnership that will inure to the financial benefit of the survivors. A realization of this fact has been one of the significant reasons why such firms have frequently set up continuation agreements. Another motivating force has been the desire to avoid a complicated and protracted accounting with respect to a deceased's share in the unfinished work of the partnership that may be in progress at the time of his death. And there has been the very human and commendable desire to set up an arrangement that would cushion the shock to a deceased's family caused by the sudden loss of the income of the deceased.

In order to solve these various problems, professional and personal-service partnerships customarily have set up a species of continuation plan resembling an entity type agreement except that all or the greater part of the payments to be made by the partnership consist of an agreed percentage of the continuing firm's income, payable to the deceased partner's estate or heirs for a fixed period of years.

Following considerable confusion in the courts as to the income tax incidence of payments made under such agreements, the Internal Revenue Code of 1954 set out fairly definite rules by separating the payments received from the partnership into two groups. The first group consists of nondeductible payments in acquisition of the partnership interest of the deceased partner. This group includes payments for good will only to the extent that the agreement specifically provides for such payments in a reasonable amount. By reason of the fact that the partnership interest of a deceased partner receives a new income tax basis at death, which is its value at that time or on the optional valuation date for Federal estate tax purposes, the recipient of these payments should have little or no income tax thereon. Normally, these payments will constitute the purchase price received upon the sale of a capital asset under circumstances in which the price and income tax basis are the same.

Payments in the second group consist of those in excess of the value of the deceased partner's interest at time of death. They include any payments made for the deceased partner's share of any unrealized receivables of the partnership. If these payments are based upon partnership income, they are treated as a distributive share, thus reducing the distributive shares of the surviving partners. If these payments are not based on partnership income, they are deductible by the partnership as a business expense. In either event, the payments in this group are treated by the recipient as ordinary income in respect of a decedent. The value of these payments (as well as those in the first group) are includible in the deceased partner's gross estate for Federal estate tax purposes, *McClennen v. Commissioner,* 131 Fed. 2d 165 (1942), but the recipient is entitled to an income tax deduction for any estate tax paid attributable to such payments [I.R.C., Section 691(c)].

Note that where a partnership possesses good-will value, the partners, by inserting or omitting a provision in their agreement to provide for the purchase of a deceased partner's interest in good will, can determine whether the survivors or the recipient of the payments will bear the income tax on payments actually representing the decedent's interest in good will.

The fact that the payments in the second group constitute ordinary income to the recipient makes it desirable that by the terms of the agreement these payments be spread over a period of years and not bunched into too few taxable years of the estate or other recipient.

Life insurance is an exceedingly valuable adjunct to an income continuation plan. In essence, the survivors under the plan are committed to the payment of a substantial amount of money each year for several years after a partner's death. Except in so far as these payments represent fees for work done by the decedent prior to death in connection with unfinished business, usually an insignficant proportion of the total amount involved, the payments consist of money earned by the survivors which they cannot keep. Even though the arrangement is such that they are relieved from the additional burden of paying taxes on this money, the steady drain on the funds of the continuing members is bound to retard their progress over the years that the payments are required. How much better it would be for them if, at the time of the death, the survivors were able to collect insurance proceeds on the deceased's life, free from taxes, in the amount of the estimated payments to be made to his estate or widow. They can readily put themselves in a position to do this if each partner, or the partnership, is insured by the other partners in the amount of the estimated post-mortem payments to be made on his account.

Before concluding this discussion of agreements for personal-service partnerships, something should be said about the advantages to the estate or heirs of making payments falling in the second group of a definite agreed amount, as against a sharing of an agreed percentage of future income. We need only to revert to the case of *Hermes v. Compton,* 260 App. Div. 507, quoted on page 195, for illustration. The continuation agreement involved in that case, in addition to certain capital sums that were paid in lump sum, called for the payment to Hermes' estate for a period of five years of a sum equal to a certain specified percentage of the annual net income derived by the surviving partners over and above $75,000. The estate received a substantial amount covering the first year after Hermes' death, for

in that year the senior surviving partner alone (two partners survived) earned in excess of $100,000. The following year, however, the senior partner retired, except as a consultant, with the result that earnings fell below $75,000 and payments under the continuation agreement stopped. The same result, of course, would have been brought about had the senior partner died that year instead of retiring, which shows clearly the weakness implicit in any plan of sharing the income of survivors.

Payments in a definite agreed amount for an agreed period also have distinct advantages for the surviving partners. Such payments eliminate any checking into the future partnership income by the deceased partner's executor or heirs. Furthermore, with a known total amount to be paid in the event of the death of a partner, the other partners or the partnership may cover such payments with the correct amount of insurance.

CHAPTER 15

Tax Problems Involved in the Insured Purchase and Sale Plan

THE FEDERAL INCOME TAX

The partnership return and scheme of taxing partners. Partnerships, as such, are not taxpayers under the Federal income tax law. Each partnership, however, must file a return. In this return the ordinary net income of the firm is calculated by totaling the gross profits and other income of the partnership and subtracting from this gross income the regular business deductions such as salaries and wages of employees (including any salaries paid to partners), rent, repairs, interest, taxes, depreciation, *et cetera.* (This calculation closely follows the schedule in the individual tax return that the life underwriter is accustomed to fill out in order to show his gross income, business expenses, and net income from conducting his insurance business.) The share of the net income of the partnership to which each partner is entitled is then shown on an appropriate schedule in the partnership return.

Another schedule itemizes gains and losses from sales or exchanges of capital assets of the partnership, and the share of each partner in the short term capital gains and losses and in the long term capital gains and losses is separately shown. The return also reports each partner's share in the charitable contributions made by the partnership, and includes many other schedules for the purpose of itemized details that are of no interest to us here.

This partnership return having been made, each partner then includes in his individual income tax return his salary, if any, and his share of the ordinary income of the firm, whether or not it has been distributed to him. Each partner also includes with his personal capital gains and losses his share of the capital gains and losses of the partnership. There are other important items, such as the deduction of the partner's share of charitable contributions made by the firm, but our principal concern at this point is merely to outline the broad scheme of taxation as it relates to the partnership and to the individual partners. With that scheme clearly in mind, the answer to most of the tax questions that come up in connection with the insured purchase and sale agreement can be anticipated.

The life insurance premiums not deductible. The premiums paid for life insurance made subject to a purchase and sale agreement are not deductible as business expenses. This holds true whether the premiums are paid by the insured partner, by the other partners, or by the firm itself. (I.R.C., Secs. 262 and 264 (a) (1); *Clarence W. McKay,* 10 B. T. A. 949; *Ernest J. Keefe,* 15 T.C. 952.) If paid by the firm, the result taxwise or otherwise is the same as it would have been had each partner paid premiums in proportion as he shares in the earnings of the partnership.

The rule that premiums are not deductible business expense also holds true regardless of the beneficiary designations contained in the policies. (*Clarence W. McKay,* supra; *Ernest J. Keefe,* supra; *Joseph Nussbaum,* 19 B. T. A. 868.)

The life insurance proceeds generally not taxable income. Life insurance proceeds paid by reason of the death of a partner insured under a purchase and sale agreement are not subject to income tax, as a general rule [I.R.C., Sec. 101(a)(1)]. Formerly, there was an exception in the case of a policy that had been transferred for value to a partner or to his firm. The Internal Revenue Code of 1954, however, provides that a policy may be transferred for value to a partner of the insured, or to a partnership in which the insured is a partner, without subjecting the proceeds at death to income tax as the proceeds of a policy transferred for value [I.R.C., Sec. 101 (a)(2)(B)]. Thus, an unin-

surable partner with a surplus of personal insurance can sell some of it to the partnership or to the other partners for the purpose of purchasing his interest in the firm at his death. Likewise, under a cross-purchase buy-and-sell agreement the surviving partners may purchase from a deceased partner's estate the policies the deceased owned on the lives of the survivors and continue such insurance under the agreement.

The sale of the partnership interest by the estate. In discussing in Chapter 10 the various factors indicating a choice between a buy-and-sell agreement and an entity type agreement, the income tax status of payments received by the estate or other recipient pursuant to each type of agreement was discussed in detail under the heading. "Income tax status of payments." Therefore, no useful purpose would be served by repeating here the discussion of such payments.

When a partner dies, the partnership taxable year closes with respect to him at the end of the normal partnership taxable year, or at the time when such partner's interest is liquidated or sold, whichever is earlier. The last return of the deceased partner includes his share of partnership taxable income for the partnership taxable year or years ending within or with the last taxable year of such partner. For example, assume that the partners report on the calendar year basis and the partnership has a taxable year ending on June 30. One of the partners dies on October 31, and under a buy-and-sell agreement his interest is purchased as of that date. The taxable year of the partnership beginning the previous July 1 closes with respect to the deceased partner and his final return will include his distributive share of taxable income of the partnership for its taxable year ending the previous June 30, plus his share of the partnership taxable income for the period July 1 to October 31.

The cost basis of partnership assets acquired from deceased partner. The cost basis of the deceased partner's share in the property of the partnership acquired by the surviving partners under a buy-and-sell agreement should be the purchase price that the survivors have paid for it. This will undoubtedly be the case if the surviving partners have been designated beneficiaries of the insurance proceeds used to finance a purchase

and sale agreement. The insurance proceeds, together with any remainder of the purchase price paid in instalment notes, should also constitute the cost basis of the acquired property if the insurance proceeds are received by a trustee and paid over by it to the deceased partner's personal representative in return for a transfer of the deceased's interest in the firm, provided the surviving partner has paid the premiums on it and he or his trustee has owned the policy.

On the other hand, if the deceased partner has paid the premiums on the insurance covering his own life, and particularly if there has been no accompanying provision for reimbursement of premiums paid by the deceased, the survivor may expect that the Treasury Department will oppose the inclusion of the insurance proceeds in the cost basis of assets acquired. If the insurance proceeds are made payable directly to the insured partner's estate or to his personal beneficiaries, there is little reason to believe that such proceeds may be included in the cost basis of the property acquired from the deceased partner if the insured partner has participated in the premiums on his own insurance or they have been paid by the partnership. (*Paul Legallet,* 41 B. T. A. 294. See discussion of this case in Chapter 13.) The arrangements that appear to raise no doubt that the insurance proceeds will be included in the cost basis of the surviving partners are those under which the survivors paid the premiums and under which they, or a trustee acting for them, have been the policyowners and beneficiaries of the deceased partner's insurance.

The effect of the workings of an entity type agreement upon the bases of the interests of the partners is somewhat complex. It has been discussed in detail in Chapter 10 under the heading "Income tax bases of the surviving partners" and will not be repeated here. Accordingly, reference should be made to that discussion in the case of an entity agreement.

THE FEDERAL ESTATE TAX

No double taxation. In general, it may be said that the existence of an insured partnership purchase and sale plan does

not materially affect the amount of estate taxes a deceased partner's personal representative will be called upon to pay. This is because the courts have repeatedly prohibited inclusion in the taxable estate of both the value of the deceased partner's interest and the insurance proceeds received by the estate in payment for the sale of that interest. *Estate of Ray E. Tompkins,* 13 T.C. 1054.

The decisions of the courts, however, have not been consistent in determining which of the two types of property, to the extent that the partnership interest and the purchase price for it represents the same value to the estate, should be included in the taxable estate. For example, the Board of Tax Appeals in *Boston Safe Deposit and Trust Co. (Estate of Scovell),* 30 B. T. A. 679, held that the full value of the partnership interest, $129,247.19, was to be included in the decedent's taxable estate, and that the insurance proceeds, $100,000, applied on the purchase price were to be excluded. Then, in the subsequent case of *M. W. Dobrzensky, Executor,* 34 B. T. A. 305, the Board reversed its reasoning by holding that the insurance proceeds were taxable, and that the value of the deceased partner's interest represented by the insurance was to be excluded. The current trend is to look at the tax status of the insurance first, taxing it if the policies are so arranged as to come within the taxable provisions of the statute, and exempting from the taxable estate an equivalent amount representing the partnership interest.

Regardless of which reasoning is applied, however, the tax result since the removal of the $40,000 insurance exemption appears to be the same; viz., that the amount that will be taxed is the larger of the two items. Therefore, the life insurance proceeds received by the personal representative of the deceased partner will not increase his taxable estate unless the amount of such proceeds received is greater than the value of the deceased partner's interest.

The insured purchase plan establishes Federal estate tax value. The insured purchase and sale plan performs an important function in connection with Federal estate taxation. The value agreed upon as the purchase price of the deceased partner's interest is held to govern for estate tax purposes, even

though the actual value is higher at time of death, if (1) it fairly represents the value of the interest at the time the purchase price is stipulated in an arm's length transaction, and (2) the partner has been prohibited from disposing of his interest from the time of the execution of the purchase and sale contract until his death without first offering it to the other partners at the contract price. *Estate of Lionel Weil,* 22 T.C. 1267 (1954); *Brodrick v. Gore,* 224 F.2d 892.

This fact may be of great benefit to the deceased's estate. Without a subsisting agreement, a difficult appraisal must be made at the time of the death, not only of the value of the tangible assets of the partnership, but also of the value of good will. At best, the values to be established in such an appraisal are to a considerable degree matters of opinion about which honest men may disagree. Therefore, it is not unusual for the Government and the deceased's estate to be far apart in their respective opinions as to the value of a deceased partner's interest, a divergency that often leads to dispute, prolonged negotiations, and sometimes to litigation, in order to determine the value. The result to the estate is a delayed and costly settlement of the deceased partner's affairs, all of which is avoided by a properly set up insured purchase agreement.

The fact that the purchase price in a properly set up purchase agreement controls for Federal estate tax purposes appears sound in principle because the partnership interest cannot be worth any more to the estate than the estate is bound to accept in an obligatory sale. The proviso that the purchase price must be adequate when it is established is, of course, necessary to prevent undervaluations made to avoid estate taxes.

Book III

CORPORATIONS

Part I

FUNDAMENTAL FACTS ABOUT CORPORATIONS

CHAPTER 1

General Information About Corporations

KNOWLEDGE OF THE FUNDAMENTAL NATURE OF A corporation is necessary to understand and appreciate both the problems brought about by the death of a close corporation stockholder and the most satisfactory arrangements for the continuation of the corporate business, in the best interests of the deceased's family as well as the surviving stockholders.

WHAT A CORPORATION IS

Corporation defined. One of the early definitions of a corporation was recorded in the year 1613 when Lord Coke, in the case of *Sutton's Hospital,* 10 Coke's Rep. 1, 32, said: "A corporation aggregate of many is invisible, immortal, and rests only in intendment and consideration of the law." In the year 1819, Chief Justice Marshall of the United States Supreme Court, in the case of *Dartmouth College v. Woodward,* 4 Wheat. (U. S.) 518, nearly repeated the words of Lord Coke by stating: "A corporation is an artificial being, invisible, intangible, and existing only in contemplation of law." These and similar definitions,

however, have been severely criticized as overemphasizing the nature of a corporation as an artificial legal entity and failing to give proper emphasis to the association of natural persons that comprise its membership. A modern and realistic definition is given by Professor Wormser as follows: "In the last analysis, it would seem correct to state that a corporation is a group of one or more human beings acting as a unit and vested with personality by the policy of the law." [1]

HOW CORPORATIONS ARE FORMED

A corporation may be created only by virtue of sovereign authority. So far as we are concerned here, such authority rests with each state and with the Federal government. Ordinary business corporations, the type in which we are interested, are chartered by the Federal government if they are set up in the District of Columbia and the various state governments incorporate the remainder.

Originally, each corporation charter was granted by a special legislative act. But the tremendous development of the corporate form of conducting business proved this method too cumbersome, and general incorporation laws, under which corportations can be organized with greater speed and better supervision, were enacted.

Under the most modern of these laws, the procedure to be followed in creating a corporation is concise and well-defined. The organizers prepare a certificate of incorporation that includes such facts as the name of the corporation, the location of its principal office, its purpose in detail, data regarding its capital stock, its duration, the number of its directors, the names and addresses of the incorporators and the number of shares of stock each has agreed to take, and any other information required by the particular state statute. (Usually, the law lays down specifications as to minimum number of incorporators and directors, and as to a minimum number of them who must be citizens of the United States and residents of the state of incorporation.)

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[1] I. Maurice Wormser, *Frankenstein, Incorporated.* New York: McGraw-Hill Book Company, Inc., 1931, p. 62.

The completed certificate is then sent to the proper state official, often the Secretary of State, together with the necessary incorporation tax and fees. If it is found to be in proper form and otherwise in compliance with the law, copies will be filed in the required locations, and the new corporation is born. It will become fully organized when the organization meetings of the incorporators and of the directors have been held, at which time by-laws will be adopted for the government of the corporation, its officers will be elected, and any other business will be transacted that the incorporators then wish to complete. At this point, the corporation is ready for business.

Thus a corporation comes into being by the incorporators complying with the stipulated requirements of the state. The state, by enacting the corporation law, has made a general offer to prospective incorporators to form a corporation. The incorporators, by their compliance with the terms of the offer set out in the statute, have accepted the offer. The resulting relationship, therefore, between the incorporators and the state is contractual in nature.

TYPES OF CORPORATIONS

Corporations may be classified in many different ways, but an exhaustive classification will not be attempted here. For our purposes, we may start by making a division between public and private corporations. The public corporation is a governmental body, as, for example, a state or political subdivision of a state. Private corporations may be subdivided into stock corporations and non-stock corporations.

Non-stock corporations are usually subdivided into various types of membership, and religious and eleemosynary corporations.

A stock corporation is one that has a capital stock divided into shares and that is empowered by law to distribute dividends or shares of surplus profits to its stockholders. Such corporations may be further classified as moneyed corporations (such as banks and insurance companies), public service corporations, and business corporations.

A business corporation may be defined as one organized to carry on manufacturing, trading, or other ordinary commercial pursuits. These corporations, for our purposes, may be subdivided into open corporations and close corporations. The former is typified by those corporations owned by a substantial number of stockholders, most of whom take no part in the active management of the enterprise.

Close corporations. A close corporation may be defined as a corporation whose franchise is owned by a small group of stockholders, all of whom usually are actively engaged in its management. Frequently, all of this group comprises the board of directors and officers, as well as the only shareholders. It is a business organization that, in its unity of ownership and management in the hands of a small, closely knit coterie of persons, strongly resembles a partnership. Because of this resemblance, the close corporation owners are exposed to business continuation problems somewhat similar to those of partners and stand in need of an equally satisfactory solution. Consequently, this text will be concerned primarily with the close corporation.

CHAPTER 2

Property Rights in a Corporation

THE CORPORATION, OF ALL TYPES OF BUSINESS organization, presents the most interesting and unique pattern of property rights and liabilities, both in respect of the corporation itself and of the stockholders. Some of the details of this pattern will be discussed.

THE ASSETS OF THE CORPORATION

The corner grocery is a close corporation, King & Gay, Inc., with Mr. King and Mr. Gay the only stockholders. Now, who owns the can of beans on the shelf? The title is vested in the corporation as a separate legal entity and the can of beans can be sold to a customer only by the corporation, acting through its authorized representatives. Neither Mr. King nor Mr. Gay has any legal ownership in the beans. If someones takes unlawful possession of them, the beans can be recovered only in the name of the corporation. In other words, the assets of a corporation are owned by the corporation and not by the stockholders, and this is true even though there is only a single stockholder. If Mr. King, for example, wants to own the beans, he may purchase them from the corporation; or he may receive title to them if a dividend, payable in property, is declared by the corporation out of surplus profits; or he may receive title to the beans as part of his share upon a dissolution of the corporation, liquidation of its affairs, and distribution of the remaining assets to the stockholders.

THE INTEREST OF EACH STOCKHOLDER

What property, then, do Mr. King and Mr. Gay own in connection with the corporation? Do they own the capital stock that they contributed to it when they dissolved their partnership and formed the corporation? No, the capital stock of a corporation is the money or property put into the corporate fund by the subscribers, which fund becomes the property of the corporation. What they do own are certain valuable but intangible rights.

First, they collectively own the franchise of the corporation *to be* a corporation. This primary franchise of its being a corporation is a special privilege conferred by the state and vests in the group of individuals who compose the corporation. Second, they own the bundle of rights accruing to one who holds a share in a stock corporation. As expressed in the case of *Burrall v. The Bushwick R. R. Co.*, 75 N. Y. 211, "A share of the capital stock, is the right to partake, according to the amount put into the fund [the capital stock], the surplus profits of the corporation; and ultimately on the dissolution of it, of so much of the fund thus created, as remains unimpaired, and is not liable for debts of the corporation."

In addition to the two basic rights that, according to the quoted definition, go to make up a share of stock, namely, the right to receive an aliquot share of surplus profits in the form of dividends when they are declared and the right to receive a like share of the residuum upon the dissolution of the corporation, a stockholder has other important rights, some of which are exercisable by him alone, and others exercisable when he acts with the other stockholders as a body.

Among these additional rights are: The right to receive a certificate as evidence of his share of the stock; the right to transfer his stock interest and to have the transfer made on the corporate books; the right to inspect the books and records of the corporation; the right to attend stockholders' meetings and to vote for directors; the right to adopt by-laws; the right to require that the property of the corporation be employed for proper corporate purposes; the right to subscribe for any new shares of stock; and usually, the right to vote on such fundamental matters as change of corporate name, increase or de-

crease in (or other alteration of) the capital structure of the corporation, or any material change in the scope of the corporate business. Some of these rights have an important bearing on our subject and will be discussed further.

The right to dividends. A stockholder's "right to partake, according to the amount put into the fund, of the surplus profits of the corporation" is his right to share in dividends as and when they are declared by the board of directors of the corporation. Dividends are corporate funds derived from the earnings and profits of the corporation and appropriated by a corporate act to the use of, and to be divided among, the stockholders.

It should be reiterated that dividends of a corporation are declared, not by the stockholders, but by the board of directors of the corporation. Even though a majority of the stockholders want such action, the directors may honestly refuse to vote for dividends. Probably in most jurisdictions, a dividend could be declared by the unanimous vote of all the stockholders but such action, for obvious reasons, is a rare exception. Normally, the only recourse of the stockholders is to vote for a change of directors at the next election of the board.

But if the stockholders can prove to a court of equity that the directors, in refusing to declare dividends, are acting not in good faith in the interest of the corporation, but rather to serve their own personal ends, the court will grant relief. Nevertheless, successful prosecution of such a suit is exceedingly difficult, for the stockholders "must establish as matter of law that the action of the directors on this record was inimical to the welfare of the corporation and all its stockholders." *City Bank Farmers Trust Co. v. Hewitt Realty Co.,* 257 N. Y. 62, 177 N. E. 309 (1931).

The cited case was an action brought to compel the payment of dividends. It was proved that earnings and assets were ample to do this. It was also proved that the president and director of the corporation had shown personal animosity toward the widow and child who owned the beneficial interest in the block of stock held in trust by the plaintiff bank. But the court, in refusing to interfere with the policy of the directors in not declaring dividends, had this to say in part: "That such personal

animosity is visible may not be denied, but it does not follow that the impelling motive of the action of the board was such ill feeling. On the contrary, the old policy has been continued, not as a freeze-out policy, but to pay debts and provide against emergencies. . ."

One of the few successful cases of this nature, and well worth reading, is that of *Dodge v. Ford Motor Co.,* 204 Mich. 459, 170 N. W. 668, 3 A. L. R. 413 (1919).

On July 31, 1916, the Ford Company, a gigantic close corporation, had capital stock of $2,000,000 and surplus of about $112,000,000. Notwithstanding the fact that it was selling cars for $440 (reduced to $360 on August 1st, 1916) its profits during the last fiscal year had been over $60,000,000 and it had on hand approximately $54,000,000 of bonds and cash. The company was paying a regular quarterly dividend equal to 5 per cent monthly on the capital stock and since 1910 had paid the stockholders $41,000,000 in special dividends. No special dividends had been voted after October, 1915, however, and the Dodge brothers, owners of one-tenth of the stock, brought this action to compel an additional dividend payment. Although the corporation declared a special dividend of $2,000,000 in November, 1916, before filing an answer in the action, the court decreed the payment of an additional dividend of over $19,000,000. While justifying the decree on the facts, the court nevertheless quoted the applicable rule as phrased by various authorities, including Cook on *Corporations* (7th ed.) section 545, which reads in part:

> It requires a very strong case to induce a court of equity to order the directors to declare a dividend, inasmuch as equity has no jurisdiction, unless fraud or a breach of trust is involved.

If there exists only one class of stock, namely, common stock, each share is entitled to its pro rata amount of the total dividends declared. In many instances, however, one or more classes of preferred stock are also issued. Preferred stock is a class of stock entitling the owner to whatever preferences are agreed to in the stock certificate and in the charter. The rights of the holder are contractual and are confined to these provisions. Usually there is a preference as to dividends and often there is

included, also, a preference in the distribution of the remaining assets of the corporation in the event of its dissolution. These shares may be given a priority in the appropriation of dividends up to an agreed percentage, such as 6 per cent, which may be made the maximum dividend rate on such stock. Or, it may be provided that dividends beyond the stated preferential figure shall be shared equally with the common stock, in which case the preferred stock is usually called "participating." The priority granted the preferred stock may be cumulative or non-cumulative. If it is non-cumulative, the preferred shareholders are entitled to receive the specified dividends in any one year before any dividends may be declared on common stock during that particular year, but each year is taken by itself. If the stock is cumulative, the shareholders are entitled to receive the specified dividends accumulated from the time the preferred stock was issued before any dividends may be declared on the common stock.

The general rule is that ordinary dividends on any class of stock, common or preferred, may not be paid except out of surplus, and every shareholder must be treated in the same manner as every other shareholder of the same class.

The right to inspect the corporate books and records. At common law, and by statute in most states, a stockholder has a right to inspect the books and records of the corporation at reasonable times and places and for proper purposes. In fact, most state statutes grant this right, regardless of the motive or purpose behind the inspection. Generally, this right may be exercised in person or by the stockholder's authorized agent or attorney, and copies and memoranda may be made for reference. In most instances, this right will be enforced in a court proceeding if such inspection has been wrongfully denied by the corporation. It is a valuable privilege, especially in the case of a minority stockholder.

The right to attend stockholders' meetings and vote. Incident to the ownership of a common share in a private corporation is the right of the shareholder to attend meetings of the stockholders and to vote upon the corporate matters acted upon at such times as, for example, the election of members of the

board of directors. In large corporations the right to vote by proxy — conferred by statute, charter or by-law — is frequently exercised. In close corporations, all the stockholders are usually present to vote in person. In a stockholders' meeting, a shareholder represents himself and his own interests and has a right to vote as he desires. Ordinarily, his motives are irrelevant, although there is an implication that the corporate affairs will be conducted in the interest of all of the stockholders.

As a general rule, the majority of outstanding stock must be represented at a meeting to constitute a quorum for transacting business, and a majority vote of the stock represented at such a meeting will carry the matters voted on, except as to certain extraordinary matters that, by statute or by-law, may require the affirmative vote of the holders of perhaps as much as two-thirds of the outstanding stock.

One vote is generally allowed by statute for each share of voting stock. In corporations having more than one class of stock outstanding, such as common and preferred, it is often provided that the preferred shall be non-voting stock, or shall not have voting power unless dividends on the preferred have been in arrears for a stipulated period.

In many states, statutes authorize cumulative voting by stockholders when two or more vacancies are to be filled on the board of directors. Under such statutes, a stockholder may cast as many votes as there are offices to be filled, multiplied by the number of his shares of stock, all of which votes may be cast for one candidate or distributed among the candidates as the stockholder sees fit. A stockholder with fifty shares, for example, could cast fifty votes each for three candidates to fill three vacancies on the board; he could "cumulate" all the votes he is entitled to cast for all three vacancies and divide them among the candidates in whatever proportion he desires; or he could cast the total one hundred and fifty votes in favor of one particular candidate. By means of this cumulative voting device, minority stockholders are often able to obtain representation on the board when they otherwise could be outvoted on every office to be filled. It should be kept in mind, however, that the decisions of the board of directors in conducting the affairs of the

corporation are usually made by majority vote and therefore that mere representation on the board still will leave the minority stockholders with little "say" in the actual management of the corporation.

The right to transfer stock. As an incident of his ownership of stock, a shareholder has a general property right to transfer his shares at will. This inherent right of alienation, however, may be reasonably restricted by the corporate charter or by contract betwen the stockholders, although "an absolute prohibition unlimited in point of time against transfer of stock would be invalid as against public policy." *Bloomingdale v. Bloomingdale,* 177 N. Y. S. 873 (1919). Accordingly, it is generally held that a restriction against the sale of shares of stock, unless other stockholders or the corporation have first been given the opportunity to buy, is valid. *Weissman v. Lincoln Corporation,* —, Fla. —, 76 So. 2d 478 (1954). The law on the subject is well summed up by Judge Untermeyer in *Penthouse Properties, Inc. v. 1158 Fifth Ave., Inc.,* 11 N. Y. S. 2d 417, 422 (1939), as follows:

> The general rule that the ownership of property cannot exist in one person and the right of alienation in another (*De Peyster v. Michael,* 6 N. Y. 467, 493, 57 Am. Dec. 470) has in this State been frequently applied to shares of corporate stock (*Kinnan v. Sullivan County Club,* 26 App. Div. 213; *Brown v. Britton,* 41 App. Div. 57; *Rosenback v. Salt Springs National Bank,* 53 Barb. (N. Y.) 495; *Conklin v. Second Nat. Bank of Oswego,* 45 N. Y. 655; *Bank of Attica v. Mfrs. & Traders Bank,* 20 N. Y. 501), and cognizance has been taken of the principle that "the right of transfer is a right of property, and if another has the arbitrary power to forbid a transfer of property by the owner, that amounts to annihilation of property" (*Fisher v. Bush,* 35 Hun (N. Y.) 641). The same rule has been applied in other States. *People ex rel. Malcolm v. Lake Sand Corp.,* 251 Ill. App. 499; *In re Klaus,* 67 Wis. 401, 29 N. W. 582; *Bank of Atchison County v. Durfee,* 118 Mo. 431, 24 S. W. 133; *State ex rel. Howland v. Olympia Veneer Co.,* 138 Wash. 144, 244 P. 261; *Bloede Co. v. Bloede,* 84 Md. 129, 34 A. 1127, 33 L. R. A. 107. But restrictions against the sale of shares of stock, unless other stockholders or the corporation have first been accorded

> an opportunity to buy, are not repugnant to that principle. *Kritzer v. Chloral Chemical Co., Inc.,* 238 App. Div. 611; *Hassel v. Pohle,* 214 App. Div. 654; *Cowles v. Cowles Realty Co.,* 194 N. Y. S. 546; *Moses v. Soule,* 118 N. Y. S. 410, aff'd 120 N. Y. S. 1136. The weight of authority elsewhere is to the same effect. See annotations on *Validity of Restrictions,* 65 A. L. R., pp. 1168–1171. . . .

It may be said in general, however, that the courts look more leniently upon restrictions against the transfer of close corporation stock than upon restrictions involving the shares of large corporations. Furthermore, restrictions imposed as a provision of a private contract between particular stockholders may be considered valid, although similar restrictions appearing in the corporate by-laws might be held invalid.

It is readily apparent from the foregoing that the scheme of property rights in a corporation is entirely different from that subsisting in a partnership. Because of this, it may be expected that the death of a stockholder has a quite different effect than the death of a partner. A later chapter will show this to be the case.

CHAPTER 3

The Powers of a Corporation

IN GENERAL

A corporation has only such powers as are expressly granted to it by the state and as are found in the formal corporate charter and applicable statutes, together with such implied powers as are incidental to, or consequent upon, or reasonably necessary to the carrying out of those powers specifically conferred upon it.

It has power to conduct the type or types of business authorized by its charter and no other. Therefore, it is customary to make the expressed powers in the charter as broad as possible in order to avoid any question of *ultra vires* acts, acts that are beyond the powers of the corporation. With the exception of certain learned professions such as the practice of law, which is prohibited everywhere by corporations, and the practice of medicine or dentistry, which is prohibited nearly everywhere by corporations, a corporation may ordinarily be formed for any lawful purpose. Special statutes and requirements, however, govern the organization and conduct of corporations to carry on banking, insurance, transportation, and other businesses closely related to the public interest.

Among the incidental powers of a corporation is the power of continued existence during the period designated in its charter, subject to any reserved right of the state to dissolve it sooner. It has the right to use its corporate name and it has the power to change such name, subject to applicable laws relating to this. It has the right to have and use a corporate seal, although in most states its use is not required except for such formal documents as deeds, bonds, mortages and the like in cases in which

the seal of an individual would be required under similar circumstances. It has the power to enter into all contracts necessary to carry on its business. It has the power to employ officers and other employees and agents to conduct its affairs. It has the power to acquire, hold, and otherwise deal with property for purposes consistent with the powers granted to it. It has the power to borrow money and to contract indebtedness, to furnish security for any debt and to loan money if necessary. It has power to sue and be sued in its corporate name. It has power to make by-laws for the government of its affairs, consistent with its formal charter and the applicable statutes. It has power to enter into joint ventures, but not to become a partner unless specifically authorized by charter. Generally, unless authorized by statute or charter, it has no power to purchase the stock of another corporation, but this rule is modified in cases in which it is necessary to acquire such stock to protect some right in which event the stock of another corporation may be acquired. A typical example of this is the acquisition of such stock in liquidation of a debt that might be worthless otherwise.

POWER OF A CORPORATION TO ACQUIRE ITS OWN STOCK

In England the courts have held that a corporation, unless expressly authorized, has no right to purchase its own shares of stock. At common law in America, a small coterie of states have followed the English doctrine that such a purchase was *ultra vires,* but the majority of our courts have held that a corporation has an implied power to acquire its own shares, provided it does so in good faith and without injury to its creditors or stockholders. To prevent such injury, it is held almost universally that such purchase must be made out of surplus. Massachusetts, however, appears to require only that the purchase be made in good faith and that it does not result in loss to its creditors or stockholders. In *Barrett v. W. A. Webster Lumber Co.*, 275 Mass. 302, 175 N. E. 765 (1931), it is said: "The contention of the plaintiff that a corporation cannot purchase its own stock except out of surplus profits cannot be sustained."

In recent years, many states have legislated on this matter, and nearly all of the states that formerly followed the English rule have enacted statutes permitting such purchases under proper circumstances. Because of the frequency with which changes occur by reason of new statutes and court decisions, no attempt will be made here to present the current status of such a transaction in each state. The most suitable media for such an exhibit are the loose-leaf business insurance services, to which the reader is referred for up-to-the-minute information with respect to any state in which he is particularly interested. Furthermore, a local attorney should be consulted if the matter is not entirely clear.

Distinction should be made between the power of a corporation to make a present purchase of its own shares and its ability to enter into a valid contract in which the corporation agrees to make such a purchase at some future time. If, for example, the particular state law allows a purchase only out of corporate surplus, such a contract obviously cannot be consummated by the corporation when the time for performance comes if at that time the corporate surplus is insufficient to pay for the stock. This fact introduces a contingency, a possible circumstance under which the corporation will be unable to perform, which in turn raises the vital question as to whether such a contract is binding at all. It would seem that the promise of the corporation to make the purchase can be construed as a promise to do so unless at the time for performance it had no surplus with which to make the purchase, and as so construed, the corporation's promise can be deemed to be more than illusory and therefore to constitute sufficient consideration for the agreement. But one New York case has held to the contrary. *Topkin, Loring & Schwartz v. Schwartz,* 249 N. Y. 206 (1928).

In that case, a close corporation sold 114 shares of stock to an employee and entered into an agreement with him in which the corporation was to repurchase the stock at its book value upon termination of the employment of the employee. Bearing on the case was Section 664 of the New York Penal Law which provides that it is a misdemeanor for a director of a corporation to vote "to apply any portion of the funds of such corporation,

except surplus profits, directly or indirectly, to the purchase of shares of its own stock." Upon termination of employment, the employee refused to sell the stock on the ground that the agreement was not binding. The corporation brought suit for specific performance, but New York's highest court sustained the employee's position. The reasoning of the court appears to have been that because it would have been impossible for the corporation to perform the contract if no surplus existed when the employee left, the contract was one not mutually binding on the parties and therefore lacking in consideration. It is very important to note, however, that the court also pointed out that, if the corporation had given as consideration something other than its bare promise to buy the stock, e.g., had given employment to the employee *in consideration* for his agreement to sell the stock at the end of his employment, then the contract would have been enforceable unless, as a matter of defense by the corporation, no surplus existed with which to make the purchase. This latter point has an important bearing on our main subject, which will be developed later.

CHAPTER 4

The Management of a Corporation

THE STOCKHOLDERS

As we have seen, the nature and extent of the powers of a corporation are those specifically granted to it and contained in its charter and in the applicable statutes, together with those incidentally implied therefrom. To set these powers in motion, the stockholders will elect a board of directors and will adopt by-laws (or will delegate this task to the board) that define the duties and regulate the conduct of the members and officers.

The stockholders, as such, have no authority to participate in the conduct of the ordinary business of the corporation, since these activities are managed by the board. In addition to the election of directors, however, there is usually reserved to the stockholders, by law, decisions on various important matters pertaining to the existence, powers, and capital structure of the corporation. Among these matters are the approval of the disposal of the aggregate corporate assets; approval of a mortgage on the corporate property; amendment of the corporate charter; increase, reduction or other change in the capital stock; and approval of the dissolution of the corporation or its merger or consolidation with another corporation.

In some of these matters, the stockholders decide by majority vote; in others, for example, the mortgaging of the corporation realty, a two-thirds or greater vote is usually required by statute. In addition, the laws of a few states now require the vote of the stockholders before a corporation may purchase its own stock and they specify the affirmative percentage necessary to secure approval.

THE BOARD OF DIRECTORS

Following their election, the board of directors chosen by the stockholders meet and take up the management of the ordinary affairs of the corporation, since such management is placed in their hands by the laws of most states. It should be noted, however, that a board member as such has no individual authority to act for the corporation; he acts only as a *board* with his fellow members when they are assembled at a duly held meeting of the directors. Corporate officers are elected and their salaries fixed by the directors. These officers proceed through their own efforts and the efforts of hired agents and employees, to carry into execution the daily routine of the business of the corporation.

The board of directors, however, can delegate to officers and agents only ministerial power to administer the affairs of the corporation. As manager of the corporation and the primary possessor of all the powers conferred by the corporate charter, the board cannot delegate the exercise of the discretionary powers vested in it, such as, for example, the election of officers or the declaration of corporate dividends.

In their possession and use of the property of the corporation and in their management of its business, the directors, although not strictly trustees, occupy a fiduciary relation to the corporation and its stockholders, and are obligated to exercise the same degree of care and prudence in conducting its affairs as would be exercised by the ordinary prudent man in conducting his own affairs, to the end that the corporate assets will not be wrongfully wasted, dissipated or misapplied. Accordingly, a director may not exercise his official position for his own benefit; he must act only for the benefit of the corporation. Furthermore, by the weight of authority, any contract between a director and his corporation is voidable by the corporation.

Ordinary routine contracts of a corporation are usually entered into on its behalf by its officers. The board of directors, however, may make any ordinary contract that the corporation is empowered to make. But as previously stated, an individual director has no such power to act for the corporation; he functions

solely through the collective action of the board in its duly constituted meetings.

In sizable corporations, it is common practice for the board of directors to set up subcommittees from among their members and to delegate to these committees various advisory and ministerial duties. The board may, for example, form an executive committee or a finance committee reporting to, and responsible to, the board of directors.

OFFICERS AND AGENTS OF THE CORPORATION

Since the board of directors acts only in an official meeting and since such meetings cannot be held continuously, it delegates the performance of ministerial duties on behalf of the corporation to officers and agents. The officers are elected by the board of directors, which board also regulates their salaries. The official positions to be filled and the duties of each office are customarily specified in the by-laws and usually consist, as a minimum, of a president, one or more vice-presidents, a secretary and a treasurer.

Upon these officers falls the task of carrying on the business of the corporation, including the hiring and supervision of the agents and ordinary employees of the organization.

CHAPTER 5

The Liabilities in a Corporation

A THOROUGH STUDY OF ALL THE PHASES OF LIABILITY involved in the corporate form of conducting business is beyond the scope of this text. Some understanding of the subject is necessary, however, and an attempt will be made to review the general rules of liability that concern the corporation itself, its officers and agents, its directors and its stockholders.

LIABILITY OF THE CORPORATION

A corporation is held liable for all acts of its officers, agents and ordinary employees performed within the general powers of the corporation and with the express or implied authority of the corporation. Furthermore, if the representative, although unauthorized, acts within the powers of the corporation, which subsequently ratifies the act or accepts its benefits, the corporation will be held liable.

If an authorized corporation representative enters into a contract which is beyond the powers of the corporation, an *ultra vires* contract, such a contract cannot be enforced against the corporation, unless the other party has already performed and the corporation has received the full benefit of such performance. If such a contract has been fully performed by both parties, the court will usually leave the parties as it finds them. The Federal courts, however, and probably some state courts, declare all *ultra vires* contracts void, whether executory, partially executed, or fully executed. Contracts that not only go beyond the express powers of a corporation but are also in themselves illegal, or that go against public policy, are held void in all jurisdictions. But

this latter doctrine is not peculiar to corporations; all such contracts are held void, regardless of the identity of the parties involved.

The liability of the corporation for the acts of its representatives when acting within the general scope of their authority goes beyond the field of contracts into the field of torts and sometimes into the field of crimes. Moreover, in these fields the fact that the wrong was committed in the course of a transaction that was *ultra vires,* does not relieve the corporation of liability.

LIABILITY OF THE OFFICERS, AGENTS AND EMPLOYEES

In a contractual matter, a representative acting for a corporation assumes no personal liability if his act, whether within the powers of a corporation or merely *ultra vires,* either is within his authority or is later ratified by the corporation. Without proper express or implied authority or ratification, however, the representative would ordinarily be liable to the corporation for any damages caused it and liable to the party dealt with for breach of implied warranty of authority, but since he did not purport to act for anyone but the corporation, he would not be liable under the contract terms, except in the case of a negotiable instrument.

If a representative of the corporation commits a tort, as, for example, a trespass or a negligent or willful injury to another, while acting within the general scope of his authority, such representative, as well as the corporation, will be liable for the damage or injury caused. The same result would probably follow in the case of a crime, although this would depend upon the scope of the particular criminal statute involved.

LIABILITY OF THE DIRECTORS

Directors are obligated to exercise the same degree of care in their management of the corporation that they would use in the prudent handling of their own affairs. They must be honest, diligent, and loyal in performing for the corporation the duties they have undertaken. This rule is applied against each direc-

tor individually as to his own acts or neglect, unless two or more directors have joined in a wrongful act. In applying the rule, however, directors are not held liable for mere mistakes or errors in judgment, but they may be held liable for damage or injury to the corporation resulting from their neglect to act, their failure to act with reasonable prudence or their negligent or willful acts inimicable to the welfare of the corporation.

In some states, specific laws impose statutory liability upon directors and officers for breach or neglect of certain duties, as, for example, the failure to make a required report or the making of a false report on behalf of the corporation.

In general, directors assume no contractual liability, because all contracts made by them are the corporation's contracts. In some jurisdictions, however, directors are held personally liable on *ultra vires* contracts made by the corporation.

Any tort or criminal liability of a director is determined by application of the general rules previously outlined.

LIABILITY OF THE STOCKHOLDERS

For the reason that stockholders as such are not concerned with the active management of the corporation, the imposition of any tort liability against them in such capacity would be rare indeed. The same may also be said of contractual liability, since any special contracts that the stockholders might enter into would be executed for and in the name of the corporation as the contracting party.

This brings us to a general rule, and one of the distinguishing characteristics of a corporation, namely, that the stockholders are not liable for the debts of their corporation. In the absence of special statutes or special individual agreements, therefore, the stockholders, in the event of the corporation's becoming insolvent, stand to lose only their capital invested in it plus any unpaid balances that they might owe the corporation on their stock.

By the laws of some states, however, stockholders of certain types of corporations have what is known as statutory liability. These statutes usually provide that such stockholders shall be personally liable for a sum equal to the par value of their shares

in the event that the assets of the corporation prove insufficient to meet its liabilities. Such statutory liability is sometimes imposed against stockholders of banks and trust companies. A few states impose statutory liability against shareholders in manufacturing corporations. But the trend is toward abolishing such statutes.

Of course, a stockholder is liable to creditors of the corporation for the amount distributed to him in dividends or capital stock in a case in which such a distribution was made while the corporation was insolvent, for this is a clear case of a transfer in fraud of creditors.

CHAPTER 6

Characteristics of a Corporation Summarized

IN GENERAL

We are now in a position to summarize the unique characteristics of the corporation as a form of organization for the conduct of a business enterprise.

The primary characteristic of a corporation is its own recognized legal entity, separate from the group of individuals who compose its stockholders. From this it follows that the death of a stockholder or the disposal of his stock does not affect the identity of the corporation. As stated by Blackstone, it is "a person that never dies; in like manner as the River Thames is still the same river, though the parts which compose it are changing every instant" (1 Bl. Com. 468). It remains the same corporation, irrespective of changes in the ownership of its stock. Its span of life is limited only by its charter and applicable laws, and may be perpetual. By way of contrast, a partnership, in the absence of an agreement to the contrary, is dissolved upon the death of a partner or upon the disposal of his partnership interest.

Another characteristic is that a corporation is the creature of the state. A franchise from a state or the Federal government is necessary to create it. In contrast, a partnership is formed by the written or oral agreement of the parties themselves.

A third characteristic of a corporation is the limitation of its powers to those expressly granted to it by its charter and those incidental to it or consequent upon such enumerated powers.

A partnership, on the other hand, may delve into any lawful business at the whim of the partners, subject, of course, to laws applicable to certain businesses and professions that may require proper licenses or appropriate evidence of the individual qualifications of the partners, as in the case of a firm of lawyers, doctors, or dentists.

A fourth characteristic of a corporation is the so-called limitation of liability of the stockholders. They are not liable for the debts of the corporation. In the absence of special statutory liability, a stockholder stands to lose only what he has put into the corporation by way of capital stock. This feature, together with the fact that an investor can buy as much or as little stock as he sees fit and need not participate in the management of the enterprise, has made possible the gigantic corporations of today, of which the American Telephone & Telegraph Company is an example. Without such corporations, the national government would remain the only instrumentality capable of carrying on the "big business" of the country, and socialism would be forced upon us. Again, in contrast, partners are fully liable for the debts of their partnership. This fact, together with the intimate business association required of them, sets a relatively low limit on the capital that a partnership can assemble, and this, in turn, restricts the scope of ordinary partnerships to comparatively small business operations.

A fifth characteristic of a corporation is that its management, although elected by the stockholder-owners, is not in their hands but in the hands of its directors. A stockholder cannot bind his corporation by individual action unless, of course, he is acting as its authorized agent, in which event he is acting not in his capacity as a shareholder but as a servant of the corporation. In the general partnership, each partner is ipso facto an agent of the partnership and binds all of the partners by his acts within the ordinary scope of the business carried on by the firm.

PECULIAR CHARACTERISTICS OF THE CLOSE CORPORATION

The general characteristics of corporations extend to close corporations as well as to the huge enterprises with hundreds of

thousands of stockholders. The fact remains, however, that the method of operation of the usual close corporation requires that some important distinctions be made.

We have defined a close corporation as one whose franchise is owned by a small group of stockholders, all of whom usually are actively engaged in its management. In other words, in the composition of its ownership and management, it closely resembles the usual partnership. From this resemblance flow some special characteristics important to our subject.

First, there is the same intimate association of a few men pooling their talents and industry in the conduct of a business enterprise that is found in the case of a partnership. Each of the close corporation stockholders is usually a director and an officer as well and, furthermore, is making the business of the corporation his life work. It is his full-time career as well as his investment. The natural result is that in the event of the death of one stockholder, the survivor or survivors is just as anxious for the enterprise to be continued as in the case of a partnership, and it is just as vital for him or them that this be done.

Second, a stockholder's limitation of liability often assumes minor importance in a close corporation for the reason that large creditors frequently require the joint and several personal obligations of the stockholders before dealing with them. The extent of any such outstanding obligations is of great consequence to all concerned in the event of the death of a close corporation stockholder.

Third, stockholders in a close corporation are accustomed to taking the profits of their enterprise mostly in the form of salaries rather than in the form of dividends. This is natural and proper, for in many cases the overwhelming share of such profits is attributable to the personal services performed by the stockholders as against the earnings on their invested capital. The full significance of this practice, however, is not realized until the death of a stockholder and the consequent discontinuance of his salary.

Fourth, because the stockholders in a close corporation conduct themselves and their business affairs largely as if they were partners, often referring to each other as such, the courts are

lenient in applying the rules of corporate law, especially with respect to stockholders' agreements relating to the management of such corporations and to restrictions on the transfer of shares to outsiders. In fact, such an outstanding jurist as Chief Judge Cullen has referred to close corporations as "little more than (though not the same as) chartered partnerships" (*Ripin v. U. S. Woven Label Co.*, 205 N. Y. 442 at page 447). And Justice Shearn, at page 639 of his dissenting opinion in *Cuppy v. Ward*, 187 App. Div. 625, described the two-man corporation there involved as "what has frequently been called in this court an 'incorporated partnership.' "

Fifth, and again because they look upon themselves as partners, the stockholders of a close corporation pay little attention to majority and minority stockholdings. Their business sessions resemble conferences of partners much more than the formal meetings of stockholders or directors. They are accustomed to a unanimous meeting of the minds on every important decision before going ahead. And once a decision is made, all pitch in to work for its success. The various legal rights of controlling and minority stockholders are foreign to them. Foreign to them, also, are stockholders who want a voice in the management of the corporation but not in its work. "Drone" stockholders have no suitable place in such a corporation. Yet the death of a close corporation stockholder will bring them in, unless careful plans are made in advance to keep them out.

Sixth, because the stock in a close corporation is owned by only a few individuals, all of whom are usually active in its management, the shares have no ready market. Consequently, the only persons ordinarily interested in purchasing a deceased associate's shares are the surviving stockholders. This characteristic, alone, makes such stock an unsuitable investment for the family of a deceased close corporation shareholder.

CHAPTER 7

The Effect of Death of a Close Corporation Stockholder

THE DEATH OF A STOCKHOLDER IN A CLOSE corporation usually has important and far-reaching consequences in spite of the fact that such event has no automatic legal effect on the life-span of the corporation. As the incidence of these consequences depends upon whether the deceased was a sole stockholder, a majority stockholder, a minority stockholder, or owned exactly one-half of the shares of stock in the enterprise, an analysis will be made of the effect of the death of a stockholder occupying each such status.

DEATH OF A SOLE STOCKHOLDER

We have seen that one of the prime characteristics of a corporation is its continued succession for the period specified by its formal charter or by statute, unless it is sooner dissolved by affirmative action, and that its legal existence is not disturbed by any changes in the ownership of its shares of stock. The death of a stockholder, even though he owned all of the shares of stock in a corporation, does not ipso facto affect the life of the corporation. Its stock merely passes on to new owners: first, to the executor or administrator of the deceased stockholder's estate, and later, unless the corporation is liquidated by the estate, to the heirs, or purchasers from the estate, as transferees of the executor or administrator.

Status of the stock in the hands of the executor or administrator. The rights and duties of the personal representative are significant to us with respect to the shares of stock. These

are succinctly set out in the case of *In re Steinberg's Estate,* 150 Misc. 339, 274 N. Y. S. 914 (1934), a case in which the testator had been the sole stockholder:

> The executor in the case at bar received certain property rights as a result of his qualification. For present purposes, these consist primarily of three things, namely: First, the right to receive dividends which may be declared on the shares of the company; second, the right to vote upon such shares; and third, the right to receive all of the net assets of the company on its dissolution after the payment of its obligations to third parties. His possession of these rights, however, is not beneficial but purely fiduciary, and he is answerable to his beneficiaries who are primarily the creditors and secondarily the distributees of the estate, for the manner of his conduct in the holding of, and transactions or omissions in respect to, every item of the property thus held in trust.

But what about the personal representative's right, if any, to continue the corporate business? He has only such rights of continuance as are given to him under the decedent's will. In other words, if a decedent owned all or substantially all of the shares of stock of a corporation, his personal representative is subject to the same business continuation rules that govern in the case of a proprietorship business and he must deal with the corporation in the same manner that he would be required to if it were an unincorporated business. This is clearly brought out in the case of *In re Stulman's Will,* 263 N. Y. S. 197, 146 Misc. 861 (1933), in which Surrogate Wingate stated:

> The question in the case at bar is really broader, however, than that of mere continuance of investment by the fiduciaries, and in essence concerns the continuance by them of the testator's business, since he was virtually its possessor by reason of almost complete stock ownership. [The testator had owned 925 shares and his son 75 shares.] Under such circumstances the rule of law has been inflexible for the last half century, at least, that, to permit a testamentary fiduciary so to continue, a power to that effect "must be found in the direct, explicit and unequivocal language of the will or else will not be deemed to have been conferred." *Willis v. Sharp,* 113 N. Y. 586, 21 N. E. 705, 706, 4 L. R. A. 493; *Columbus Watch Co. v. Ho-*

> *denpyl,* 135 N. Y. 430, 435; *Matter of Kohler,* 231 N. Y. 353, reversing 193 App. Div. 8; *Matter of McCollum,* 80 App. Div. 362; *Matter of Archer,* 77 Misc. 288; *Matter of Gorra,* 135 Misc. 93. The equitable powers of a Surrogate's Court permit it to penetrate to the inner verities of the situation. Thus, where the business in question is actually within the sole control of the testator, his testamentary fiduciaries will be held to a strict accountability in this regard, whether or not the formality of incorporation has taken place. In the absence of unequivocal authority for continuance contained in the will, "an executor or administrator has no authority virtute officii to continue it, except for the temporary purpose of converting the assets employed * * * into money." *Willis v. Sharp,* 113 N. Y. 586, 589. . . .

The conclusion seems evident from the above quotations that the problems and hazards brought about by the death of a sole stockholder are similar to those faced upon the death of a sole proprietor.

DEATH OF A MAJORITY STOCKHOLDER

At this point it is important to recall to mind the outstanding characteristic of a close corporation, namely, that there is the same intimate association of a few men, combining their full time, talent and industry in the conduct of a business enterprise as was found to exist in a partnership. Therefore, although the death of a majority stockholder in a close corporation does not automatically dissolve the business association *legally,* as would be the case in a partnership, it nevertheless shatters the well-balanced combination of diverse human talent that has been working together as a successful business "team."

The position of the surviving minority stockholders. In many instances, the surviving minority stockholders are left on the death of the majority stockholder occupying a worse position than would have been the case had the organization been a partnership. In either situation, there is the loss of the chief member of the "team." But if the enterprise had been a partnership, they, as surviving partners, could wind up the old concern and would then be free to seek out a new associate, if one could

be found, who could bring like talent and congeniality to the new firm. Because the enterprise is a corporation, however, the controlling interest of the deceased stockholder passes into the hands of a new majority stockholder, first to the executor or administrator and ultimately to a legatee or a purchaser from the estate. The choice of the new associate is entirely out of the hands of the survivors; and the chance is slim indeed that his personality and special abilities will harmonize agreeably and successfully with those of the survivors. In fact, it is probable that the stock will pass into the hands of an heir, such as the deceased's widow, who is incapable or unwilling to contribute to the work of the corporation and is interested only in substantial future dividends.

But whoever the heir is, whatever his temperament and qualifications, whether he is an active or a "drone" stockholder, as the new owner of the deceased's shares he will have the deciding voice in future meetings. Since the directors of the corporation are elected by vote of the stockholders, the new interests can dominate the board. The board of directors, in turn, not only appoints the officers and fixes their salaries, but dictates the dividend policy of the corporation as well.

Picture, in this new setting, the unenviable position of the surviving minority stockholders. Left to carry the burden of the work of the corporation, they nonetheless can be out-voted at all meetings, and their very jobs and salaries as officers are placed in jeopardy. Of course, they can resign, and perhaps start a new organization of their own, but first, they will probably need to sell their stock in order to raise capital, and there is little or no market for minority holdings in a close corporation. Then too, they have been identified with a corporation whose name and location is familiar to the trade, and they will be handicapped by a strange name at a strange location. Had there been a partnership, then as surviving minority partners they would at least have had the right to wind up the affairs of the old firm and to have thus eliminated it and its name as a competitor before they started a new enterprise. In such a case, they would obviously have had a better opportunity to acquire the customers that had been "orphaned" by the dissolution of the

partnership. The minority stockholders in a close corporation stand in dire need of a plan that will give them control of the organization in the event of the death of a majority stockholder.

The position of the estate and heirs of the majority stockholder. The first destination of the shares of stock of the deceased majority stockholder is with the executor or administrator, who, as we have seen, holds the stock during the administration of the estate primarily for the creditors of the estate and secondarily for the heirs or legatees.

If the deceased stockholder has left no will, it is the duty of the administrator of his estate to dispose of the personal property of the estate for cash, to pay the creditors of the decedent and the taxes and administration costs, and to turn over the residue to those heirs or distributees entitled to it under the intestate laws of the state. (If the personal property is insufficient to pay the debts and charges, the real property may be resorted to.) If other property is sufficient to pay the debts, taxes and expenses of administration, and if the consent of all the heirs, provided they are all adult, is obtained, the administrator can conserve the deceased's close corporation stock and ultimately deliver it to those agreed upon to receive it under any agreement of consent. Without such a fortuitous post-mortem arrangement, the administrator has no right to hold the stock beyond the time necessary for the prudent liquidation of it.

Because the estate has a controlling interest to dispose of, it would seem at first glance that this should bring the estate a fair price, but the result is usually disappointing. In the first place, the stock is sold under a forced sale, for the administrator must carry through the administration of the estate with reasonable promptness, a fact well known to all prospective buyers. In the second place, the administration of the estate may take place during a general business depression or during a depression in the particular trade or industry involved. Hence, such a sale ordinarily results in a bargain for the buyer and a substantial loss to the stockholder's estate and heirs.

If the deceased stockholder has left a valid will, which is the least he should do in view of the above, the situation with respect to his close corporation stock is unchanged unless he has

dealt specifically in the will with such shares of stock. If they have been specifically bequeathed or placed in trust, the stock will not be liquidated to pay creditors' and other claims except as a last resort. But if such shares represent almost all of the deceased's assets, some portion will have to be sold in order to raise money for the discharge of the debts of the decedent and the post-mortem obligations, including estate and inheritance taxes, of the estate. Should such a sale become necessary, it may involve disposing of sufficient shares to alter the balance of control, in which event the shares sold will no doubt command an attractive price from the surviving stockholders if they are able to finance the purchase, but the remaining shares in the estate will be of little value.

If, on the other hand, it is possible to pass on the majority shares intact to the legatees, the recipients will then inherit control of the corporation. But unless the recipients are capable of taking an active and successful part in the management of the business of the corporation, trouble, disappointments, and losses lie ahead. Control of any vehicle without the requisite ability and experience to operate it safely, be it a highly powered car or an erstwhile smoothly running business organization, usually means that the vehicle and all aboard are headed toward disaster. If the surviving experienced minority stockholders decide not to risk remaining with the corporation, calamity is sure to follow.

Perhaps the legatees will be content to remain inactive and to allow the surviving minority stockholders to run the business. Such a course is much less hazardous at the start, but it cannot subsist for long because of the conflict of interests engendered. The surviving stockholders, called upon to conduct the business alone, will feel that the profits should go to them in the form of salary increases, if they are not "plowed back" into the enterprise for future development. The inactive stockholders, not being on the payroll, can derive benefit from the business only from dividends on their stock. Accordingly, they will insist on a dividend income if there are any profits, and because of their voting control, they will be in a position to command dividend distributions in lieu of salary increases to the active minority stockholders. Thus, the latter, left to do all the work, are ex-

pected to share a substantial portion of the fruits of their labor. Such an arrangement obviously will not long endure.

The conclusion is evident that unless the majority stock passes into the hands of an experienced legatee such as a capable son or other relative of the deceased majority stockholder who is already active in the affairs of the corporation, who has proved to be a congenial associate, and who will be ready and willing to shoulder his share of the burden, the heirs will be far better served with the prompt receipt of the cash value of the stock.

DEATH OF A MINORITY STOCKHOLDER

From the standpoint of the business "team," the death of a minority stockholder may be just as serious as the loss of a majority stockholder. In fact, there are many close corporations in which the minority stockholder contributes the major part of the work while the other associate contributes the major part of the capital. In any event, the death of the minority shareholder disrupts the intimate group of well-balanced business talent and leaves the survivors with the problem of reorganizing the management of the corporation.

The position of the surviving majority stockholders. Faced with the necessity of reorganizing their management staff, the surviving majority stockholders are in a position to readjust this particular matter promptly. By means of their controlling number of votes as stockholders, they can reconstitute the personnel of the board of directors. The board, in turn, can search out and appoint, at a suitable salary, a new officer to take over the duties of the deceased stockholder.

Provided always that the surviving majority stockholders, in their capacity as controlling directors, act in good faith for the best interests of the corporation, the new minority stockholder will be unable to interfere successfully with the future dividend policy that the survivors adopt.

In the matter of their own future salaries, however, the majority stockholders may find themselves vulnerable. The underlying difficulty here is that the vote of a director in the matter of his own salary is a nullity and should not even be cast. While

all of the original stockholders were alive, this point was of no moment, for they were accustomed to act unanimously and there was no one to complain. But the death of one of their number brings a vital change in this respect. Now, there is a new minority stockholder who is likely to complain if any salary increases are attempted. The vulnerability of the surviving stockholders on this point is demonstrated in the following quotation from the opinion in *Fitchett v. Murphy,* 46 App. Div. 181 (N. Y.), referring to the lower court opinion:

> The learned court, in its opinion, correctly held that "Directors of a corporation have no right to vote salaries to one another as mere incidents of their office as was done here. They are not debarred from becoming employees of the incorporation and they are entitled to a reasonable compensation for their services as such. But as in fixing their compensation they are in the position as trustees dealing with themselves in respect of their trust, their action is subject to question by the stockholders or to review by the court of equity at the suit of a stockholder. In the case of a large board of directors the fixing of a salary of one of their number for prescribed services might be deemed conclusive, where the influence of one employed was not a factor therein. This case is quite different."

That the fact that the by-laws of the corporation provide for the salaries to be established by the board of directors does not surmount the difficulty is shown by the following quotation from the opinion in *McConnell v. Combination M. & M. Co.,* 31 Mont. 563, in which the court said at page 568:

> The directors had power to adopt a code of by-laws (Comp. Statutes, 1887, Div. 5, Sec., 454), but they could not, even under a by-law, vote a salary to one of their number when the vote of such director was necessary to make up a quorum.

Thus, it is not to be expected that the future acts and decisions of the surviving majority stockholders will go unchallenged. On the contrary, unless the minority stockholders are treated more liberally than good business judgment usually dictates, their plight will be such that they will take advantage of every opportunity to harass the majority. The survivors will be fortunate indeed if they succeed in avoiding not only unpleasantness

and bickering in every stockholders' meeting but ultimately, a hostile, expensive and time-consuming shareholders' suit.

The position of the estate and heirs of the minority stockholder. The shares of the deceased minority stockholder pass first into the hands of his executor or administrator, but their ultimate destination is dependent upon the status of the estate and the provisions of the deceased's will, if any.

If there is no will, the administrator is called upon to dispose of the stock for cash unless all of the heirs, provided they are all adult and thus capable of consent, agree to accept the shares themselves and unless there is also sufficient other property in the estate for the payment of all the debts and obligations of the deceased and his estate.

If the deceased stockholder leaves a will without specific provisions with respect to his stock, the situation is the same. The executor is required to sell the stock in the absence of a valid post-mortem agreement among the legatees to accept the stock certificates in lieu of cash, again keeping in mind that such an agreement cannot be effectuated unless there is sufficient other property in the estate available to the executor for the discharge of all estate obligations.

In either of the foregoing situations, the position of the executor or administrator appears at first glance to be identical with that which prevails in the case of the death of a majority stockholder, but in reality there is a vast difference. Because he has a controlling interest in a close corporation to dispose of, the personal representative of a deceased majority stockholder usually possesses a marketable estate asset. This is not true of the personal representative of a deceased minority stockholder. In most instances, his only available market consists of the surviving majority stockholders who, already having control of the corporation, can well afford to play a waiting game. Fortunate is the personal representative who, in this situation, is able to dispose of the minority interest at a price acceptable to the probate court and pleasing to the legatees, if, indeed, he is able to dispose of it at all during the limited probate period of the estate.

If there is a valid will specifically bequeathing the shares of the minority stockholder to one or more legatees, or an effective

post-mortem agreement on the part of the heirs to accept such shares, together with other funds avaliable for the payment of estate obligations, the minority stock ownership will pass ultimately into the hands of one or more members of the deceased's family. If the ultimate owner is a son or other relative ready, willing, capable, and acceptable to the surviving majority stockholders as an intimate business associate, no difficulties should ensue. But if, as is usually the case, the new owner proves to be an inactive stockholder, then the trouble starts.

Often the new owner is the widow of the deceased. Before his death, the minority stockholder derived a good livelihood from the corporation and it will be difficult, if not impossible, to persuade his widow that her deceased husband's income resulted almost entirely from his personal activity as a working associate rather than from the fact that he happened to own some shares of stock in the enterprise. In all probability, she will never cease to expect more income in the form of dividends on the stock than the board of directors is willing to declare. In fact, the payment of substantial dividends on the common stock of close corporations is the exception and not the rule. Any residue of corporate earnings left after the payment of commensurate salaries to the active stockholders is usually needed for the further development and expansion of the corporate business.

It is in this setting that the new minority stockholder will attend stockholders' meetings, there to participate in the discussions and to vote, however impotently, upon all the matters brought up. These discussions may well become bitter as time goes on and as the true situation of the inactive stockholder unfolds. If the cumulative system of voting for directors is used, the minority stockholder will be able to gain representation on the board and thus to carry such bitterness into the deliberations and actions of the board on the vital matters of salaries paid and dividends declared.

Eventually, the minority stockholder will either give up the unequal struggle and sell the stock at a bargain price or, bitterness turning to rancor, will bring the majority stockholders into court on charges of mismanagement in an attempt to compel the payment of smaller salaries and greater dividends.

The case of *Harrington v. Milton C. Johnson Co.*, 283 App. Div. 865, 129 N.Y.S. 2d 442 (1954) is an example. Following the death of one of the stockholder-officers of the company, his widow inherited 44 per cent of the corporation's stock. No dividends had been paid on the stock for many years. This policy was continued after the stockholder's death, although there was ample corporate surplus. However, the salaries of the officers and directors of the corporation were increased substantially. In an attempt to change the situation, the widow eventually applied to the lower court in New York for an order permitting her to examine the corporation's books and records. The lower court denied her application and she appealed to the Appellate Division of the New York Supreme Court. Here was the result, in the words of the Court:

> Order unanimously reversed and the motion granted. . . . The husband during his lifetime was an officer and employee of the corporation. Since his death the salaries of the three officers and directors have been increased over fifty per cent. Five of the respondent's salesmen are stockholders. In 1952 this group received a total of $57,210.71 for salary and expenses. The respondent refuses to reveal to petitioner how these payments are divided between salary and expenses. It states that no effort is made to scrutinize the expenses of a salesman because it would adversely affect the morale of the salesmen. At the end of 1952 the respondent had a total surplus of more than $235,000. No dividends have been paid for many years. In the light of these and other facts presented in the record, the appellant is entitled to the requested examination of the respondent's books and records.

Such suits are common, but few of them are successful in procuring larger dividends because the underlying situation usually justifies the conduct of the majority stockholders. Such a lawsuit causes the controlling stockholders considerable expense and embarrassment and sometimes loss of newly voted salaries. But instead of forcing payment of larger dividends, it usually only demonstrates to the inactive minority stockholder that the income producing power of his shares of stock in the close corporation is relatively small.

Clearly, it is the duty of every minority stockholder in a close

corporation to make sure that his stock interest does not pass into the hands of an inactive member of his family. This he can readily prevent by becoming a party to a plan by means of which his shares will be purchased at his death for a fair price by the surviving majority stockholders.

DEATH OF AN EQUAL STOCKHOLDER

Scattered throughout the country there are a host of "two-man" corporations. In each of these corporations, the enterprise is carried on by two men, each owning one-half of the shares of stock. Many of these concerns originally started out as co-partnerships and were incorporated later to obtain the advantage of limited liability. They are typical "incorporated partnerships," in which the work and the profits are shared equally in an atmosphere of harmony and unanimity on all important decisions. Informality is the rule, and voting power is never thought of as such. In fact, the stockholders consider themselves, and customarily refer to themselves as, "partners," to the dismay and confusion of their more legally minded friends.

A detailed analysis is hardly necessary to depict the situation brought about by the death of one of these equal stockholders. The equal sharing of the work of the corporation is terminated, and the survivor, for some time at least, must carry the burden alone. Gone, also, is the spirit of harmony that prevailed in the management of the enterprise. First, the personal representative, in a new and strange atmosphere of formality, will occupy the place of the deceased associate at stockholders' and directors' meetings. Representing primarily the creditors of the deceased stockholder and secondarily his heirs and legatees, the viewpoint and objectives of the executor or administrator will be foreign to that of the surviving stockholder. Ultimately, the deceased's place will be occupied either by a purchaser of the deceased's stock, if the personal representative is required to sell, or by a member of the deceased stockholder's family. In either event, there is little possibility that the new stockholder will prove to be an acceptable "partner" to the surviving stockholder. The probability verges into certainty that the resultant differences in experience, burdens or objectives, in combination with equal

ownership and voting power, will rapidly develop into a stalemate that can be resolved only by the liquidation of the corporation.

Surely, equal stockholders stand in need of a plan that will eliminate any such unfortunate result.

Part II

PLANS ATTEMPTED, TO AVOID DELETERIOUS EFFECTS OF CLOSE CORPORATION STOCKHOLDER'S DEATH

CHAPTER 8

Plans Improvised after a Stockholder's Death

IN THE PREVIOUS CHAPTER, WE HAVE SEEN THAT the death of a close corporation stockholder has important and deleterious consequences to all concerned, even though such a death does not of itself affect the life-span of the corporation. As the adverse effects of such a death become apparent, it is only natural that the parties concerned will attempt to remedy the situation in which they find themselves. We shall review some of these attempted remedies in order to demonstrate the sterility of all such post-mortem improvisations.

DEATH OF A SOLE STOCKHOLDER

The death of a stockholder who owns all or nearly all of the stock of a corporation leaves his estate and heirs in much the same position as if the business was not incorporated. The personal representative has no authority to continue the cor-

poration business but must proceed promptly to dispose of it or to dissolve it, unless the will states otherwise in language that is direct, explicit and unequivocal. If, therefore, the sole stockholder has neglected to act prior to his death with respect to the future of his corporation, it devolves upon his personal representative to sell or to liquidate the enterprise. This is not easy to do, however, if the corporation has been a profitable one that provided the livelihood of the deceased stockholder and his family, and occasionally the personal representative or the heirs will attempt to keep the business operating despite the lack of proper authority to do so. This was the situation in the following case, which again illustrates the folly of dealing with estate assets without proper authority.

The case of *In re Kinreich's Estate*, 244 N. Y. S. 357, 137 Misc. 735 (1930), was a proceeding in the Surrogate's Court in which the widow, as executrix, and Turkus, as co-executor, were called upon for an accounting of the estate assets of Leo Kinreich. At his death, Kinreich owned all of the stock of the Sterling Wax Paper Manufacturing Company. His will contained certain legacies to two employees and named his wife residuary legatee, but it did not give her the authority to continue the corporate business. Approximately ten days after Kinreich's death the personal representatives and their attorney held a conference to plan for the continuance of the corporation at which the widow was elected its president, at a salary of $300 a week. Thereafter, she actively conducted the business for two years and four months until it became bankrupt in January, 1929. During this period, the co-executor refrained from taking any active part in the affairs of the corporation, although the widow sent him periodic reports.

Following the failure of the business, the legatees under the will brought this proceeding in an effort to hold the personal representatives accountable for the loss. The court held both executors liable and surcharged them with the book value of the business at the date of the sole stockholder's death. With reference to the liability of the widow, the opinion stated, in language reminiscent of that used in cases dealing with sole proprietorships and already familiar to us in that connection:

> As to the liability of testator's widow, who qualified as executrix and actively managed the business, it clearly appears that, in the absence of any authority in the will, she must be held strictly accountable for the loss sustained in continuing the business. *Manhattan Oil Co. v. Gill,* 118 App. Div. 17, 19, 103 N. Y. S. 364; *Matter of Glass' Estate,* 134 Misc. 291, 235 N. Y. S. 299—both citing *Willis v. Sharp,* 113 N. Y. 586, 21 N. E. 705, 4 L. R. A. 493.

With respect to her salary of $300 per week, the opinion stated:

> The payment of this excessive amount furnished a strong motive on the part of the widow to continue the business in disregard of her legal duty.

In holding the co-executor also liable, the court said:

> As to the co-executor, Turkus, the contention that he took no active part in the running of the business and therefore should not be held liable for the loss cannot be sustained either by the testimony or as a matter of law. . . . The referee finds, however, that the corporation was not insolvent at that time [upon testator's death], and that, as executor, Turkus was negligent in failing to determine its exact status and in permitting Mrs. Kinreich to operate the business and conduct the estate as though it were her own personal affair, he is equally liable with her for the loss suffered by the legatees. . . .
>
> From the entire record it appears that the executor, Turkus, was properly held responsible with the executrix for the loss to the beneficiaries of the estate. His duty, as the developments show, was to insist that the business be sold or liquidated as soon as reasonably possible after testator's death. [Several cases cited as authority, also Harvard Law Review, March, 1921, p. 483.]

With reference to the corporation, the opinion commented as follows:

> That the estate held only shares of stock in the business corporation does not affect the question of the executors' liability. This question has been decided by the Court of Appeals in *Matter of Auditore's Will,* 249 N. Y. 335, 345, 164 N. E. 242, 244, the Court saying: "The surrogate is not dealing with the corporation, but with the value of its stock at specified times."

Since it is patent that the sole stockholder of a corporation is confronted with the same business continuation problems as the sole proprietor, it should be equally patent that those problems are susceptible to like solutions. Furthermore, since the solutions of the problems encountered by the proprietor in perpetuating his enterprise and in assuring its full going value to his heirs have been fully discussed in the book on Proprietorships, our discussion of the sole stockholder will be concluded by referring the reader to the appropriate material in that section and by calling attention to the fact that in working out a satisfactory solution, the sole stockholder has the distinct advantage of dealing with more readily identifiable and more easily divisible property, for he is dealing with shares of corporate stock instead of the divers items of real and personal property used in the conduct of a proprietorship business.

DEATH OF A MAJORITY STOCKHOLDER

There are in existence many close corporations made up of two stockholders, one of whom owns a few more shares of stock than the other. While both stockholders are alive, this difference in holdings is disregarded, and they conduct the business as if they were equal partners in the enterprise. Upon the death of the majority stockholder, however, this difference must sooner or later assert itself, and the new owners of the majority stock will take the control away from the surviving minority stockholder. Such a development is illustrated by the following cases.

Gaines Bros. Co. v. Gaines and *Gaines v. Gaines Bros. Co.* Frank Gaines and his brother, James Henry Gaines, had organized a partnership in 1893 for the purpose of farming, stock raising, and the conduct of a general trading business that included the buying and selling of hay, grain, and other commodities. James contributed $1,000 more to the partnership capital than Frank.

In June, 1907, the two brothers formed the corporation of Gaines Bros. Co. under the laws of the United States governing the Indian Territory, with capital stock of $40,000, divided into

1600 shares of $25 each. The incorporation papers showed James the owner of 820 shares and Frank the owner of 776 shares, 4 shares being assigned to one Walter Gaines in order to have the necessary three incorporators.

The handling of the affairs of both the former partnership and the new corporation was entirely informal. During their days as partners, the two brothers had kept a joint bank account, against which they drew such checks as they desired for the operation of the partnership and for their own individual needs. After the formation of the corporation, the finances were continued in the same manner, no detailed records being kept. There were no official meetings of the corporation; the brothers met at various times and places to plan their course of business and again no record was ever kept of the meetings or business planned.

This harmonious relationship continued until the death of James in 1914, at which time the first formal meeting of the corporation took place in order to elect one of the deceased's two sons a director, the majority interest having passed to James' widow and sons.

The business of the corporation was then carried on as before for a period of nearly sixteen years; it operated as a family affair, with Frank and the heirs of his brother drawing checks against the corporation bank account to meet their individual needs and without the keeping of any detailed records. Eventually, however, the heirs of the deceased brother constituted themselves a majority of the board of directors and in about the year 1930 they began to assert their authority. Friction developed immediately, and soon afterward the majority put through a dividend declaration of $260,000.

Frank then brought these two actions, *Gaines Bros. Co. v. Gaines,* 176 Okla. 576, 56 P. 2d 869, and *Gaines v. Gaines Bros. Co.,* 176 Okla. 583, 56 P. 2d 863 (1936), with various objects in mind but with the primary purpose of establishing his right to equal ownership of the shares of stock in the corporation, based upon an alleged oral agreement to that effect made with his deceased brother at the time of its incorporation. This object, if established, would of course give Frank the equal say in

the management of the corporation that he had always exercised in operating the partnership and the corporation with his brother. The court, however, refused to go beyond the written and verified articles and agreement of incorporation and decided against him. And not only did Frank lose his major contention, he also, since he had not alleged any wrongdoing on the part of the heirs, failed to obtain the other forms of relief requested, including an injunction against further dividends and for an accounting. On the subject of majority control, the court said as follows:

> In the absence of any allegations in the petition of negligence, misfeasance, fraud, oppression, or mismanagement on the part of the officers and directors of the corporation, the plaintiff has no standing in a court of equity to enforce an accounting or for dissolution of the corporation. The majority interest in a corporation have a right to dictate the business policy of the company so long as it is done in an honest, reasonable, competent, and efficient manner. The law has always recognized the right of majority stockholders of a corporation to control its business and affairs, and a court of equity will never interfere with such control except for the very best of reasons.

It is clear from this case that the death of a majority stockholder leaves the surviving minority stockholder in a helpless position, barring affirmative wrongdoing on the part of the heirs, and it takes little imagination to foresee what the next step will be in most instances. Because of the acrimony developed in the advanced stages of litigation, in all probability the stockholders are never again able to work together harmoniously. Therefore, unless the services of the surviving minority stockholder are absolutely indispensable to the corporation, the "final act" will find the controlling majority stockholders dispensing with his services.

What can the surviving minority stockholder, acting alone, do to protect his position in the corporation? He can buy out the heirs of the deceased majority stockholder, *if* they are willing to sell, *if* an agreement can be reached as to the purchase price, and *if* the survivor can raise the necessary purchase money. Provided that the corporation is prosperous, there is little like-

lihood that the new majority stockholders will consider selling their stock, let alone do so at a price that the survivor can pay. Second, the survivor can sell his stock interest, *if* he can find a buyer. Outsiders are usually not interested in purchasing a minority interest in a close corporation, and therefore, probably the only prospective buyers are the new majority stockholders. But since they already have control of the corporate affairs, they have no particular incentive to purchase the additional shares and will offer little for them. Moreover, this alternative sells the survivor out of a job instead of protecting his position in the corporation. Third, the survivor can submit to the control of the new majority stockholders and hope for the best.

The mere recital of these alternatives makes it obvious that a minority stockholder cannot afford to trust his future to the chance that, after the majority stockholder's death, he will somehow be able to conclude a satisfactory arrangement with the heirs. To protect his position in the corporation, he must enter into an arrangement with his majority associate; he must act before a death occurs.

DEATH OF A MINORITY STOCKHOLDER

By far the greater number of associates in close corporations own a minority stock interest. The situation most frequently involved, therefore, is that brought about by the death of a minority stockholder. In the previous chapter, this situation was discussed in general terms. Now, let us observe what actually happens in some of these cases in the absence of any special arrangements between the original stockholders to take care of such a contingency.

Situations frequently occur in which it becomes the duty of the executor or administrator of a deceased stockholder to sell his shares of stock in the process of administering his estate. In the case of the death of a minority stockholder who has made no specific provision with respect to his stock, this duty often presents an embarrassing dilemma to the personal representative. If he holds the stock, he may be surcharged for any losses to the estate resulting from the retention of a non-legal investment. On the other hand, because the market for a minority interest

in a close corporation is extremely limited, if any market exists at all, he may be surcharged for selling the stock at what is ruled to be an inadequate price. Such a dilemma was barely avoided by the personal representative in the following case.

Matter of Middleditch. Livingston Middleditch died possessing a minority interest in a close corporation, and it was the duty of his personal representative to dispose of this stock, if possible. When the time came for an accounting of the affairs of the estate however, the personal representative, unable to find a buyer, still held the stock among the estate assets. The heirs then entered objections to an approval of the account and urged that a surcharge should be made. The rest of the story appears in the following quotation (N. Y., Kings County Surrogate, N. Y. Law Journal, Feb. 18, 1935):

> . . . The burden rested upon the objectors to demonstrate that the actions of the executors in retaining the stock of the company have resulted in loss to the estate *(Matter of Pollock,* 134 Misc., 212, 214). In this they have failed. It may be conceded that it would have been the duty of the executors to sell the stock if a reasonable market could have been found. This consideration is, however, pointless on the record since no suggestion has been made that any such market has ever existed. This is not surprising since the purchase of a minority interest in a close corporation is a transaction which would appeal to few persons. There is no more reason for criticising the accountants for failure personally to buy the stock than for the like failure of the objectants. The difficulties encountered by the executors in liquidation were inherent in the nature of the property in the hands of the testator and the situation was not altered by his death. . . .

The real lesson from this case, however, is not the final avoidance of personal liability by the executors of Middleditch, but the plight of his legatees. The failure of minority stockholder Middleditch to make specific plans for the satisfactory disposal of his stock resulted in an unsuccessful litigation that was costly to the heirs. Moreover, they took possession of the stock because no buyer could be found. In fact, it is difficult to foresee how it could ever be sold for more than a fraction of its true value, and further loss to the heirs seems inevitable. How much better

it would have been, both for his executors and for his family, and probably for the surviving majority stockholders, as the next case will show, had Middleditch arranged to sell his minority holdings to the surviving stockholders for an adequate cash price.

Godley v. Crandall & Godley Co. In 1871, the partnership of Crandall & Co. was formed by William D. Godley, Allen B. Crandall and William Zeigler to deal in fixtures and supplies for grocers, confectioners, and bakers. In 1878, Zeigler sold his one-third interest to Crandall. In 1887, Crandall died and his two-thirds interest was sold by his estate to Lyman F. Pettee, who then formed a new partnership with Godley to continue the business under the original name. In 1892, Godley and Pettee incorporated as Crandall & Godley Co. under the laws of New Jersey and the corporation so formed then took over the assets and good will of the partnership. In 1895, the defendant Crandall & Godley Co. was organized under the laws of New York by Godley, Pettee and Karlsruher. This corporation then acquired the assets and good will of the New Jersey corporation and the latter was dissolved. Shortly after this, Godley and Pettee allotted a small amount of their stock to certain favored employees who were to pay for the shares from subsequent dividends to be declared.

In May, 1895, Godley fell ill and became incapacitated, and in August of the same year the other members of the board of directors, Pettee and Karlsruher, carried a resolution discontinuing Godley's salary as president and voting an increase to Pettee.

During the years 1896 and 1897 the board of directors, consisting of Pettee, William Pfeiffer and Charles Finckenstadt, passed blanket resolutions authorizing salary increases to be made to selected employees. Under these resolutions 9 per cent was paid upon the common stock held by each employee stockholder in each year from 1895 to 1908 inclusive and also upon the common stock held by the directors in each of such years except the last three. These increases were purportedly "additional salaries" and the total paid out in this fashion amounted to $103,248. As for the last three years, the directors, in November, 1906, voted themselves increases in salaries amounting

to $14,310 for services already performed in that year. A total of $42,330 increased compensation was paid during that and the following two years.

During this same period from 1895 to 1908 inclusive, dividends of 6 per cent were paid to all common stockholders in each year except 1907, when 7 per cent was paid and in 1908, when none were paid.

In the meantime, in December, 1897, Godley died, leaving to the plaintiff, his widow, who was sole executrix and sole legatee under his will, his minority holding of upwards of one-third of the capital stock of the corporation. The widow demanded representation on the board of directors but this was refused by Pettee, who controlled the majority of the stock. From time to time after this Pettee endeavored to purchase her stock, always, however, refusing to give her information as to the financial condition of the company. During 1905, he advised her to sell her common stock at par when, for the previous year, the total earnings, exclusive of the 9 per cent "additional salaries" paid, amounted to over $100,000 and the surplus stood at $242,509.76. In 1908, although the earnings for the previous year were about $40,000 and the surplus was $243,276.47, he caused a dividend to be passed. Then in the summer of 1908 he again sought to purchase the widow's stock for the stated purpose of turning over the entire business to his sons; however he still refused to give any information as to the financial condition of the corporation.

In January, 1909, the premises of the corporation were destroyed by fire, the resultant loss being fully covered by insurance. At that time the same directors, holding a majority of the stock but less than two-thirds necessary to dissolve the corporation, decided to discontinue its business and to liquidate. Shortly after this Pfeiffer resigned as director and, together with a son of Pettee, organized a new corporation. Pettee then proceeded to liquidate the affairs of the Crandall & Godley Co. by selling its tangible assets for value, reducing its capital from $300,000 to $15,000 and turning over to the new corporation its customers, brands and trade names without compensation, although good will had been carried on the books of the old cor-

poration at $132,000. Pettee was then voted $13,750 by the directors of the old corporation for his services in connection with the liquidation, although the corporation was never legally dissolved.

Ultimately, the widow brought this representative action, *Godley v. Crandall & Godley Co.*, 212 N. Y. 121, 105 N. E. 818 (1915), against all concerned to compel payment back to the Crandall & Godley Co. of (1) the money paid out under the guise of "additional salaries"; (2) the money paid to the directors as salary increases under the 1906 resolution; (3) the value of the good will of the corporation transferred without compensation to the new corporation; and (4) the money paid to Pettee for his services in liquidating the assets of the Crandall & Godley Co.

New York's highest court held the defendants accountable for the "additional salaries" paid, totaling $103,248, with interest from the time each item had been paid out, for the $42,330 in salary increases received under the 1906 resolution, for the $13,750 paid Pettee in connection with the liquidation, and for $90,000 as the fair value of the good will of the corporation.

The court's opinion is too lengthy to quote in full, but some excerpts are enlightening.

With reference to the "additional salaries," the opinion stated in part:

> There is at least some evidence to sustain the finding that the directors distributed the surplus earnings of the corporation among themselves and certain employee stockholders under the guise of additional salaries but upon the uniform basis of nine per cent of the common capital stock held by each, and not according to the services rendered the corporation by the distributees. Plainly, such a distribution of assets was without consideration and a wrong to the corporation itself, and it is immaterial that the plaintiff called the payments dividends and that the directors called them additional salaries.

Regarding the salary increases voted under the 1906 resolution, the opinion stated, among other things:

> . . . It is undoubtedly the general rule that acts done in the interest of the corporation, which are voidable only, *i.e.*, not fraudulent or *ultra vires*, may be ratified by a

majority of the shareholders, and that those who object must correct them within the corporation. . . . [Citing cases] That rule results from the necessity that the majority must determine the policy of the corporation, with whose internal management the courts wisely refrain from interfering. Whether increases of salaries voted by the directors to themselves come within the rule may well be doubted. . . . Doubtless the directors may appoint and fix the compensation of the ministerial officers of the corporation, but the payment of salaries to themselves as mere incidents of their office is a different matter. There is authority and sound reason in support of the proposition that, in the absence of some provision of statute, by-law or charter, the directors have no authority to vote salaries to each other as mere incidents of their office. . . . [Citing cases] and there is ample authority to sustain the right of a minority stockholder to maintain a representative action to recover salaries voted by the directors to themselves. [Citing cases] . . . The court found in this case that there was no by-law of the corporation authorizing the directors to vote salaries to themselves as officers. Doubtless the directors of a corporation may employ one of their number to perform services outside of the usual duties pertaining to his office and agree to pay him a salary therefor, and it may be that the act would not be wholly void, though he voted for the resolution. . . .

Whatever the power of directors to vote salaries may be, they certainly had no power to vote increases of salary to themselves for services already performed under a stipulated salary. Under that resolution the directors paid to themselves an increase of $14,310 for services already performed. That constituted nothing less than a gift to themselves of corporate funds and of course was a fraud, and it was perforce of that resolution that the increases were paid in subsequent years. In view of the other findings bearing on the question of actual, as distinct from constructive, fraud, dubious as they are, we are not disposed to hold that the resolution of 1906 was fraudulent as to past services and honest as to the future.

As to the $13,750 paid to Pettee in connection with the liquidation, the court said in part:

. . . However, it plainly appears from the findings referred to under the next head that his services in that regard were not rendered in good faith in the interest of

> the corporation, but were in bad faith, and destructive of its true interest. It thus conclusively appears that the payment of compensation therefor was a fraud upon the corporation and the dissenting stockholders. The recovery of the sum thus paid was, therefore, proper.

With respect to discontinuing the business of the corporation and turning over its good will to another corporation without compensation, the opinion comments in part:

> . . . It may be assumed that a majority of the stockholders could, each in his own interest, vote to discontinue the business. But they could not lawfully do that in bad faith for the purpose of turning its business and good will over to another corporation without compensation so as to exclude minority stockholders from participating therein.
>
> The court found on sufficient evidence that the good will was worth $90,000. It was the duty of the directors if they decided to discontinue the business to make an honest effort to realize on the good will. Doubtless it is true, as contended, that good will cannot exist apart from an established business. But the business was not destroyed by the fire. The corporation had assets of $534,439.13, exclusive of good will. The directors did not discharge their fiduciary duties simply by realizing on and honestly accounting for the tangible assets. The business, the organization, the list of customers, the brands and trade names — everything pertaining to good will — were turned over without compensation to the new corporation. Being unable to secure the consent of a two-thirds majority of the stockholders to dissolve the corporation, the defendants accomplished their purpose by reducing the capital to $15,000 and by turning over the business and good will without compensation to a new corporation. Directors may not thus as against dissenting stockholders in effect terminate the existence of a corporation.

Lest the reader jump to the conclusion that Godley v. Crandall & Godley Co. typifies a rare and unusual case, a statement appearing early in the opinion is quoted:

> It is the typical case of a dispute arising from the incorporation of a trading partnership followed by the death or incapacity of one of the members and the adoption by the others of measures to limit the dividends of the inactive shareholder to what they conceive he ought to have.

That an action of this type frequently follows upon the death

of a minority stockholder in a close corporation is born out in the intermediate court opinion in this same case, in which, at pages 706, 707 of 153 App. Div., the following vivid portrayal of the underlying situation is given:

> The basic reason of the corporate disputes which have produced the crop of representative actions, similar to the case at bar, is this: the original members of a joint enterprise or partnership engaged in trade, business or manufacturing, seeing certain real advantages in incorporation — the two most important being (1) a limitation of personal liability for the debts of the business to the amount invested therein, and (2) freedom from dissolution by reason of the death of a partner — transform the trading partnership into a business corporation, the partners receiving stock in proportion to their interests. So long as they all live, and agree, they treat it as a partnership, and, whether they distribute the surplus profits among themselves as dividends or by way of salaries, the financial result is precisely the same and there is no one to complain. But when a partner (that is, such a stockholder) dies, or by reason of disagreement with the majority is ousted from the management, the majority refuse to regard the stock of that deceased or ousted partner as entitled to the treatment that he was when alive or in agreement. They think that as they do the work and have the responsibility, they are entitled to keep to themselves and divide among themselves all, or the substantial part, of the profits or gains of the business, thus losing sight of the fact that the very form of the enterprise which they have created, to wit, a corporation, which has conferred upon them the benefits of a limitation of liability and a survival notwithstanding the death of a member, couples with those advantages the equality of all the stock, irrespective of ownership, whether original or recent, and irrespective of the participation in the affairs of the company or of the work or labor for it. All the stock is on the same basis of partnership *inter sese* and the right of the majority, or the surviving original partners, to still treat the enterprise as their own and as they will, has ceased. That is the penalty or payment which they have to make for the original advantage which they have received by incorporating. It is for this reason that, chafing under the legal necessity of treating all the stock alike and of dividing the profits *pro rata* to the holders thereof, they became

> ingenious in devising methods to evade and avoid their corporate responsibilities. The only safeguard lies in strict adherence to the equitable principle that the directors are fiduciaries, and may not, therefore, deal with themselves. The court is still the refuge and the support of the minority. Whenever a minority stockholder can show that the directors, his fiduciaries, have deviated from the path of square and honorable dealing for their own benefit, the court will exercise its power to right the wrong.

The outstanding specific import of the Godley case to close corporation stockholders is that surviving majority stockholders are held accountable to the heirs of a deceased minority stockholder for salaries voted themselves against the wishes of the heirs who take over the deceased's stock. In the previous chapter two cases were quoted to the same effect, but the rule is of such supreme importance and is so frequently overlooked that further authorities will be quoted.

An excerpt from the case of *Raynolds v. Diamond Mills Paper Co.*, 69 N. J. Eq. 299, 60 Atl. 941 at page 946, is in point:

> Now, in this case the salaries have been fixed by the directors themselves — these three salaried agents, who collect $29,000 per annum for their services and control the board of directors. . . . The rule is well settled that the burden is upon the directors and managers in such a case as this to satisfy the court that the salaries which they have paid themselves have been earned. The situation is absolutely different from that which I described in dealing with the claim of the stockholders to have a dividend declared. Here the court cannot avoid or evade the discharge of a duty, however difficult it may be. I must confess that it is a difficult task for this court, upon such proofs as have been taken here and upon such proofs as might have been taken, if every piece of evidence possible had been adduced to fix the just compensation which these men are entitled to receive for their services. But they cannot fix it themselves. They cannot pay themselves. They cannot be the judges of their own case. They are acting very differently in awarding themselves salaries from what they are doing when determining whether dividends shall be declared or not, although, of course, they have an interest in the declaration of the dividends as stockholders.

Here are some excerpts from *Bates Street Shirt Co. v. Waite,* 130 Me. 352, 156 Atl. 293 (1931), that contrast in bold relief, first, the situation as to the stockholders voting themselves salaries prior to 1923 when all them were alive, all were actively engaged in the corporate business and all were on the board of directors; and second, the changed status in this respect in 1923 after the death of a minority stockholder, Fosdick, who had owned one-fifth of the common stock of the corporation:

> In the years prior to 1923, salaries were fixed by vote or by agreement of boards of directors consisting in whole or in majority part of the officers to whom the salaries were to be paid, all participating in fixing each individual salary, in violation of the general rule which is well settled.
>
> "Directors cannot vote salaries to themselves. Nor can they vote a salary to one of their number as president or secretary or treasurer, at a meeting where his presence is necessary to a quorum. And such votes, if passed, are voidable by the corporation, and if money has been paid it may be recovered back." *Camden Land Co. v. Lewis,* 101 Me. 78; *Pride v. Pride Lumber Co.,* 109 Me. 452.
>
> The reason and justice of the rule is apparent. Directors have no authority to act for the corporation in matters in which they are personally interested. They owe their whole duty to the corporation and they are not to be permitted to act when duty conflicts with interest. They cannot serve themselves and the corporation at the same time. *European & N. A. Ry. Co. v. Poor,* 59 Me. 277.
>
> But the peculiar circumstances of this case take it out of the general rule. Here the directors were the only bona fide common stockholders. It is not illegal for a corporation to distribute its profits in salaries provided that all of the stockholders assent. 2 Cook on Corporations, 6th Ed., Sec. 657.
>
> . . . The year 1923 stands by itself. Mr. Fosdick died in 1922. The stock which he had owned was held by his estate until it was purchased by the corporation in September, 1924. Salaries for 1923 were voted at a directors' meeting in which defendants appear to have participated in fixing the amounts which they were to receive. Their action in this respect was not ratified by the stockholders, nor was it acquiesced in by the executrix of the Fosdick estate. On the contrary, she vigorously protested against it. In so doing, she was quite within her rights as a rep-

> resentative of minority stockholders. No dividends were being paid on the stock. Prior to Mr. Fosdick's death, it was immaterial whether the profits of the business were distributed in salaries or in dividends, but when his salary ceased, a different situation obtained. The objections of his executrix were finally silenced by the sale of the stock, but until that was arranged she was entitled to register pertinent protest against the action of the directors.

Incidentally, the "pertinent protest" of Fosdick's widow and executrix was registered in the form of two lawsuits. The comment that concerns these lawsuits that appear in this opinion should be of particular interest to surviving majority stockholders:

> . . . Although the first bill was dismissed and the second never came to a hearing, the allegations contained in both were widely published, as a result of which both these defendants and the corporation were subjected to unpleasant criticism; applications for loans were more closely scrutinized than had been ordinarily the case; and those connected with the company believed with good reason that the pendency of the litigation was injurious to its business.

The economic reason that Fosdick's widow registered "pertinent protest," followed by two lawsuits, is also set forth in the opinion of this case as follows:

> . . . His family was left with an investment which was necessarily unproductive, unless the method of distributing profits which the corporation had followed for many years was abandoned, and even then, it was not such an investment as would recommend itself to any but an active business man valuing it as a means of securing profitable employment.

The legal troubles of the surviving majority stockholders, Parker R. Waite and his wife, culminated in the principal action, *Bates Street Shirt Co. v. Waite,* from which we have been quoting. In addition to the common stock of the corporation, all of which was owned by the Waites except that which was sold by them to Fosdick and later purchased by the corporation from his estate, there was still outstanding $300,000 of preferred stock under a covenant that provided that in the event of the failure

to pay preferred dividends for six months, the voting power of the common stock would pass to the preferred stockholders.

This did happen in 1928, and the preferred stockholders took over the entire control of the corporation. Subsequently, this action was brought against the Waites, alleging various charges of fraudulent conduct in their handling of the corporate affairs, among which was the matter of the salaries that they had received and the purchase of the Fosdick stock by the corporation. The court held that the preferred stockholders were "in quite a different position than" the Fosdick estate in challenging the salaries paid, and the preferred could not question those voted during the period that the Waites were in control, for during that period the preferred stockholders had received all they were entitled to, that is, full dividends on their stock. The court also held that the purchase of the Fosdick stock was justified, and dismissed the action.

In examining the facts of the Bates case, one is led to a conjecture of what might have happened under different circumstances. If a plan for the purchase of Fosdick's minority stock had been set up before his death, the lawsuits brought by his estate, with their damaging publicity and injurious effect on the business, could have been avoided. And the avoidance of these injurious actions, in turn, well might have enabled the company to continue the payment of preferred dividends and the Waites to remain in control of the business they had founded. The troubles of the surviving majority stockholders and of the widow of the deceased minority stockholder could easily have been avoided if a stock purchase plan had been arranged.

DEATH OF AN EQUAL STOCKHOLDER

The remaining situation is that brought about by the death of a close corporation stockholder owning or controlling (some stock is often put in the name of the wife) one-half of the outstanding stock. The forerunner of the corporations involved in these cases, as was pointed out in the previous chapter, is usually a co-partnership between two men who have subsequently incorporated the business to obtain the advantage of limited lia-

bility, or for tax reasons. Upon the death of one of these two men, dissension and eventual deadlock may well develop from this new situation, in which the surviving active stockholder is called upon to carry perhaps the full burden of the work of the corporation at the same time that the control of the corporation's management and its earnings are to be shared equally. Let us look at an actual case of this type.

Matter of Brown. About the year 1908, Brown and Ferraro formed a co-partnership to carry on the cooperage business. The enterprise prospered, and in 1918 the two men formed a corporation to continue the business, one-half of the stock being issued to Brown and his wife and one-half being issued to Ferraro and his wife. The opinion in the case (N. Y. Supreme Court, *N. Y. Law Journal,* March 26, 1937) stated: "The business, by its nature, required the personal attention, skill, knowledge and labor of both the former partners. Since its inception the business has afforded both families a comfortable living."

The former co-partnership enterprise was carried on harmoniously and profitably under the corporate form for 18 years, until the death of Brown in December, 1936. Less than three months later, Brown's widow brought the surviving equal stockholder into court in this proceeding to prevent him among other things from raising his salary. Mr. Justice Lockwood tells the story in his opinion as it had developed during this short interval after the death:

> After the death of petitioner's husband in December, 1936, dissension arose and there appears to be little likelihood that petitioner and respondent, each owning or controlling one-half of the corporation's stock, will be able to agree and carry on the business.
>
> The grounds for the dispute are set forth at length in the petition and affidavits, each party, of course, furnishing his or her version of the circumstances.
>
> Petitioner seeks an order enjoining the respondent Anthony Ferraro from issuing checks on the corporate account and upon his sole signature, and from drawing salaries to himself in excess of $35 per week, and to enjoin the respondents from holding a meeting of the directors. No action has been brought and no proceeding is pending other than this application.

> The court has conferred with the parties and their attorneys in an unsuccessful endeavor to effectuate an amicable settlement satisfactory to both parties. Nothing remains but for the parties to secure a judicial determination of their rights by appropriate action.

Another deadlocked corporation was involved in the case of *Krall v. Krall*,—Conn.—,106 Atl. 2d 165 (1954). Prior to its incorporation in 1929, the business of the Krall Coal Company, Inc. was operated as an equal partnership between Moses and William Krall. Upon incorporation, one share of stock went to Moses, 49 shares went to his wife, and 50 shares were issued to William. Moses died in 1943. With the stock equally divided, vacancies in the offices of director and president were never filled. However, William took charge of the corporate affairs, withdrawing $125 a week in salary and operating the business "as though he personally owned all the outstanding stock."

As might be expected, dissension soon arose between the widow and William. In 1947 she brought this action against him, in which she charged various acts of fraud and mismanagement and asked for the appointment of a receiver and the dissolution of the corporation. The trial court concluded that there had been no fraud or mismanagement, but that William's actions in assuming complete and exclusive control of the business were improper and illegal, and that there was a total deadlock between the two stockholders. Accordingly, the court ordered the appointment of a permanent receiver for the corporation. This order was upheld unanimously when appealed to Connecticut's highest court. While it was felt that the appointment of a receiver for a going, solvent corporation was strong medicine, such appointment was justified here because "a complete deadlock has persisted for more than a decade."

The trouble, in the cases of equal stockholders, lies in the fact that a business enterprise founded and conducted by two men is what might be called a "business marriage" in which the parties work together for financial success in a spirit of harmony, implicit trust and confidence, and in whole-hearted co-operation.

The natural form of business organization for such business enterprises is the partnership, the rules of law concerning which have been derived from just such intimate business associations.

In such cases, it is a fiduciary relationship, in law and in fact. To the original founders, however, it does not matter whether the organization is a partnership or a corporation, for their dealings with each other will in either event be on the same intimate, informal, and harmonious basis.

But the form of organization becomes immensely important and significant once the original association is broken up by the death of one of the associates. In the case of a partnership, the form of organization is automatically dissolved. Not so with the corporation. When an equal stockholder dies, the surviving equal stockholder is faced with a situation entirely foreign to the original intimate business association and, as we saw in the Brown and Krall case, trouble is inevitable. Moreover, as we also saw in those cases, the difficulties are usually insolvable because of a deadlock brought about by the equality of control. Often the only recourse is the dissolution of the corporation itself.

SUMMARY

The cases reviewed in this chapter illustrate how, in the absence of specific plans set up in advance to take care of the situation, the death of a close corporation stockholder, regardless of the extent of his stockholdings, brings about an unwanted and economically unsound relationship between the surviving stockholders and the heirs of the deceased. The cases also demonstrate that attempts of the parties involved to "cure" the situation in which they find themselves after a stockholder's death usually result only in multiplying their difficulties. What is needed is the proverbial "ounce of prevention" in the form of a plan set up by the original stockholders before a death occurs that will prevent "unnatural" stockholder relationships from coming into being upon the occurrence of a death among their number.

CHAPTER 9

Plans Set Up by Stockholders Prior to a Death

IT NOW SEEMS CLEAR THAT CLOSE CORPORATION stockholders stand in need of some workable plan by which, in the event of the death of one of their number, the survivors will be able to continue the enterprise without outside interference or control, while at the same time the heirs of the deceased will be justly provided for. It also seems apparent that these two essential objectives can be accomplished only by a plan that will result in the acquision of the shares of stock of a deceased stockholder by the surviving stockholder or the corporation, and the prompt receipt of the full value of such stock by the deceased's estate. The certainty and efficiency with which any plan will attain these essential objectives, therefore, constitute the proper basis for testing the relative merits of the various plans available to the stockholders.

"FIRST OFFER" ARRANGEMENTS

It is not uncommon to find, either in the certificate of incorporation of a corporation or in a separate agreement entered into by all the stockholders of it, a clause providing that no stock of the corporation shall be transferred to a person not already a stockholder unless the stock shall have been first offered for sale to the other stockholders at an agreed price.

Such a restrictive agreement is essential to govern transfers of stock that may be made during a stockholder's lifetime, in

order to give the remaining stockholders a fair opportunity to prevent any shares of stock from passing into the hands of outsiders. More than this opportunity cannot be granted in most jurisdictions for protection against this particular contingency because a total restriction against the alienation of shares of stock is invalid in a majority of the states.

Little discussion is required, however, to show that a "first offer" arrangement will not solve the problems brought about by a stockholder's death, for it merely provides that *if* the estate or heirs decide to sell, they must give the surviving stockholders the first opportunity to buy. They are left free to retain the stock if they wish. This they may very well wish to do if they have inherited a majority stock interest, thus leaving the surviving stockholders in a difficult situation. If, on the other hand, a minority interest is involved, the estate and heirs will probably desire to sell; but the survivors are under no compulsion to buy and they can sometimes take advantage of the situation by waiting. This appears to have been the result in *Estate of Blanche Potter*, N. Y. Law Journal, Nov. 19, 1946, p. 1379.

In the Potter case there was a "first offer" restriction in the by-laws and in the stock certificates of O. B. Potter Properties, Inc., to the effect that the shares could not be sold until an offer to sell them to the corporation at the same price had been made and refused. Blanche Potter had owned a one-fourth interest of 2,500 shares of $100 par value. By her will, she specifically bequeathed 360 shares and the corporation voluntarily offered to buy the remaining 2,140 shares from her executor at $33 per share. This proposal was rejected, and her executor then made a formal offer of the stock to the corporation at $100 a share. The corporation, in turn, rejected this offer. At this point, restrictions against an outside sale were removed but the efforts of the executor to sell the stock to outsiders were unsuccessful. Ultimately, the stock was put up for sale at public auction, at which the corporation purchased the shares on a bid of $60 per share. Then, to increase the difficulties of the estate of the minority stockholders even further, it was held that the executor must pay New York estate taxes on the stock based upon a valuation of $97.84 per share, which

figure was computed by taking the appraised value of a share, $115.11, and deducting 15 per cent from it by reason of the fact that the stock comprised a minority interest in the corporation.

Obviously, a "first offer" provision cannot prevent the development of the undesirable after-death situations that we have examined. Consequently, its use should be confined to its proper function of protecting suitably against *inter vivos* transfers to outsiders. We must search further for a plan adequate to provide for the situation created upon a stockholder's death.

OPTION ARRANGEMENTS

The stockholders of a close corporation often enter into an agreement which provides that upon the death of one of their number, the survivors shall have an option during a limited specified period of time to purchase the deceased's shares at a stipulated price.

A brief analysis of a few of the situations that may obtain upon the death of a stockholder with this type of agreement outstanding will show that the option arrangement functions in some instances but not in others. If the facts are such, for example, that the surviving stockholders desire to buy the deceased's stock at the agreed price and are also in a position to pay this price, the survivors will thus be able promptly to regain the full ownership and control of the corporate enterprise, and at the same time the heirs will be well served if an adequate price has been set. Furthermore, the survivors will be able to obtain specific performance of their option to purchase the stock when the option is properly exercised, as evidenced by the following quotation from *Johnson v. Johnson,* 87 Colo. 207, 286 P. 109 (1930), which case involved an option given to the surviving stockholder that permitted him to purchase 100 shares:

> The corporation is a close corporation. The stock has no fixed or market value and is not quoted in the commercial reports or sold upon the stock boards. The 100 shares in question are essential to the control of the cor-

> poration. In such circumstances an action for damages would not afford adequate relief; hence a suit for specific performance will lie.

On the other hand, if the survivors are unable to purchase because of lack of funds, or if they prefer to play a "waiting game" rather than exercise their option, nothing is accomplished by the arrangement.

Because of the very definite possibility that the surviving stockholders, particularly in those instances in which they already own the majority of the stock, will prefer to let their option rights go by default, coercive "teeth" are sometimes worked into option agreements in an effort to assure their exercise. This was evidently the purpose of the provisions involved in the case of *In re Block's Will,* 60 N. Y. S. 2d 639 (1946).

Four brothers, Wolfe, Tony, Herman, and Maurice Block, had conducted a partnership engaged in the business of importing bristles. In 1939, they incorporated as Block Bros., Inc., with Wolfe and Tony each owning 40 shares, and Herman and Maurice each owning 10 shares. They then entered into an option agreement that provided:

> In the event of the death of any of the parties, the survivors shall have the right . . . to purchase the stock of the deceased. If the surviving parties do not elect to purchase . . . then the executor or personal representative of the deceased may sell the said shares to any other person. If the said executor or personal representative . . . shall be unable to sell the said stock, then at the option of the executor or personal representative . . . , the parties hereto agree that the corporation shall forthwith be dissolved and liquidated and distribution of assets promptly made.

This agreement was destined for heavy duty, for Wolfe died in 1942, Tony died in 1943 and Herman died in 1945.

At Wolfe's death, his will left all of his property to his widow, Bessie F. Block. She was nominated as executrix but renounced the appointment. She subsequently requested Maurice to purchase the 40 shares owned by her as a result of Wolfe's death, Tony and Herman having died in the interim.

Upon Tony's death, his will left his shares in trust to pay

his widow, Minnie, $25 a week for life, with the widow, his brother Maurice, and one Scheer as trustees. The will also provided that upon the dissolution of the corporation within five years after Tony's death, seven-twelfths of the amount received on his shares by the trustees upon the dissolution and distribution of the corporate assets should go to Maurice and the balance be held in further trust for the widow. The trust was set up in accordance with these provisions.

Upon the death of Herman, who was the third of the four brothers to die within a span of three years and one month, the survivor, Maurice, found himself in no financial position to purchase either the shares formerly owned by Wolfe or those formerly owned by Herman. Herman's widow, Dora, then joined with Wolfe's widow, Bessie, in demanding the dissolution of the corporation, apparently without either of them having made any effort to sell the stock to outsiders. Herman left no will, and Dora was appointed administratrix of his estate. Pursuant to the demand, a call was issued for a special meeting of the stockholders to consider, among other things, the matter of dissolution of the corporation.

The widow of Tony brought this suit to remove Maurice and Scheer as trustees under Tony's will, on the ground that they were about to vote for a dissolution and that Maurice was personally interested in seeing the corporation dissolved because in such an event he would receive seven-twelfths of the value of the stock held in the trust. Maurice's removal was also requested on the ground that he was receiving a salary from the corporation while he was acting as trustee. It was contended that the demand made by Wolfe's widow could have no legal effect because she had renounced her appointment as personal representative, and that the demand made for dissolution by Herman's widow should be disregarded by Maurice because the widow had made no prior effort to sell the stock to outsiders.

By the time the case reached a hearing, the meeting of the stockholders had been held and a dissolution of the corporation directed, Maurice and Scheer voting in its favor. The practical question, therefore, was whether they had violated their duties as trustees.

The court dismissed the petition, holding that the fact Maurice would receive a portion of the trust property on dissolution of the corporation did not disqualify him as trustee. It was also pointed out that his salary from the corporation was proper since he had always been a salaried officer of the corporation and, under another provision of the agreement, had promised to devote all his time and attention to the business of the corporation. On this point the court said further:

> It is apparent that without Maurice, the last survivor of the firm of Block Bros., Inc., there would be *no business,* since it is evident that it depends upon his knowledge and experience. The salaries which he has received have not been unreasonable. No misconduct or overreaching has been shown.

The court took the position that the widow of Herman could validly demand the dissolution of the corporation under the agreement, saying:

> Under the agreement, the demand made by her was sufficient for the purpose of obtaining a dissolution without considering the legal effect of the demand made by Bessie . . . , who did not represent the estate of Wolfe . . . as a fiduciary. It was not obligatory upon her to make efforts to sell the shares to any other person upon Maurice Block's refusal to purchase. The agreement provided that the executor or personal representative "may" sell the shares to any other person. Furthermore, in view of the nature of the shares themselves, being those of a closely held corporation, having no general market and not saleable to the general public in the usual manner, it would be extremely difficult if not impossible to obtain a ready buyer for the shares. The agreement plainly provides an estate fiduciary with a method of liquidating these shares where the fiduciary deems it necessary to do so.

Thus, the "teeth" put into this option arrangement proved to have a powerful "bite," but the ultimate result was the reverse of that intended. Instead of remedying the inherent weakness of the option arrangement, that is, freedom of choice on the part of the optionee, it resulted in dissolving the corporation.

No doubt there are rare and unusual circumstances in which

an option arrangement is justified as the best solution obtainable. The uncertainty of its exercise and its one-sidedness in favor of the surviving stockholders however, classify it as a distinctly second rate arrangement, incapable of furnishing a certain solution to the problems faced upon the death of a close corporation stockholder.

PURCHASE AND SALE ARRANGEMENTS

The most common arrangement to solve the situation brought about by the death of a stockholder in a close corporation is an agreement among all the stockholders, providing that upon the death of one of their number, the survivors agree to purchase the deceased's stock at a specified price.

Such an arrangement eliminates the defects encountered in the use of "first offer" and option plans. "First offers" need not be made at all, and if they are made, they need not be accepted, as we saw in the Potter case. Options compel an offer to be made, as held in the Johnson case, but again the offer need not be accepted, as is illustrated by the Block case. Under the purchase and sale arrangement, on the other hand, the estate of the deceased stockholder is bound to sell and the surviving stockholder or stockholders are bound to buy the deceased's shares of stock in the corporation at a figure that all have agreed upon in advance.

The purchase and sale arrangement, therefore, is the only workable plan by which, upon the death of a close corporation stockholder, the survivors may be certain that they will acquire full ownership and control of the enterprise and by which the family of the deceased may be certain that they will receive the full value of his stock. A proper agreement to that effect among the stockholders while they are all alive binds the transaction. The only remaining hazard is the possibility that the survivors will not have the funds at hand, when death occurs, to pay for the deceased's stock interest. The elimination of this hazard is a simple matter, however, provided that the stockholders are insurable. In such a case, all that remains to be done is to include in the purchase and sale arrangement an insurance policy on the life of each stockholder in the amount of his interest. The purchase price is then assured.

Part III

THE STOCK PURCHASE AND SALE AGREEMENT FINANCED WITH LIFE INSURANCE

CHAPTER 10

The Insured Purchase and Sale Agreement—General Considerations

LIFE INSURANCE ASSURES CARRYING OUT OF PURCHASE PLAN

Detailed examination of the situation confronting the surviving stockholders and the estate and heirs upon the death of a close corporation associate has demonstrated the urgent need for a plan, effective at death, that will place the entire ownership and control of the enterprise in the hands of the survivors and that will promptly reimburse the deceased's estate in full for the value of his stock interest. Careful scrutiny of the alternate plans available to the stockholders has shown that only one arrangement, a binding purchase and sale agreement financed with life insurance, guarantees the attainment of these essential objectives.

The life insurance method of financing the purchase of the deceased's stock at death not only removes the hazard that the survivors will not be in a position to buy, but also provides them with the most convenient and attractive method of obtaining

the purchase money when it is needed. A brief analysis of other methods readily confirms this fact.

Methods of financing other than with life insurance. Methods of financing the purchase price of a deceased associate's stock other than the purchase of life insurance demand that at least one-hundred cents on each dollar of purchase price be taken either immediately or ultimately from the pockets of the purchasers. If the surviving stockholders are wealthy, they can probably afford to pay the full purchase price immediately when a death occurs, but they will have no opportunity to pay over less than the full price. If the survivors are men of ordinary means, which includes the great majority of close corporation stockholders, they have the alternatives of borrowing the funds at the time of the death, or if the agreement so provides, of paying the money in instalments after the death occurs. Any plan of building up the purchase money through advance savings as an alternate to life insurance, if the parties are insurable, is unsuitable because of the impossibility of ascertaining exactly how long the savings period will be. The facts in the Block Brothers case illustrate this.

Reliance on the ability of the survivors to borrow the money at time of death is feasible only for the wealthy. Furthermore, it requires the ultimate repayment of the full amount to the lender, with interest as well. In the ordinary case, this plan is risky for the survivors and creates a situation fraught with uncertainty and danger to the family of the deceased.

Provisions by which the surviving stockholders are allowed to pay all or the greater part of the purchase price in instalments over a period of years after a death occurs obviously put the receipt of a substantial portion of the purchase money by the deceased's family to the hazard of the future of the business, a hazard that is to be avoided if it is at all possible. Furthermore, such a plan places a heavy financial drain of principal and interest payments on the survivors during the very period in which they are pressed already to overcome the handicap of the loss of an active firm member.

The life insurance method of financing the purchase agreement. The outstanding merit of the life insurance method of

financing the purchase and sale plan is the certainty that the full purchase price of a deceased's interest will be furnished in cash at the exact time the money is required. This method, moreover, has the additional merit of affording the survivors the possibility of acquiring the purchase money with dollars discounted. In essence, it constitutes an advance instalment plan for obtaining the purchase price under an arrangement by which these instalment payments cease upon the death and the full fund is available, regardless of how few instalments have been paid.

These instalment payments, in the form of convenient, periodic insurance premiums rarely aggregate the face amount; usually the premiums amount to only about 3 or 4 per cent of the purchase price annually. This is made possible, first, because this arrangement comprises an investment plan in which compound interest is earned and credited; and second, because it is an *insured* investment plan, self-completing for the full amount upon the death of the insured. By this plan, the surviving stockholders are assured of owning the entire corporate stock, paid for in full, and the deceased stockholder's estate is assured of receiving the entire amount of the purchase price promptly and in cash. As we have observed before, if the life insurance contract had not been devised previously, it so exactly fulfills the requirements of the situation that it would surely have been devised to finance business purchase and sale agreements.

LEGALITY OF THE INSURED PURCHASE AND SALE AGREEMENT

It is probably true to say that today almost every jurisdiction will uphold the legality of a mutual agreement executed by the stockholders of a close corporation which provides that, upon the death of one of their number, the surviving parties will buy, and the deceased's estate will sell to the survivors at a specified price and terms, his shares of stock in the corporation.

As in the case of partnership agreements of a similar nature however, the fact that such a contract calls for performance at time of the death of a party has caused it to be challenged from

time to time on the ground that it is testamentary in character and therefore must qualify under the law of wills if it is to be valid. This challenge is not surprising in view of the fact that agreements of all types that call for performance at or after a certain death occurs have had to meet this same challenge because of a failure to distinguish the fundamental nature of such a contract from that of a last will and testament. Because the legal principle involved in these various agreements is the same however, the previous litigations concerning other similar contracts have served two valuable purposes: First, they have helped to clarify the legal distinctions between wills and contracts to be consummated at death; second, they have successfully established the legality of such contracts in cases that may properly be considered precedents with respect to stock purchase agreements. It is in point, therefore, to refer to one of these other cases, particularly in view of the fact that the opinion was written by Justice Holmes, then on the bench of the Supreme Judicial Court of Massachusetts.

Krell v. Codman. This was an action on a voluntary covenant executed by a woman in England which directed her executors within six months after her death to pay to the plaintiffs upon certain trusts the sum of £2,500, with interest at 4 per cent from the date of her death. The woman died domiciled in Massachusetts and the question was whether the covenant was enforceable in that state. The court held in the affirmative, stating that there would have been no doubt had the instrument been a contract for value. The comments of Justice Holmes in the case, 152 Mass. 274, 28 N. E. 578 (1891), will be of interest, particularly with reference to the distinguishing features of a will.

> It is agreed that by the law of England such a covenant constitutes a debt of the covenantor legally chargeable upon his or her estate. . .
>
> In our opinion, such a covenant as the present is not contrary to the policy of our laws, and could be enforced here if made in this state. If it were a contract upon valuable consideration, there is no doubt it would be binding. *Parker v. Coburn,* 10 Allen, 82. . .
>
> The truth is that the policy of the law requiring three witnesses to a will has little application to a contract. A

> will is an ambulatory instrument, the contents of which are not necessarily communicated to any one before the testator's death. It is this fact which makes witnesses peculiarly necessary to establish that the document offered for probate was executed by the testator as a final disposition of his property. But a contract which is put into the hands of the adverse party, and from which the contractor cannot withdraw, stands differently. See *Perry v. Cross,* 132 Mass. 454, 456, 457. . .
>
> There is no question here of any attempt to evade or defeat rights of third persons which would have been paramount had the covenantor left the sum in question as a legacy by will. There is no ground for suggesting an intent to avoid the provisions of our law regulating the execution of last wills, if such intent could be material when an otherwise binding contract was made. See *Stone v. Hackett,* 12 Gray 227, 232, 233. There was simply an intent to make a more binding and irrevocable provision than a legacy could be, and we see no reason why it should not succeed. Judgment for the plaintiffs.

It is now appropriate to look at the case of *Thompson v. J. D. Thompson Carnation Co.,* 279 Ill. 54, 116 N. E. 648 (1917), parts of the opinion of which are reminiscent of the above reasoning of Justice Holmes. This case involved a stockholders' agreement that contained the following rather unusual provision:

> Third. That in case of the death of J. M. Thompson, Helen T. Fish shall have the voting of the five shares of stock standing in the name of J. M. Thompson and that the dividends on the above five shares shall be paid to Vera Thompson.

After the death of stockholder Thompson, the agreement was challenged, primarily on the ground that it was testamentary. In holding it to be a valid executory contract, the opinion stated:

> . . . The agreement by which Helen T. Fish was to acquire this stock upon the death of her father contains all of the essentials of a valid and binding agreement. It is founded on a valuable consideration and became at once binding upon the parties thereto upon its execution. None of the parties thereto could withdraw from the same without the consent of the others. In this respect it is clearly

distinguishable from a will or other testamentary disposition of property. As said in *Cawley's Appeal,* 136 Pa. St. 628, 20 A. 567, 10 L. R. A. 93:

"A contract is an agreement between parties for the doing or not doing of some particular thing. The undertaking of one party is made in consideration of something to be paid or done by or on behalf of the other party, so that the obligation to do, and the right to require performance, are reciprocal. A will, on the other hand, is simply a statement of the purpose or wish of the maker as it exists at the time. As often as his purpose or wish changes he may change the expression of it. When and why a change may be made depends upon himself, alone. He is answerable to no one for his determination to make one rather than another disposition of his property. After he has written out his will, and executed it in accordance with the forms of the law, it does not bind him; but, so long as he lives, he may change his own purpose, with or without a reason, and his last purpose, properly written out and executed, is his 'last will and testament,' because death makes any further change impossible. The binding force of a contract comes from the *aggregatio mentium* of the parties; the binding force of a will comes from the fact that it is the last expressed purpose of the testator in regard to the disposition of his property after his own death. While he lives, it is without force or value; but it begins to speak when he ceases to do so, and thereafter is heard in his stead."

. . . This contract is mutually binding upon each and all of the parties thereto from the date of its execution. It could not be revoked or canceled by any of the parties thereto during the lifetime of Thompson without the consent of all, and was intended to be of such character that it might be enforced after his death. By its terms it is made binding upon the heirs and executors of the parties thereto. It imposes reciprocal rights and duties upon each of the parties thereto, and is of such a character that we think it could have been specifically enforced by any of the parties thereto in case of an attempted breach.

For the reasons given, we think the contract is not void as a testamentary disposition of the property. . .

It is next in order to consider a case involving a specific agreement of stock purchase upon the death of a stockholder. The case is that of *Fawcett v. Fawcett,* 191 N. C. 679, 132 S. E.

796 (1926). George Fawcett and his brother owned the stock of a bank, George being its president and his brother the cashier. In 1908, they entered into the following rather unorthodox agreement:

> Whereas, upon the death of either party of this contract, it is the desire and will of each and both that any and all shares of stock in the First National Bank of Mt. Airy, N. C., owned by either of the parties of this contract, at the time of death, shall become the property of the survivor, upon a par basis, and this instrument is a contract made by each and both parties hereto, to sell to the survivor said stock at par, and to give to the survivor five years during which to make payment for said stock, to be divided into five equal annual payments. And this contract shall be binding upon the administrators, executors or assigns of either party. This contract may be canceled by either party upon a change of mind, circumstances or sentiment with proper notice to the other party hereto in writing.

When George died intestate in 1920 he possessed bank stock amounting to $29,250 and was survived by a widow and three minor children. The surviving brother then took over the deceased's bank stock, had it retired or canceled, and caused a new stock certificate to be issued to himself in lieu of it. George's widow, as administratrix of the estate and as guardian of the children, then sued to recover the stock on the ground that the agreement was against public policy, was testamentary and was without consideration.

The court upheld the agreement as a valid and binding contract.

On the question of public policy the opinion stated:

> Nor do we find in the contract anything inconsistent with the doctrine of public policy. It has been said that public policy is an unruly horse, astride which one may be carried into unknown paths; and, observant of the danger, the courts as a rule are not alert to denounce a transaction as invalid, on the ground that it is against public policy, unless the transaction contravenes some positive statute or some established rule of law. A contract, for example, whereby A agrees to make a will in favor of B, or to refrain from making a will, is not of itself void on

> any ground of public policy; and a contract which is to be performed at the death of one of the parties is not for this reason illegal.

In making the point that the agreement was not void as testamentary, the court said:

> The agreement in question is not open to the objection that it is a testamentary disposition of property. . . . [Citing cases] It has only one witness, and purports to be, not a will, but an executory agreement. Six times it is specifically designated a "contract"; evidently it is "a present contract presently executed," the performance of which is deferred until the death of one of the parties. In *Green v. Whaley*, 197 S. W. 355, 271 Mo. 636, 653, it is said that a contract of this character resembles an agreement between two persons to make mutual wills, or to devise property in a certain way, or to leave it to a person at the death of the owner, without designating in what particular way it is to vest in the party to whom it is given; and in *McKinnon v. McKinnon*, 56 F. 409, 5 C. C. A. 530, the court said that such a contract is an executory agreement, which determines the rights of the parties inter se and provides what disposition shall be made of the property on the happening of a certain event—a contract which at the promisor's death will be specifically enforced in equity or become the foundation for an action at law. It is upon this principle that a negotiable instrument may be made payable after death or a contract enforced which provides that compensation shall be made after death for services rendered in the lifetime of the promisor. [Cases and texts cited]

The agreement nearly failed however, by reason of the insertion of its last sentence with reference to cancellation. The widow claimed that the birth of three children since the date of the agreement had wrought a change in the deceased stockholder's circumstances that was equivalent to a written notice and that made the agreement void. Some of the court's comments on this point are quoted here because of the distinction drawn between a contract and a will:

> Under our statute law a will is not revoked by any presumption of an intention on the ground of an alteration in circumstances or by the birth of a child after the will is made, although children subsequently born are en-

> titled to share in the estate. C. S., §§ 4135, 4169. But as we have said, the instrument in controversy is an executory contract, not a testament; hence the appellant's contention must be determined by the law of contracts. A contract may be discharged by performance; by a breach of such a material nature as to justify the innocent party in treating it as rescinded; by fraud, mistake, or duress; by release; by renunciation by parol agreement; by accord, novation, cancellation, alteration, merger, or impossibility of performance. 3 Williston on Contracts, § 1793 et seq.; Page on Contracts, § 2447 et seq. None of these conditions is pleaded or established by the evidence; and mere change in the circumstances of the parties is not sufficient to work a cancellation. The parties to a bilateral contract may agree to rescind it in a particular way, for, as there must be mutual assent to form a contract, there may be mutual assent as to the method by which it may be rescinded; that is, as the parties are bound by their agreement, so by their agreement they may be loosed from their mutual tie. Clark on Contracts, 606. Here the method of revocation was agreed on; by the express terms of the contract there must have been, not only a change of mind, or circumstances, or sentiment, but "proper notice to the other party hereto in writing." Such notice was not given, and presumptively there was no change that made notice necessary or desirable.

Now we come to one of the very few cases that have reached the courts challenging the validity of an insured stock purchase agreement entered into by the individual stockholders; and the facts of the case make it readily apparent why this agreement was destined to be challenged in court. The case is *In re Estate of Soper; Cochran v. Whitby,* 196 Minn. 60, 264 N. W. 427 (1935).

Ira Soper, a native of Kentucky, in 1911 married the plaintiff, Adeline Westphal, who was a widow with three children. After living together until August, 1921, Soper disappeared under circumstances strongly suggesting suicide. In fact, however, he went to Canada and from there to Minneapolis, where he lived the remainder of his life under the name of John W. Young. In 1922, he married another widow and they lived together until her death in 1925. In 1927 he married the defendant Gertrude Whitby, also a widow.

Under the name of Young, he and one Karstens organized the Young Fuel Company with $10,000 capital, each family owning one-half the stock. Subsequently, Young and Karstens each procured $5,000 of insurance payable to a Minneapolis trust company, and the insurance policies and certificates of stock were delivered to the trust company under an agreement that provided:

> Upon the decease of either John W. Young or Ferdinand J. Karstens, the Trust Company shall proceed to collect the proceeds of the Insurance Policies upon the life of such deceased Depositor, and shall handle and dispose of such proceeds as follows:
>
> The Trust Company shall deliver the stock certificate of the deceased Depositor to the surviving Depositor and it shall deliver the proceeds of the insurance on the life of the deceased Depositor to the wife of the deceased Depositor if living, and if not living, then to the representatives of his estate, and the stock certificates that were deposited by the Depositor who is then the surviving Depositor, together with the policies of insurance upon his life shall be delivered to such surviving Depositor.
>
> All of the stock deposited hereunder and all of the policies deposited hereunder or any part thereof may be withdrawn by said two Depositors on the joint receipt of both of them.

Soper (Young) actually did commit suicide in 1932, at which time the trust company collected proceeds of the insurance policy on his life and paid the money over to Gertrude Whitby as his surviving wife, and at the same time delivered to Karstens the policy on his life, together with the decedent's shares of stock.

Several months after these matters had been closed out, Mrs. Soper, the true wife of Young, made her appearance; Cochran was appointed administrator of the estate, and he and Mrs. Soper brought this suit against Gertrude Whitby and the trust company to recover the insurance money.

The court held the agreement valid against the contention that it was a testamentary disposition, and held that Gertrude Whitby was the person under the agreement intended as the recipient of the insurance proceeds. The opinion of the court

on the first point is quoted at some length because it ties in most of the important cases on the subject, including the leading cases on partnership agreements. This case shows clearly that the principle involved in the contract is the decisive factor, not the subject matter of the contract. Because this particular agreement was in the form of an "escrow agreement" or revocable insurance trust, the first part of the opinion upholds the validity of such an agreement as follows:

> . . . Nor do we think the escrow agreement can be considered a testamentary disposition of the insurance money or of any other property included in that instrument. It was not so intended, and nothing therein contained can be so construed. Rather, so it seems to us, it takes the form of and functions as an insurance trust. The legal right to demand and receive the insurance money was by the agreement vested in the trust company. It was the payee in both policies. The legal title to the stock certificates vested in it Immediately upon the death of the insured the rights of the settlors and beneficiaries were finally established. The duty of the trustee to act as in the agreement stipulated became operative. What had theretofore been a passive or inactive matter became at once upon Young's death an obligation requiring action. The trustee performed thereunder. It could do no more, and duty required it to do no less. . .
>
> An insurance trust having been created, the cases seem to hold with practical unanimity that such trusts are nontestamentary. The mere fact that the settlor reserves the right to revoke the trust does not destroy its efficacy as an insurance trust if the event upon which the trust depends takes place before revocation is made effective. A late and very important case bearing on this subject is *Gurnett v. Mutual Life Ins. Co.*, 356 Ill. 612, 191 N. E. 250.

The opinion then goes on to discuss the validity of the arrangement on the assumption that the "escrow receipt" might not constitute an insurance trust, and it brings in a discussion of the contract law on this subject:

> Even if it be conceded that this was not an insurance trust, the authorities generally seem to hold that such arrangements, even if not involving the trust aspect, are valid as inter vivos transactions because they are contractual in nature. Thus in *Coe v. Winchester* (Ariz.) 33 P. (2d) 286, it

appears that two partners entered into a written agreement whereby each agreed that he would effect a policy of life insurance payable to his wife. On the death of either, the wife of the deceased was to get the insurance and the surviving partner was to take the deceased's interest in the partnership. Under Arizona law each partner's interest in the business is community property belonging equally to the partner and his wife. But as to such property the husband has complete right to disposal of the entire interest by any deal inter vivos, but cannot make a testamentary disposition of his wife's interest. One of the partners died. His wife claimed a one-fourth interest in the business on the theory that the attempted disposition of the property was testamentary and therefore could not affect her community interest. The court came to the conclusion that the contract was not a testamentary disposition of property and that as such the entire one-half interest of the deceased partner had been validly transferred. Other cases upon this phase are *Murphy v. Murphy,* 217 Mass. 233, 104 N. E. 466; *In re Mildrum's Estate,* 108 Misc. 114, 177 N. Y. S. 563; *In re Eisenlohr's Estate,* 258 Pa. 438, 102 A. 117; *McKinnon v. McKinnon,* (C.C.A.) 56 F. 409; *Thompson v. J. D. Thompson Carnation Co.,* 279 Ill. 54, 116 N. E. 648. In the last cited case the court held an agreement between a stockholder and a corporation, of similar nature, import, and purpose to those of partnership cases hereinbefore cited, to be mutually binding upon each and all the parties thereto from the date of its execution. It was held that there was no testamentary disposition of the property.

The decisions arrived at in the foregoing cases, based upon a proper and fundamental distinction between a valid executory contract and a last will, leave no doubt that stockholders in a close corporation may enter into a contract, financed with life insurance, by which, upon the death of one of their number the surviving stockholder or stockholders are legally bound to purchase, and the estate of the deceased stockholder is legally bound to sell, the deceased's stockholdings in the enterprise.

COURTS WILL SPECIFICALLY ENFORCE CLOSE CORPORATION STOCK PURCHASE AND SALE AGREEMENTS

Ordinarily, upon the failure of a party to carry out his obligations under a contract, a court will award money damages to

the aggrieved party. In the case of a contract for the purchase and sale of close corporation stock by its active stockholders however, it is readily apparent that an award of money damages constitutes an inadequate remedy for the refusal of either party to carry out his part of the transaction. In such a case, there is no open market in which the buyer may procure like shares of stock; indeed, the stock is otherwise non-procurable. And from the standpoint of the seller, there is little or no other market. For these reasons, the courts grant specific performance of such agreements; that is, they decree that the recalcitrant party specifically perform his part of the bargain.

As evidence that the special remedy of specific performance will be decreed, it was said of the contract in the Thompson Carnation case: "It imposes reciprocal rights and duties upon each of the parties thereto, and is of such character that we think it could have been specifically enforced by any of the parties thereto in case of an attempted breach."

Further evidence is available in the cases that have dealt with the enforcement of option agreements to purchase close corporation stock at death. One of such cases was *Menke v. Gold Medal Oil Co.*, 47 Ohio App. 180, 191 N. E. 472 (1933). Another, previously referred to, was *Johnson v. Johnson*, 87 Colo. 207, 286 P. 109 (1930), in which the case was remanded to the lower court with a direction to grant specific performance if the option was found to have been exercised within a reasonable time. A third was the option agreement involved in the Lindsay cases, 205 Pa. 79, 54 Atl. 488, and 210 Pa. 224, 59 Atl. 1074.

The best evidence, however, that the courts will specifically enforce a close corporation stock purchase and sale agreement financed with life insurance is such a case as *Bohnsack v. Detroit Trust Co.*, 292 Mich. 167, 290 N. W. 367 (1940).

In 1926, Bohnsack, Fouts, Pomfret, and two others organized the Mich-I-Penn Oil and Grease Company. In 1931, they entered into a written agreement providing that if any stockholder wished to dispose of his shares during his lifetime he would sell them to his fellow stockholders, and providing also for mandatory sale to the survivors upon death. Each stockholder was to take out life insurance to the amount of $20,000, payable to the Union Guardian Trust Company as trustee. On

his death, the value of the deceased's stock was to be ascertained by a stipulated method, the shares of stock were to be turned over to the surviving stockholders, and the avails from the insurance were to be applied in payment. Life insurance was purchased as agreed upon and deposited with the trust company for the purposes of the agreement.

In 1934, the other two stockholders sold their shares to Bohnsack, Fouts, and Pomfret and were released from the agreement; however, the remaining stockholders agreed in writing that the original agreement would remain in full force and effect as to them.

Then occurred an incident that ultimately brought the agreement into court. One policy for $10,000, taken out by Pomfret, lapsed and he took out another for the same amount, but instead of his making it payable to the Union Guardian Trust Company under the stock purchase trust agreement he designated his wife and relatives as beneficiaries and deposited it with another trust company. Shortly afterward Pomfret died and the defendant, the Detroit Trust Company, was appointed executor of his estate.

Upon the refusal of the executor to carry through the purchase and sale transaction, Bohnsack filed this bill for specific performance of the agreement, asking that he and Fouts be decreed the owners in equal shares of the stock that was held by Pomfret and that was now in the hands of his estate.

The court granted the surviving stockholders specific performance of the purchase and sale agreement, the opinion stating:

> The agreement was valid and under it the plaintiff is entitled to have specific performance.
>
> An action at law to recover damages for breach of the contract would not afford adequate remedy but, in effect, destroy the very purpose of the agreement by opening the way for holding of the stock by third persons.

Manifestly, the failure of Pomfret to substitute the new insurance in the place and stead of the lapsed policy under the purchase agreement created a situation that was bound to be litigated. With respect to this the court said:

> When Mr. Pomfret took out the mentioned policy, with his wife and relatives named beneficiaries, it was a breach of the contract but valid as to the beneficiaries and may not be disturbed as to them in this proceeding inasmuch as the beneficiaries are not parties, but that does not release the estate from performing the contract and giving credit for the amount of that policy in payment for the shares of stock.

Once an agreement goes to court, it is the duty of the opposing attorneys to attack it assiduously from every possible angle. It was to be expected, therefore, that the validity of this agreement would be challenged. The opinion, in addition to citing the Lindsay cases and *Coe v. Winchester,* quoting from their headnotes, had the following to say:

> It was the legitimate desire of the organizers and sole stockholders to have and maintain a close corporation, with consequent benefit, and to that end entered into the contract. The contract was of mutual benefit, upon sufficient consideration and legitimate, unless it can be said that the insurance feature rendered such part thereof invalid.
>
> Mr. Pomfret had an insurable interest in his own life, with right to designate a trustee beneficiary and direct such beneficiary to carry out his contract.
>
> The validity of the insurance is unquestioned. The contest is over the contract application of the insurance.
>
> The contract carried out the purpose of a close corporation and the insurance feature was in furtherance of that end, and was not a speculation in human life but a protection, by mutual desire, of business relations and interests.

SUMMARY

A purchase and sale agreement financed with life insurance furnishes close corporation stockholders with the most certain and most economical method of providing for the situation brought about by the death of an associate. It is the safest plan available because it sets up in advance, through the medium of a valid, specifically enforceable contract, a binding obligation to buy and sell at time of death. It is the most economical plan because it takes advantage of compound interest and the insur-

ance principle to provide the purchase money, often with a great discount of dollars. For the most recent example of this, consider the Bohnsack case, in which a binding obligation was specifically enforced and in which the death of Pomfret occurred during the third policy year of the insurance originally purchased to finance the plan.

CHAPTER 11

Contents of the Insured Stock Purchase and Sale Agreement

Introductory. Agreement must be drawn by a competent attorney. A carefully written purchase and sale agreement, including in it provisions for life insurance financing, constitutes the legal basis for assuring that upon the death of an associate in a close corporation the surviving stockholders will succeed to its full ownership and control and that the estate of the deceased stockholder will receive in cash the full value of his stock interest.

The agreement, in most states, may take either of two forms: a buy-and-sell agreement, in which the individual stockholders are the parties and the surviving stockholders the purchasers of the shares of a deceased stockholder; or a so-called stock retirement agreement, in which the corporation is a party and is the purchaser of the shares of a deceased stockholder. Since the stock retirement plan has many distinct characteristics, that plan is discussed separately in Chapter 13. Until that chapter is reached, the text will be concerned largely with plans of individual purchase of stock under buy-and-sell agreements. Such an agreement stipulates that, upon the death of a stockholder, the surviving stockholders will buy the deceased's stock in the corporation at an agreed price; that insurance will be carried on the life of each stockholder to supply the purchase

money; and that simultaneously with the payment of the purchase price, the executor or administrator of his estate will transfer the deceased's shares of stock to the surviving stockholders. Because the surviving stockholders rely upon this contract for the ultimate acquisition of full ownership and control of the enterprise, and because the deceased's family relies upon it for prompt cash payment of the full value of the deceased's stock, the document assumes a role of such obvious importance to all concerned that the parties are reckless indeed if they fail to entrust its preparation to a competent attorney.

THE BROAD PATTERN OF THE AGREEMENT

Insured stock purchase and sale agreements have been in common use for a substantial number of years; thousands of them have been drafted, each "tailored" to fit the particular circumstances involved. Since all of these agreements have dealt with similar problems and like subject matter, however, their contents have followed a broad general pattern consisting of the essential commitments that such agreements should include. They may be itemized as follows:

1. A definite commitment on the part of each of the stockholders not to sell or otherwise to dispose of his stock during his lifetime without first offering it for sale to the other stockholders (or to the corporation, in case of a stock retirement agreement) at a stipulated price.
2. A definite commitment, not merely an option, on the part of all the stockholders in which they agree, binding their estates, that the surviving stockholders will buy, and the deceased stockholder's estate will sell and transfer to the survivors, the shares of stock of a deceased stockholder. In the case of a stock retirement agreement, the corporation commits itself to purchase the shares.
3. A definite commitment as to the purchase price to be paid for the deceased stockholder's shares.
4. A definite commitment by the stockholders to purchase and maintain under the agreement life insurance policies in an agreed amount with which to finance the purchase, the proceeds of which policies to constitute purchase-price money

for the shares of stock when it is received by the deceased stockholder's estate. In the case of a stock retirement agreement, the policies are purchased and maintained by the corporation.

5. A definite commitment as to the ownership and control of the life insurance policies made subject to the agreement, and as to the disposal of the policies on the lives of surviving stockholders.

6. A definite commitment with respect to the time and manner of paying any balance of the purchase price in excess of the insurance proceeds, and, conversely, with respect to the disposition of any insurance proceeds in excess of the purchase price.

CONTENTS OF THE AGREEMENT

Introductory. Because each close corporation differs in some respects at least from every other corporation, no two insured stock purchase and sale agreements can be identical. Nevertheless, since they all serve to accomplish the same basic objectives, that is, the buying and selling of a deceased stockholder's shares and the payment for them from the proceeds of business insurance carried on his life, the general structure of such agreements is sufficiently circumscribed to permit an analysis and discussion of the principal provisions usually contained in them. This will now be attempted from a functional standpoint without our considering the important matter of the appropriate technical legal wording of such provisions, since this last is the special province of the drafting attorney.

The parties to the agreement. Ordinarily, all the stockholders, together with a trustee selected by them, constitute the parties to the purchase and sale agreement. Obviously then, all the stockholders must become parties if the arrangement is going to make certain that upon the death of any stockholder the survivors will succeed to full stock ownership in the enterprise. A trustee is not a necessary party to the agreement, but he is desirable as an impartial "third party" to act as a depositary for the shares of stock and the insurance policies during the lifetime of the stockholders and, when a death takes place, to supervise the consummation of the transaction. More will be said later of the functioning of the trust plan, in discussing insurance beneficiary arrangements.

In the case of a corporation stock retirement agreement, the corporation itself will acquire the shares of a deceased stockholder, and is made a party to the agreement for that purpose.

In community property states, it is recommended that the agreement include the wives of the stockholders as signatories unless the attorney for the stockholders in the particular case, who is familiar with the requirements of the local community property law, decides that this is unnecessary.

The purpose of the agreement. The preamble of a well-drafted stock purchase agreement contains a recital setting out in brief the purpose and intent of the parties entering into the agreement. These recitals state, for example, that the parties all are active in, and together own the stock of, the close corporation involved; that in the event of the death of one of their number, the transfer of his stock to any person other than the surviving stockholders (or the corporation) would tend to disrupt the harmonious and successful management and control of the corporation to which the parties concerned have devoted years of time, attention, and personal energy; that it is the desire of the parties to avoid any such unfortunate contingency and to assure that the estate of a deceased party will receive the full going-value of his stock interest by making provision for the purchase of a deceased's shares at time of death by the surviving parties (or the corporation) and for the use of life insurance to aid in funding such purchase. Recitals of this nature serve to clarify the intentions of the parties and have proved of real significance in cases in which ambiguities have inadvertently crept into the agreement elsewhere.

The "first offer" commitment. The preservation of the enterprise as a close corporation among the original associates who remain active obviously calls for a provision in the agreement that requires that any stockholder who retires or desires to dispose of his stock for other reasons shall first offer his shares for sale to the other stockholders (or to the corporation) before he shall have the right to make any other disposition of them. The usual provision of this type allows a period of at least thirty days during which to accept such an offer and may provide that upon refusal and subsequent failure of the offering

stockholder to dispose of his stock elsewhere within a specified period, such as six months, a new "first offer" must be made of the stock to the other stockholders (or the corporation). Furthermore, the other stockholders (or corporation) should be given the right to purchase such stock at the same contract price that governs on purchase in the event of a stockholder's death, if such a price is to be binding on death as to the valuation of the stock in the deceased's estate under the Federal estate tax law. There are other important phases in the matter of estate tax valuation, however, and more will be said on this point later in a chapter devoted entirely to tax problems.

The commitment to sell and buy. A buy-and-sell agreement should stipulate in unequivocal terms that each stockholder, binding his heirs, distributees, personal representatives, and assigns, agrees to sell to the surviving stockholders and the surviving stockholders agree to purchase, all of the stock that the deceased stockholder may own in the corporation at the time of his death. In the case of a stock retirement agreement, the stockholders commit their estates to sell their stock to the corporation, and the corporation agrees to buy a deceased stockholder's shares.

(For purposes of identification and clarity, it is advisable to state, either in the recitals or in an appended schedule, the certificate number and the number of shares owned by each stockholder. An appended schedule is preferable, since provision may be made to register in it any subsequent changes in stockholdings among the parties.)

The provision for stamping stock certificates. Unless a trustee is made a party to the agreement, in which case the stock certificates will be endorsed in blank and delivered to the trustee, each stock certificate should be stamped or inscribed with a legend to the effect that the certificate is subject to a stock purchase and sale agreement of specified date between its owner and the other stockholders and is transferable only in accordance with the agreement.

The price to be paid, and valuation formula, if used. The purchase price to be paid per share for the stock of a deceased stockholder may be fixed by the use of any one of a variety of

available methods. The stockholders should choose whatever method is most satisfactory to them and see that it is clearly set out in the agreement.

Probably the most popular method is to fix the exact purchase price in advance. At the time of entering into the agreement the price per share will be agreed upon and stated, with the further proviso that the parties may revise the stated figure at any time by indorsing the revised figure upon the contract, the last price stated prior to death to control. If it is expected that there will be need for frequent revisions, it may be provided that a price must be indorsed upon the contract in each fiscal year; and in case of failure to do so, the purchase price will be fixed by taking the last stated figure as a base and adjusting it for subsequent changes in book value to date of death as determined by the accountants of the corporation. Or if the parties prefer, they may provide for the substitution of an entirely different method of valuation in case no stated price has been filed within a year prior to death. The method of using a stated purchase price has the following advantages: First, there can be no misunderstanding as to the amount itself; second, each of the stockholders, knowing exactly what his stock will bring, can plan his estate with precision; third, the stockholders, knowing the exact purchase price that will be required, are afforded an opportunity to keep the price fully insured; fourth, it simplifies the terms of the agreement and the consummation of the transaction.

Sometimes the agreement will provide that the purchase price of a deceased's shares will be their book value at time of death, this to be determined by taking the value from the last company statement drawn off prior to death and adjusting it by adding 6 per cent interest to the date of death and by subtracting any dividends paid in the interim. A variation of this method is to take the book value as found by the corporation's accountants as of the date of death. Whatever plan is used to obtain book value, however, the fact remains that this method is deficient in that it does not set the purchase price of the deceased's stock at a figure that reflects the going value of the business; it fails to include any value for good will, and consequently it is not to be recommended under normal circumstances.

Many stock purchase agreements provide that the purchase price shall be determined by the application of a stated formula. The purpose of this method is to reflect as accurately as possible the value of good will in setting the price, but unfortunately there is no consensus that any one formula among those in use will do this best. A few of these formulas will be discussed.

One formula calls for the "straight capitalization" of the average net profits of the corporation at a definite rate, for example, 10 per cent, the result being taken as the total value of all the stock, including good will. This is then divided by the number of shares to arrive at the price per share. It should be explained that capitalization of net earnings is simply the capital figure that, at the rate of capitalization used, would yield those net earnings. To illustrate, such a formula might require that the net profits be averaged for the last five complete fiscal years prior to death and then capitalized at 10 per cent to obtain the total value. Assume, then, that the average net profits for the last five years have been $20,000. Dividing this figure by 10 per cent gives a total figure that, at 10 per cent, will yield $20,000 per year; namely, $200,000. Dividing this total value by the number of shares gives the value per share; and multiplying that value by the number of shares owned by a deceased stockholder determines the total purchase price for his shares.

This plan is flexible in that a capitalization percentage may be selected by the stockholders to approximate most closely what they believe to be the value of their stock. It is often an impractical plan in the case of a small close corporation for the reason that the corporate books rarely portray the true profits of the enterprise, most of the earnings of which are absorbed in the form of salaries. Then too, abnormally profitable and unprofitable years should not be used in striking an average of past net profits; and it would be a difficult matter to provide properly for doing this in a purchase agreement. And lastly, the past profits have been earned by *all* the stockholders and may very well overvalue the stock in the light of the fact that one of the two, three, or more associates will be gone when the valuation is made.

Another formula is that known as the "years' purchase method." Under this method, a return of 6 per cent is usually

allowed on the average book value (averaged over a stated period of years) and this amount is deducted from the average earnings (also averaged over a stated period of years). The remaining profits are then multipled by the stated number of years' purchase, such as three, four, or five, to compute the value of good will. The value of good will so determined is thereupon added to the book value to arrive at the total value under the formula. The following illustration should make this method clear:

Average book value (capital stock and surplus)		$120,000
Average net profits	$12,000	
6 per cent return on average book value	7,200	
Excess of profits over 6 per cent of book value	$ 4,800	
$4,800 multiplied by 5 years' purchase, shows a good-will valuation of		$ 24,000
Total value of the corporation		$144,000

It will be noted that the years' purchase method is also flexible in that the number of years taken may be varied with the circumstances of the particular corporation. Like the straight capitalization method, however, it must rely upon average net profits, which may or may not reflect the true profits earned by the enterprise. To correct this, it would probably be necessary to provide in the formula that salaries beyond a specified amount be considered part of the profits. Again, provision should be made for the elimination of abnormal years when applying the formula. And to all of these difficulties must be added the drawback inherent in every formula; the purchase price established by it cannot be ascertained finally until after a death occurs.

Thus it is apparent that the use of any method of valuation except that of taking book value alone, which is patently deficient, calls for some arbitrary decision on the part of the stockholders. In the case of a stated purchase price, the stockholders must set the actual figure. If the straight capitalization method is employed, they must decide upon the rate to be used. And if the years' purchase method or a similar method is decided upon,

they must stipulate in the formula the number of years to be used. In addition, there is the problem of defining and eliminating the abnormal years before applying any formula that uses average net profits, not to mention the problem of isolating only normal salaries in place of the actual salaries drawn by the stockholders. It is submitted that in most agreements the parties might as well go "whole hog" in the first place by stipulating the exact purchase price, with provision for its future revision from time to time as circumstances dictate. After all, the value of shares of stock in a close corporation cannot be ascertained with exactitude, and there is good reason to believe that a stated purchase price determined and agreed to by the stockholders among themselves while they are all alive not only will be as accurate as any other obtainable, but will be the most practical figure to use.

The financing of the purchase with life insurance. The life insurance policies made subject to the agreement should be recorded in the body of the agreement or, preferably, in an appropriate schedule appended to it. The agreement should state that the purpose of the insurance is to provide cash to be applied against the purchase price of a deceased insured's shares of stock and that the proceeds of the insurance when received by the deceased's estate or heirs, whether the estate receives it directly as named beneficiary or indirectly from the surviving stockholders or from their trustee, shall be credited to the survivors as payment on account or in full, as the case may be, of the purchase price for the deceased's stock. Careful scheduling of all policies made subject to the agreement is essential in order to eliminate any possible confusion with the personal insurance owned by the stockholders or with any other business insurance that may be carried for the purpose of indemnifying the enterprise for the loss of services of a valuable associate, or for credit purposes.

Provisions for adding, substituting, or withdrawing policies. A stock purchase agreement is likely to remain in effect for a number of years, during which time substantial changes may occur in the value of the stock of the corporation. If the value of the stock increases substantially, a common development, the stockholders will want to cover the commitment to buy with

additional insurance. On the other hand, if the value decreases, they may desire to release some of the insurance from the obligations of the agreement. And even though no appreciable changes take place in the value of the stock, it is possible that a stockholder (or the corporation, in case of a stock retirement agreement) might prefer at a later date to substitute a different policy of like amount. Hence the agreement should provide for the addition, substitution, or withdrawal of policies on notice to, or written consent of, all the parties. It is essential, of course, to record in the agreement any changes made in the composition of the insurance made subject to the agreement.

Adjustment when amount of insurance proceeds differs from purchase price. The amount of insurance payable on the death of a stockholder may exactly match the purchase price to be paid for the deceased's stock, or the insurance proceeds may be either over or under that figure. If, for example, the purchase price is to be ascertained by a formula applied at death, it would be a rare coincidence were the two figures the same. And in the case of a stated purchase price, a death could occur at a time when, for one reason or another, the full component of insurance was not carried. Every agreement, therefore, should contain provisions specifying the adjustments that are to take place if the insurance proceeds and the purchase price of a deceased's stock differ in amount.

When the insurance proceeds exceed the purchase price, it is usually provided in a buy-and-sell agreement that the full amount of such proceeds will nevertheless be paid over as the minimum purchase price. In other words, it is provided that the purchase price will be the amount called for under the regular price-fixing clause of the agreement or the amount of the insurance proceeds, whichever amount is greater. Although any other disposition of excess insurance proceeds may be made that the parties desire, a provision establishing the insurance proceeds as the minimum amount of money that a deceased stockholder's estate will receive has the distinct advantage of enabling the parties to plan their estates with a precision otherwise unobtainable, particularly if a valuation formula is to be applied at time of death. Where a stock retirement agreement

is used, it is customary to provide that any excess of insurance proceeds over the purchase price collected by the corporation shall be retained as general corporate funds.

When the purchase price exceeds the insurance proceeds, it is customary to provide that the balance, if not paid in cash, will be paid by the delivery of a series of interest-bearing notes made by the surviving stockholders or by the corporation, depending upon the type of agreement, and payable to the estate of the deceased stockholder. This series of notes may mature over a period of months or over a period of years, depending upon the circumstances of the particular case and the wishes of the stockholders. Better than merely providing for the period over which the notes are to run, however, is a provision to the effect that any balance of the purchase price be paid in stated equal amounts at specified intervals, thus permitting the number of instalments, rather than their amount, to vary with the size of the total balance owed.

The advantages of this arrangement are obvious. The stockholders usually know approximately what amount can be paid periodically by a survivor (or by the corporation under a stock retirement agreement) without financial embarrassment. Often the amount of these instalments can be set at a figure to approximate the amount of salary payments being made to the deceased stockholder at time of death. This arrangement affords both definiteness and flexibility. Under it, a small balance will be quickly retired. On the other hand, a large balance will not impose too heavy a financial burden upon the survivors. Any instalment arrangement should include the privilege of prepaying any outstanding notes at any time. Provision may also be made, if desired, for the immediate maturing of all the notes outstanding in the event of default in making any payment.

Securing any unpaid balance. Collateral security for any unpaid balance of the purchase price may be provided for by stipulating in the agreement that the personal representative of the deceased stockholder shall retain stock to perhaps 150 per cent of the amount of, and allocable to, each unpaid note; the personal representative is to transfer the stock held as collateral for this amount as each note is subsequently paid. Col-

lateral assignment of the insurance policies on the lives of the survivors subject to the agreement may also be specified.

At this point it should be emphasized again that the maximum benefit cannot be obtained from an insured purchase and sale agreement unless the stockholders keep the purchase price as fully insured as possible, in the light of the valuation method used by them. Most stockholders realize the great value to them of doing this, with the result that in the vast majority of cases the balance payable, over and above the insurance proceeds, is either nonexistent or insignificant in amount.

The payment of premiums. The agreement should state clearly who is obligated to pay the premiums on each life insurance policy made subject to it. In the case of a stock retirement agreement, the premiums are paid by the corporation. Most buy-and-sell agreements provide that the premiums for each policy shall be paid by the stockholders other than the insured in proportion to the number of shares of the insured's stock each will acquire in the event of the insured's death. In other words, each stockholder pays premiums on those policies, the proceeds of which will be credited against the purchase price he will be called upon to pay, in proportion as he is given credit out of these proceeds. This plan is in keeping with the true nature of the insurance method of supplying the purchase price: an advance instalment accumulation method under which the insurance premiums constitute the instalments. There is no difficulty in setting up a schedule of premium allocations in accordance with this method and in making it a part of the agreement. The method is exactly the same as in the case of a partnership, and the reader is referred to page 228 of the Book on partnerships for examples equally applicable to stockholders.

The corporation should not be designated the premium-payer unless the stock retirement plan discussed in a later chapter is used. In any case, however, the corporation may be authorized to make the actual payments to the insurance company and to charge such payments to the salary accounts of the individual stockholders in accordance with the method of premium allocation adopted by them. In fact, this procedure is highly

recommended, for it gives assurance to all the stockholders that all the premiums payable under the agreement will be paid when they fall due and that none will be overlooked. Any method of premium allocation is readily implemented by this procedure.

Premiums may be pooled and shared pro rata by the stockholders if their stockholdings are equal. This method, however, introduces other complications. If there is a substantial difference in the ages of the stockholders, it has the effect of requiring the older stockholders to pay more than their just portion, which complicates the adjustments that must be made when a death occurs. If each stockholder has shared equally in the premium burden, he is entitled to share equally in the cash values of the policies at the time of a claim. The difficulty created in this situation is that the cash value credits do not correspond with the cash values in the policies on their own lives that the survivors will take over upon the adjustment.

To illustrate, let us take the simplest kind of a case. Assume a corporation worth $50,000, the stock of which is owned equally by two stockholders, one of whom is age 37 and the other age 49. Assume further that each is insured for $25,000 ordinary life and that the older stockholder dies at age 69. Since the premiums were equally divided, equal credit should be given to the combined cash values of the two policies as of the moment prior to death. Taking the figures of a well-known company, this credit to the estate of the deceased stockholder would amount to $10,475. The surviving stockholder would therefore owe the deceased's estate $25,000 as the price of the stock, plus $10,475 as representing one-half of the cash values of both policies at time of death. He would be credited with $25,000 insurance proceeds on the policy on the deceased's life, but the policy that he would take over on his own life would have a cash value of only $9,100, so that even if he should take a maximum loan against this policy, he would still be $1,375 short of funding the transaction.

On the other hand, had each paid the premiums on the policy on the other's life, the proceeds of the policy on the deceased's life would have discharged completely the purchase price for the deceased's stock, and the surviving stockholder could be

given the privilege of taking over the policy on his own life by paying the deceased's estate the exact amount of the cash value of that policy. If necessary, the money with which to do this can be made available by a policy loan. If he does not desire to take over the policy, the deceased's estate is fully paid off upon surrender of the policy to the insurance company. But if the premiums are pooled and the older stockholder is first to die, which is reasonably to be expected, the surviving younger policyholder can never have the arrangement completely funded. Far better, if possible, is the plan of each stockholder's paying the premiums on the other's policies under which the money is made available to discharge in full the obligations of the parties.

A plan requiring each stockholder to pay the premiums for the insurance on his own life is totally wrong in principle, for in effect each stockholder is then maintaining the fund with which to purchase his own property, that is, his own shares of stock.

Ownership of the insurance policies and restrictions on use for other purposes. The agreement should specify who is to own the right to exercise the benefits and privileges contained in each policy during the insured's lifetime. If a trustee is made a party to the agreement, the ownership may be vested in the trustee if desired. If this is not done, then the logical owners of each policy are the particular premium payers. This will be the corporation, in the case of a stock retirement agreement. The agreement should provide restrictions upon the exercise of ownership rights in derogation of the objectives of the agreement.

CHAPTER 12

Insurance Beneficiary Arrangements

THE PURCHASE AND SALE AGREEMENT SHOULD state to whom the life insurance policies are to be made payable upon death. In this matter, one may choose from among a number of different arrangements.

The corporation as beneficiary. If a plan is adopted in which the corporation will be the purchaser of a deceased's shares of stock, then preferably the corporation should be designated to receive the insurance proceeds.

A trustee as beneficiary. If the stockholders desire to have a buy-and-sell plan administered by a trustee as an impartial "third party," then the trustee, preferably the corporation's bank, if it has trust powers, should be designated beneficiary of the life insurance made subject to the agreement. This plan is highly recommended.

Under the plan, the trustee becomes a party to the agreement along with the stockholders. The contract is in the form of a business insurance trust agreement, the provisions of which follow the general purchase and sale contract form, modified and supplemented by the necessary trust provisions. It will be provided that the life insurance policies are made payable to the trustee and deposited with it. Ownership rights under the policies may be given to the trustee or may be retained by the stockholders who pay the respective premiums on them. Funds with which to pay the insurance premiums may also be de-

posited with the trustee, but ordinarily the stockholders themselves, or the corporation as their agent, will pay the premiums directly to the insurance company. The stockholders will indorse their stock certificates in blank and deposit them with the trustee for the purposes of the agreement, reserving to themselves, however, the right to receive all dividends payable on the stock and the right to vote their respective shares.

The foregoing arrangements place the trustee in an ideal position to carry through the consummation of the purchase and sale in the event of a stockholder's death. The proceeds of the insurance on the deceased stockholder's life are collected by the trustee. Then, if the agreement provides for the application of a valuation formula to ascertain the purchase price of the deceased's shares, the trustee applies the formula or supervises its application, whichever procedure is called for by the agreement. Upon ascertainment of the purchase price, either from a clause in the agreement stipulating a predetermined figure or from the application of a specified formula, the trustee, after reserving its commissions, delivers to the deceased's executor or administrator as much of the insurance proceeds as is required to pay the purchase price of the deceased stockholder's shares, and disposes of any excess of insurance proceeds as directed in the agreement. The shares of stock owned by the survivors and the shares purchased by them from the deceased's estate are then indorsed over to them and the insurance policies on the lives of the survivors are made over to the respective owners, who will offer to transfer them to the insureds in accordance with the terms of the agreement covering such an exchange.

If the insurance proceeds, however, are less than the purchase price, then the trustee procures from the surviving stockholders a series of notes as called for by the agreement, payable to the deceased's estate and aggregating the balance of the price owed by the survivors. These notes, together with the insurance proceeds and any specified collateral in the form of a portion of the deceased's stock, or collateral assignments of the insurance on the lives of the survivors, or both, are delivered to the executor or administrator. Any shares of stock and any in-

surance policies not required as collateral are delivered to the proper owners by the trustee; and the stock and insurance held as collateral by the deceased's personal representative are made over by him to the surviving stockholders as the notes are subsequently paid. Upon the discharge of the trustee's duties, the trust is terminated.

This brief outline of the trustee plan shows that when an experienced corporate trustee is made a party, the consummation of the purchase and sale of a deceased's stock will be carried through smoothly in an impartial and responsible manner; thus the stockholders are relieved of most of the details and bother, while at the same time they are assured that the interests of all concerned will be supervised by a capable, unbiased third party. All things considered, there is no better plan.

The surviving stockholders as beneficiaries. If the trustee plan is not chosen, the designation of the surviving stockholders as beneficiaries of the insurance is a logical choice under a buy-and-sell agreement. It places the purchase money in the hands of those who are to be the purchasers and who are obligated to use the insurance proceeds in payment for the deceased's stock. It places the purchase money in the hands of those who have created it and own it if, as is usually the case, the survivors have paid all the premiums on the deceased's insurance and have possessed the incidents of ownership during his lifetime.

Furthermore, this arrangement tends to balance the situation at death between the surviving stockholders and the deceased's estate. The survivors, obligated to buy and to pay the agreed purchase price for the deceased's stock, hold the insurance proceeds pending consummation of the transaction. The personal representative, obligated to sell and transfer the deceased's stock in the corporation, holds the shares. Thus, each side of the transaction holds something that it is obliged to deliver over to the other side upon the receipt of that which the other side possesses. Given this balanced status, together with the realization that either side may, if necessary, obtain specific performance of the agreement by court decree, the purchase and sale should function smoothly.

Under this arrangement, as under the trustee plan, if the

survivors have been the premium payers and policy owners of the deceased's insurance, the proceeds are not subject to estate taxation, and will be included in figuring the cost basis of the shares of stock acquired by the survivors, to give them the most favorable income tax position possible should the survivors later sell any of these shares.

Attention should be called, however, to the fact that the proceeds and avails of insurance made payable to the surviving stockholders are not protected against the claims of their creditors. But in this connection, it should be kept in mind that the creditors of the corporation are not creditors of the individual stockholders. It should be remembered also that aside from the secured creditor, such as a mortgagee, who holds by contract a contingent right of disposal of a specific item of the debtor's property, the relationship between a debtor and his creditor is personal; the creditor, as such, has no property interest in his debtor's assets. Upon default in payment of a debt that has become due, the creditor has the right to sue, and the debtor has the right to defend the action on the merits. It may be said in general that unless a debtor, after the maturity of a claim against him, conceals himself or his property or removes himself or his property from the state, or is about to do this, with intent to defraud his creditor; or has made a transfer in fraud of his creditors; or until a creditor obtains a judgment against him, the creditor has no right to touch or interfere with any of the debtor's property.

That any conduct or transactions in fraud of creditors will occur is improbable. If, however, the financial status of any of the stockholders should deteriorate to the extent that he may have unsatisfied judgment creditors, they can levy not only on the insurance that he owns under the plan, but also on his shares of stock in the corporation and on his other available property as well. The result would be that, until the judgment was satisfied, the purchase and sale agreement, unaltered, would be impracticable and the parties would no doubt take advantage of their reserved right to amend or revoke it, as dictated by the changed circumstances.

Moreover, the creditors of a stockholder-beneficiary not only

must be in a legal position to attach his property, but must act before the insurance death proceeds are paid over by him in payment of a deceased's stock. Assuming the purchase price to have been set at a fair figure, the transfer of the proceeds, since it is in good faith and for a fair consideration, cannot be set aside as a transfer in fraud of creditors. Therefore the transaction, if consummated, will hold, even though creditors of a surviving stockholder under certain circumstances might be able to attach or levy on his shares of stock, including such stock as he might have acquired from the deceased's estate.

It is believed that substantially the same creditor status as outlined above would ultimately prevail if the trust plan is used, although in most jurisdictions the courts would then be called upon to resolve the conflict between statutes protecting insurance payable to "third person" beneficiaries and the rule of law or its statutory counterpart which holds that a transfer in trust for the benefit of the transferor may be reached by his present and future creditors. There seems to be a paucity of cases on the subject, and this fact alone indicates that in the great majority of cases there will be no need for protection of the insurance from claims of creditors.

The insured's estate as beneficiary. Among the other arrangements that may be chosen is that of designating the respective estates of the insured stockholders as beneficiaries. Although this is a workable plan and is sometimes used, there are several objections to it.

A deceased stockholder's death finds his executor or administrator holding the title to both the subject matter of the sale and the purchase money for it. This creates an imbalance in the situation in favor of the estate and against the surviving stockholders. Although this alone is not serious, nevertheless if the agreement does not contain a clear and positive statement that the insurance proceeds thus received by the estate directly from the insurance company are to be credited to the surviving stockholders as purchase money for the deceased's shares of stock, the personal representative or heirs may contend that they are entitled not only to the insurance proceeds but to the full purchase price as well. Furthermore, if this plan called for

all or any part of an insured's premiums to be paid by himself, a contention that all or part of the insurance proceeds constituted personal insurance might prove formidable.

Another objection is that both the deceased's shares of stock and the insurance proceeds are exposed to the claims of the creditors of his estate. Here, we have a quite different debtor-creditor relationship than subsisted during the deceased stockholder's lifetime. After death, his estate constitutes a fund impounded in the hands of his personal representative for the benefit, first, of his creditors, and second, of his distributees. True, the personal representative is charged with the duty of carrying out the executory contracts of the deceased stockholder, except those calling for the deceased's personal services and those expressly terminable upon death, and is therefore bound to carry through the stock purchase and sale agreement. But in case the deceased's assets prove inadequate, the surviving stockholders well might be forced to resort to litigation in order to assert their rights. Estate creditors, including the tax collectors, are naturally militant in the situation, for they are afforded their last opportunity to collect their debts, and because of this, the personal representative may actually desire litigation for his own protection in the premises. Again we are dealing with a situation best avoided by the trust plan, in which the title to the stock and the insurance proceeds are vested in the trustee, the former to be made over to the survivors and the latter to be made over to the deceased's personal representative upon the consummation of the agreement.

A further objection to designating the respective estates of the insured stockholders as beneficiaries is the possibility of controversies over the amount of estate taxes. It seems to be well settled by the court decisions that if there is an insured buy-and-sell agreement effective at death, an estate tax is not imposed on both the purchase price and the value of the business interest being sold under the agreement, but the taxing authorities nevertheless from time to time continue their efforts to impose "double" taxation. They are given the opportunity to attempt this under every arrangement by which the insurance proceeds are estate taxable, that is, if the insured has any of the incidents of ownership in the policy on his own life, or

if, as is here under discussion, the proceeds are payable to his estate.

This was the controversy in the *Estate of John T. H. Mitchell v. Commissioner,* 37 B. T. A. 1 (1938). Lennen and Mitchell each owned one-half the stock in Lennen & Mitchell, Inc. In April, 1929, they entered into a stock purchase and sale agreement, insured by $200,000 of life insurance on each party, payable to their respective estates, the proceeds "to be received on account of the purchase price as if the surviving party had paid the sum." In 1930, Mitchell died and insurance proceeds of $202,666.67 were paid to his estate subject to the agreement. In accordance with the agreement, his stock was valued at $313,771.93 and Lennen paid the balance of $111,105.26 in cash to the estate. (Lennen had also carried $400,000 of life insurance on Mitchell, payable to Lennen.) In the estate tax return, Mitchell's administratrix reported the insurance proceeds of $202,666.67 payable to the estate and the $111,105.26 as the value of the stock over that figure. The Commissioner, however, increased the value of the stock to $313,771.93 for tax purposes and assessed an estate tax deficiency against the estate of $35,769.14. The effect, of course, was to assess a double tax on the amount of $202,666.67. The administratrix petitioned the Board of Tax Appeals to set aside the deficiency, and was successful.

Other cases of similar nature have likewise resulted favorably to the taxpayer. Nevertheless, as long as there is the possibility that a controversy may arise it seems advisable to avoid the kind of insurance arrangements that make such controversies possible.

If the estate of the insured is named as insurance beneficiary, there is also some danger that the rule of the Legallet case (41 B. T. A. 294) will be applied on a subsequent sale of the stock. If applied, the insurance proceeds paid directly to the estate will not be included in the cost basis of the stock acquired from a deceased associate when the survivor computes his gain or loss on a subsequent sale. (See discussion of the Legallet case at page 243 of the Book on Partnerships, and note the reliance on the Mitchell case.)

Lastly, the estate beneficiary arrangement is not suitable, for

obvious reasons, unless the agreement stipulates that the insurance proceeds shall constitute the minimum purchase price.

Designation of personal beneficiaries of the stockholders. At this point it is apropos to re-emphasize that the purpose of a stock purchase and sale agreement is to enable the surviving stockholders to purchase the shares of a deceased stockholder in the corporation and in this way to continue in full ownership and control of the enterprise, and at the same time guarantee that the estate of the deceased will receive full value for his interest in the business promptly, in cash. The function of life insurance in connection with such an agreement is to guarantee that the surviving stockholders will have the cash available with which to pay over the full purchase money promptly at the time of a stockholder's death, whenever it may occur. However, other arrangements are designed to go still further; that is, instead of providing that the deceased's estate receive the purchase price in cash, the insurance proceeds are paid directly to the personal beneficiaries of a deceased party. In other words, the objective in some instances is that the insurance proceeds function, first, as business insurance to supply the purchase money to pay for the stock of a deceased stockholder; and second, as personal insurance, the purchase money remaining in the form of insurance proceeds held by the insurance company and payable in instalments to the deceased stockholder's family under the settlement options of the policy.

The possibility and feasibility of making such insurance arrangements have been discussed at some length at pages 241-247 of the Book on Partnerships, to which the reader is referred, since the discussion there is equally applicable to close corporation stock purchase agreements. By way of supplement, however, something more should be said at this point on a few phases of the subject of personal beneficiary designations in connection with business purchase and sale agreements.

One of these phases deals with the problem of providing for the payment of claims of creditors of the deceased stockholder's estate. This problem arises in those situations in which the transfer of the deceased's stock to the survivors, with the pur-

chase money for the stock in the form of insurance proceeds going direct to the personal beneficiaries of the deceased, leaves his executor or administrator with insufficient estate funds to pay debts, administration expenses and taxes. Thus the problem is created by the fact that although a fair price has been paid for the stock, the price has been paid to third persons, and the estate has been by-passed. It is believed that if, in such a situation, the purchase plan does not make it possible for the personal representative to obtain a portion of the insurance proceeds sufficient to pay the claims against the deceased's estate, then the personal representative has ample power under the Fraudulent Conveyance laws in force in most jurisdictions to prevent or set aside the transfer of the deceased's shares of stock to the survivors to the extent necessary to procure the required estate funds for paying its creditors.

This belief is borne out by Glenn in his leading book entitled *Fraudulent Conveyances and Preferences* (Baker, Vorhis & Co., 1940), in which he states in Section 275: "an essential feature of the fraudulent conveyance is, depletion of the debtor's estate"; and in Section 276, captioned "The Consideration Must Pass Directly into the Debtor's Estate," in which he writes: "When we speak of the debtor's estate, we mean the estate available to his creditors. It follows that a consideration which by the very nature of the transaction, does not pass into the estate at all, is not fair value within the rule just mentioned."

It seems clear that the right of the personal representative, of an estate that will be made insolvent by the transfer of the decedent's stock to the survivors, to interfere to the extent necessary for paying estate creditors is a matter separate and apart from the question of the validity of the purchase and sale agreement as an enforceable contract between the parties. This distinction is brought out in *Bowery v. Vines,* 178 Tenn. 98, 156 S. W. 2d 395 (1941).

In this case, several relatives of Robert E. Vines, the debtor, had given their notes to certain banks. When the notes became due, Vines, in consideration of an extension of time given to the relatives on the notes, gave the banks his mortgage as security. He was insolvent at the time, and the mortgage was

later foreclosed and the property lost to Vines. A judgment creditor of Vines, however, brought this action to recover the amount of the mortgage from the banks as having been a fraudulent conveyance as to plaintiff on the ground that no consideration had moved to his debtor for the transfer. Counsel for the defendants urged that the extension of time given to the relatives on the notes was sufficient consideration to make the transaction valid and therefore that it could not be attacked. The following was quoted by these attorneys from 41 Corpus Juris, page 387:

> Under the rules applicable to contracts generally, the forbearance of a creditor from enforcing the payment of a debt or claim by legal proceedings or his extension of the time for payment of the debt or interest thereon may constitute a sufficient consideration, and the consideration may be forbearance extended to a third person.

The court, however, held the transfer fraudulent as to Vines' creditors. The opinion referred to the foregoing statement and to other statements also cited in the opinion as follows:

> These are excellent statements of generally recognized rules. But do they apply and control here? They apply to Robert E. Vines as the promisor, or obligor. He could not plead lack of consideration for his conveyance made to secure "a forbearance extended to a third person." But may he, being insolvent, thus voluntarily convey his property to the prejudice of his creditors, without a fair consideration passing to him which would inure to their benefit?
>
> We are cited to no Tennessee case directly in point, and indeed, to but one from other jurisdictions, to which we will later refer. We deem it unnecessary to consider distinctions suggested between a "valuable" and a "good," or a "fair" consideration. We seem to have here a case of no consideration whatever passing to the grantor, Robert E. Vines, for this transfer of his property. We have here a voluntary conveyance, fraudulent in fact as against existing creditors by the terms of the statute above cited. A voluntary conveyance was prima facie fraudulent in fact as against existing creditors before the passage of this uniform statute.

The other case referred to in the opinion was *Davis v. Hudson Trust Co.*, 3 Cir., 1928, 28 Fed. 2d 740, cert. denied, 278 U. S. 655, from which was quoted in part as follows:

> It is true, as counsel for appellees say, that 'the agreement of a creditor to extend his debtor's time for payment, or to forbear suing on the claim, constitutes a valuable consideration for the promise of a third party to pay the debt.' But we are not here dealing with a 'valuable' consideration for the promise of a third party to pay another's debts. We are here dealing with what constitutes 'fair consideration,' which when given in good faith may prevent creditors from setting aside a conveyance under the Uniform Fraudulent Conveyance Act.

With respect to the fact that the consideration did not move to the debtor, the *Bowery v. Vines* opinion stated in part:

> It cannot be denied that counsel for appellant is correct in his contention that the uniform Act of 1919 . . . exacts the passing to an insolvent grantor of a consideration of approximate value to the property conveyed, if the conveyance is to be good as against his creditors. It is essential that the consideration must not only be fair, but that it pass into the insolvent's estate. This is the lack in the instant case.
>
> In the 1931 edition of Glenn on Fraudulent Conveyances, page 370, Section 275, discussing the principle involved, the author says:
>
> "In final effect the test from the creditor's standpoint should be the diminution of the estate, and the first inquiry therefore must be whether the transfer, in view of the consideration received, lessened the value of the estate. If not, the creditor can claim no injury. . .
>
> "When we speak of the debtor's estate, we mean, of course, the estate available to his creditors. It follows that a consideration which by the very nature of the transaction, does not pass into the estate at all, is not within the general rule just mentioned."

Although the quoted cases were not dealing with business purchase agreements, their reasoning is in accord with that in the partnership cases of *Ireland v. Lester* and *Silverthorne v. Mayo,* at pages 187 and 240. The reasoning would apply equally to a stock purchase agreement. Therefore, where the

parties desire that the purchase price for the shares of a deceased stockholder be paid direct to a beneficiary, instead of to the estate, they must make sure that there will be ample assets in the estate for the payment of claims.

Another phase of the subject of personal beneficiaries about which something more may be said is that of the use of some modified form of personal designation which will make the insurance proceeds available to the deceased's estate, if and to the extent necessary, to satisfy the creditors' claims. One such arrangement calls for the use of modified personal beneficiaries in connection with a trustee plan. That is, if the particular insurance company concerned is willing to do so, there is the possibility of designating a trustee as primary beneficiary under the interest option for a limited period of time, during which the trustee is given the right to withdraw cash for the purpose of enabling the personal representative to satisfy creditors of the deceased's estate as well as the distributees, if any, who have unsatisfied and indefeasible rights in the estate. After this the trustee will select settlement options under the insurance in favor of the individual beneficiaries of the deceased, as directed in the agreement.

The usual business trust arrangement places the possession of and the bare legal title to the share certificates in the trustee, the trustee acting as a depositary until a death occurs. Reserved to the respective stockholders, are the following rights: the right to vote the stock, the right to receive all dividends on the stock, and the right to repossess and dispose of the shares prior to death in compliance with the terms of the agreement. Thus, most of the "bundle of rights" that make up ownership are reserved to the respective depositing stockholders while they are alive, and because of this, there is grave doubt as to whether an estate left with insufficient funds to pay its debts can be by-passed by the endorsement over to the survivors of the stock of the decedent. Special statutes in force in most states might prevent interference with the disposition of the insurance proceeds elsewhere, but it seems, in most jurisdictions at least, that the executor or administrator can reach the deceased's shares of stock to the extent necessary to pay any remaining estate

creditors, if other estate assets have been exhausted in the process. Therefore, if the usual plan of paying over the full purchase price to the deceased's estate is departed from in order to make use of settlement options to personal beneficiaries, some provision should be included by which the insurance proceeds, if and to the extent necessary, are made available to settle the estate.

To sum up the matter of designating personal beneficiaries: the designation of personal beneficiaries and the use of settlement options are foreign to the basic purposes to be accomplished by a business purchase and sale agreement. Such a designation will probably give rise to an income tax problem as presented in the Legallet case. It raises the problems of satisfying estate creditors and heirs with statutory rights in the estate. The problems of creditors and heirs, however, are not present in some estates by reason of other suitable provisions, and if they are present, their solutions often can be worked out. Nevertheless, in the great majority of cases there is need in a deceased's estate for all or nearly all of the cash supplied by the purchase price. Consequently most stockholders are well advised to eschew the advantages of settlement options under the insurance used to finance their business purchase and sale agreements, and to adhere to a plan against which no valid objection can be raised.

Disposition of policies on the lives of survivors. The matter of the disposition of the insurance policies on the lives of the surviving stockholders does not come up in the case of a stock retirement agreement that continues in force irrespective of the death of one or more stockholders. On the other hand, an individual buy-and-sell agreement should contain provisions disposing of the insurance policies on the lives of the stockholders after a death occurs.

The usual arrangement is to grant each insured an option, exercisable within a specified period, such as thirty or sixty days after the appointment of the executor or administrator, to take over the insurance in force on his own life under the agreement after he has made a suitable financial adjustment for differences in cash values. This plan is readily accomplished by crediting

each stockholder, including the deceased, with the cash values that have been created in the survivors' policies by the premiums each has paid, charging each surviving stockholder with the cash value of the insurance he is acquiring on his own life, and settling the balances with those entitled to them. In the event any policy is not taken over during the option period, its owner is empowered to surrender it to the insurance company for cash.

It should be noted that by the above process, the deceased's estate will receive credit for the premiums the deceased has paid to the extent of the cash values created, in addition, of course, to receiving the full purchase price for his shares of stock in the enterprise.

It should also be observed that, if each stockholder has contributed to the premiums on the insurance other than that in force on his own life, the amount that any survivor must put up in order to take over the policy on his own life will never exceed the cash value of that policy, and therefore under such circumstances the exchange may be financed in full, if need be, by a policy loan. In fact, the only situation in which he would owe the full cash value of his insurance on the adjustment, if each has paid the other's premium, is in the case of the death of one of only two stockholders, in which event the survivor would have the option to take over his policy from the deceased's estate upon paying to the estate the cash value of it. If more than two stockholders are involved, the adjustment calls for the surviving stockholders in taking over their policies to pay considerably less than the cash values of the policies being acquired on their own lives, since each receives credit for part of the cash values of the policies on the other survivor or survivors.

If the premiums have been "pooled" and paid pro rata by the stockholders, then the cash values of all the policies as of the day before a death occurs should be totaled and divided pro rata to ascertain the credit to be given each party. On taking over his policy, each survivor, as before, will be charged with its cash value. Thus, in addition to its other shortcomings the plan of pooling premiums produces an imbalance in the adjust-

ment after death. This is not a serious problem, however, except in the case of the death of the older one of two stockholders. In this event, the survivor must pay to the deceased's estate an amount greater than the amount of the cash value of the policy being acquired.

If the insurance carried under the plan has been substantially less than the purchase price, which leaves a sizable balance for the survivors to pay in instalments, then it may be provided in the agreement that upon taking over the insurance on their own lives the survivors will make collateral assignments of their policies to the deceased stockholder's estate as security. Obviously, this procedure furnishes valuable protection to the survivors as well as to those interested in the estate of the deceased.

Provisions for amending, revoking, or terminating the agreement. The agreement should reserve to the stockholders jointly the right at any time to amend or revoke it by a writing signed by all of them. Of course, if a trustee is also a party, it will be necessary to provide that the stockholders shall not make any change in the terms of the agreement that will increase the obligations or reduce the rights of the trustee without its consent.

The agreement should also contain provisions for its automatic termination upon the happening of any one of certain specified events as, for example, the dissolution or bankruptcy of the corporation, or, in the case of two stockholders, the death of both prior to the consummation of the purchase and sale of the stock of the first stockholder to die.

The agreement may also provide that any stockholder except the offending stockholder (or a majority of the stockholders, if preferred) has the right to call for a revocation of the agreement if the insurance of any other stockholder, who is obligated to maintain insurance subject to the agreement, is allowed to lapse without value or is withdrawn.

Supplemental to the provisions for revocation and termination, there should be included provisions giving each stockholder the right, upon suitable adjustment, to take over the insurance in force upon his own life, and any other provisions

relating to the shares of stock or insurance appropriate to the circumstances.

The foregoing comprise the principal provisions that should be contained in an insured stock purchase and sale agreement entered into by the individual stockholders. Again, sample forms and clauses have been left out of the text purposely. Their inclusion, if only a few were set out, would tend to cramp the discussion; and the inclusion of a number sufficient to illustrate all the available variations in arrangements would be impracticable. Furthermore, many such forms are accessible in the legal form books and in the specialized business insurance and trust services, and still others may be obtained by attorneys from the law departments of insurance and trust companies. Lawyers will find these forms of assistance in drafting the tailor-made finished document that each situation requires.

CHAPTER 13

The Corporation as Purchaser

IN SOME CASES, CLOSE CORPORATION STOCKholders will find that the individual purchase plan providing for the purchase of a deceased stockholder's shares by the survivors is the best one suited to their situation. Many instances will occur, however, when the stockholders will desire a plan in which the corporation agrees to purchase a deceased's stock and retire it into the corporate treasury. In a few states, this latter plan is not available because of restrictions against the purchase of its own stock by a corporation, but when the law does not prohibit the transaction, the stockholders are offered a choice between these two basic arrangements. Because the corporation purchase plan, often called the stock retirement plan, has many distinct characteristics, a separate discussion of it has been reserved for this chapter.

When stock retirement plan is considered useful. Under certain circumstances, the stock retirement plan appears to offer close corporation stockholders the most suitable means of preserving ownership of the enterprise for the survivors. For example, if there are more than two or three active stockholders this plan offers a simpler method of continuing the purchase arrangement in operation beyond the first death. Again, if a corporation has an ample surplus after paying full salaries and commensurate dividends on its stock, it may well be in a better economic position, because of an income tax differential existing in its favor, and in a better financial position, to purchase a deceased's stock. Situations of this latter type were frequent during World War II, with high corporate earnings on the one hand and salary "freezing" on the other.

Situations such as those described, however, by no means account for all of the corporation purchase plans adopted. Many are set up in place of an individual purchase plan for no other reason than the stockholders' fallacious rationalizing that if the corporation agrees to purchase the stock and if it pays the premiums on the insurance with which to finance the purchase, such premiums do not come out of their pockets.

General characteristics of the usual corporation plan. Under the usual corporation plan, the corporation becomes a party to the agreement along with the stockholders. The agreement stipulates that upon the death of a stockholder, his estate will sell, and the corporation will buy, his shares of stock in the enterprise. To make as certain as possible that the corporation will have surplus funds on hand at the death of a stockholder with which to carry out its end of the bargain, the corporation agrees to purchase and maintain a specified amount of life insurance on each stockholder.

It is readily apparent that this arrangement differs in many respects from the individual purchase plan. The life insurance is bought and owned by the corporation. The policies constitute a corporate asset; the creditors of the corporation must therefore be considered. The premiums are paid by the corporation; hence each stockholder, including in each instance the stockholder whose stock will be sold on consummation of the plan, contributes indirectly to the purchase price in proportion to his stockholdings.

Characteristics of other stock retirement plans. Unfortunately, a wide diversity of opinion exists among respectable authorities as to what a corporation can properly obligate itself to do toward the purchase of its own stock and as to the possible tax consequences that may result. Assuming a jurisdiction in which a corporation can legally buy its own shares, some authorities nevertheless feel that a direct contract by the corporation to do so and to carry life insurance for the purpose of financing the purchase may run some risk of not being considered for a corporate purpose, and that, consequently, the arrangement may encounter difficulty from Section 531 of the Internal Revenue Code. This section imposes a penalty ac-

cumulated earnings tax on the earnings of a corporation that, instead of being distributed, are accumulated for the purpose of avoiding income tax upon its stockholders. These authorities, therefore, believe that the life insurance must be divorced from any agreement to purchase stock, and that it must be purchased, owned and justified by the corporation as insurance to compensate it for the loss of the services of valuable, 'key" men. Then too, various methods are used to implement the purchase of a deceased's stock. Some recommend a definite agreement between the corporation and the stockholders to this effect, and others recommend an agreement among the individual stockholders committing the survivors, when a death occurs, to vote their stock in favor of having the corporation purchase the deceased's stock.

Obviously, indirect stock purchase arrangements such as these differ radically from the individual purchase plan, as well as from the direct or formal corporation purchase plan.

LEGALITY, VALIDITY, AND ENFORCEABILITY OF CORPORATION PURCHASE PLANS

Legality. The first inquiry in any case is whether the law of the state of incorporation permits a corporation to purchase its own shares of stock. In England, the courts have held such a purchase to be illegal, unless the particular corporation is expressly authorized to do so. (See the leading case in that country, *Trevor v. Whitworth,* L. R., 12 App. Cas. 409.) In the United States, the courts of some of the states have followed the English rule. But the clear weight of court authority in this country upholds the right of a corporation to buy its own stock if the purchase is made in good faith and does not prejudice the rights of creditors.

However, most of the states today have statutes on the subject, some of them enacted to grant corporations the right to purchase their stock when previous local court decisions had held to the contrary. These statutes differ somewhat in each jurisdiction as to their conditions and limitations; some of the statutes are very broad and others confine the right to purchase

within very narrow bounds. The situation, therefore, requires reference to the applicable law in each instance. No attempt is made here to set out the present status of the law in the various states because new statutes are being enacted with considerable frequency. Up-to-date digests of the prevailing law, state by state, may be found in any of the various periodic supplement loose-leaf business insurance services, to which the reader is referred.

Validity of executory contract by corporation to purchase its own stock. Assuming that the laws of the particular jurisdiction permit a corporation to purchase its own stock, if it is done in good faith and out of surplus so that the rights of creditors are not endangered, the next inquiry in any case is whether the proposed contractual arrangement actually imposes upon the corporation a legally binding obligation to buy. The general rule is stated in 5 Thompson, Corporations, s. 4086 (4080), as follows: "In jurisdictions where corporations have the power to purchase their own shares of stock, within the foregoing rules [as to good faith, rights of creditors, *et cetera*], there is nothing to prevent the corporation from entering into a valid contract to repurchase shares sold by it." The pertinent inquiry, therefore, is what constitutes "entering into a valid contract" on the part of the corporation.

Probably in most jurisdictions where such purchase is authorized, a simple agreement in which at death the stockholders agree for their estates to sell, and the corporation agrees to buy, their shares of stock at the stipulated price or terms is valid and binding, except only, that it could not be enforced against the corporation if at time of performance the purchase would impair its capital. In such jurisdictions, the purchase agreement may be set up independent of the life insurance, if such an arrangement is considered desirable.

In the State of New York, however, such a contract, standing alone, has been refused specific performance by the Court of Appeals (*Topken, Loring & Schwartz v. Schwartz,* 249 N. Y. 206, 163 N. E. 735, 66 A. L. R. 1179). In this case the corporation sold Schwartz 114 shares of its stock for $11,400, coupled with a purchase and sale agreement by which Schwartz could

buy more under certain conditions. Under the agreement Schwartz agreed to sell back, and the corporation to buy back, upon his termination of employment, these and any subsequent shares acquired by him, at book value exclusive of good will. Schwartz terminated his employment at a time when the 152 shares then owned by him appeared to have no book value, and he refused to give up his shares. The corporation then brought this action for specific performance, based on the agreement and on the fact that it was a close corporation having only four stockholders and conducting a business wholly of a private nature.

Schwartz defended on the ground that the agreement was invalid because of lack of consideration given by the corporation. His counsel cited Section 664 of the New York Penal Law, to the effect that: "A director of a stock corporation, who concurs in any vote or act of the directors of such corporation, or any of them, by which it is intended: . . . (5) To apply any portion of the funds of such corporation, except surplus, directly or indirectly, to the purchase of shares of its own stock, is guilty of a misdemeanor." It was contended that the only purported consideration given by the corporation had been its promise to buy, and as that promise could not hold under certain circumstances, i.e., those calling for violation of the Penal Law, the promise was illusory, and that therefore the agreement was entered into without mutual consideration and was unenforceable.

New York's highest court agreed with Schwartz, stating: "the contract for its consideration rests upon mutual promises. One of the promises may or may not be good, the same as if a discretion were left to one of the parties to perform or not perform. Under such circumstances there is no consideration and the contract cannot be enforced."

The court's decision did not rest entirely on the proscription of the New York Penal Law, as the following quotations from the opinion will show:

> This provision of the Penal Law of course has application only to the State of New York, but it has generally been held that no corporation can purchase its stock with its capital to the injury of its creditors. The capital of a

corporation is held in trust for its creditors, so that any agreement to purchase stock from a stockholder, which may result in the impairment of capital, will not be enforced, or will be considered illegal if the rights of creditors are affected. (*McIntyre v. Bement's Sons,* 146 Mich. 74; *Hoover Steel Ball Co., v. Schaefer Ball Bearing Co.,* 90 N. J. Eq. 164; *Fremont Carriage Mfg. Co. v. Thomsen,* 65 Neb. 370; *West Penn Chemical & Mfg. Co. v. Prentice,* 236 Fed. Rep. 891; *Tierney v. Butler,* 144 Ia. 553; Cook on Corporations, vol. II, sec. 311, p. 1040; *Boley v. Sonora Development Co.,* 126 Mo. App. 116.) "The stock of a corporation is its only basis of credit, and it is of vital importance that it be rigidly guarded and protected. Courts have conceived it to be their duty to detect and defeat any scheme or device calculated in any way to place this fund beyond the reach of the creditors." (*Matter of Fechheimer Fishel Co.,* 212 Fed Rep. 357, 365; *Grasselli Chemical Co. v. Aetna Explosives Co., Inc.,* 258 Fed. Rep. 66; White on Corporations, pp. 712, 713; *Strodl v. Farish-Stafford Co.,* 145 App. Div. 406.)

This contract, therefore, in question would have been impossible of performance under certain conditions. The defendant Schwartz it is said was bound to sell and convey his stock at book value at the end of his employment. How about the corporation? What were its obligations? If it had no surplus, it could not legally perform the purported contract; it could not make the purchase. Under our statute it would have been illegal; without our statute it would have been unenforceable as against the corporation, if there were creditors and no surplus. (*Hoover Steel Ball Co. v. Schaefer Ball Bearing Co.,* supra.) Whichever way we look at it there were certain conditions under which the corporation would be unable to perform its promise to purchase the stock and under which the courts would declare its contract so to do illegal. If, therefore, we consider the contract in question, as we must, one dependent upon mutual promises for the consideration, we have the defendant promising that at a certain time he will sell at a certain price and the plaintiff promising to buy. The promise is binding upon the defendant but may or may not be binding upon the plaintiff. It is as if the plaintiff had a choice to buy or not as it pleased. By "binding" I mean that the corporation could execute the contract by purchasing the stock out of its surplus, but could not, with-

> out violating the law, purchase its stock when it had no surplus. Under these circumstances, we have a contract not mutually binding, and, therefore, lacking in consideration. (*Schlegel Mfg. Co. v. Cooper's Glue Factory,* 231 N. Y. 459, 462.) "The principle is ordinarily stated in the axiom that in a bilateral agreement both promises must be binding or neither is binding." (Williston on Contracts, sec. 103-e.)

Under this decision, which was widely criticized, it would appear that a bare purchase and sale agreement of a corporation's stock running between the corporation and its stockholders is unenforceable in New York. However, a "clue" pointing toward a valid stock purchase agreement was implanted in the opinion in the following words:

> If in the case before us the defendant had been given employment and the employment had furnished the price or the consideration for his agreement to return the stock at the end of his employment, we would then have a contract resting not on a mutuality of promises, but upon a consideration given and paid in part by the corporation. (*Hoover Steel Ball Co. v. Schaefer Ball Bearing Co.*, supra [last paragraph, p. 171]; vol. I, Williston on Contracts, sec. 13; *Strait v. Northwestern Steel & Iron Works,* 148 Wis. 254.) The contract then would be good unless it appeared that the stock would be purchased out of capital. This would be a matter of defense.

In other words, the Topken case indicated that something more is needed to create an enforceable contract of this nature in New York than the naked promise of the corporation to buy the shares of a stockholder upon his death; there must be added "a consideration given and paid in part by the corporation." What about the usual corporation agreement, under which the corporation not only promises to buy the deceased's stock, but also agrees to purchase and maintain insurance on his life with which to finance the purchase? The answer is found in *Greater New York Carpet House, Inc. v. Herschmann,* 258 App. Div. 649, 17 N. Y. S. 2d 483 (1940).

In 1932, an agreement was made between the corporation, Emil Herschmann, and Milton Goldstein which provided that on the death of either the corporation would purchase and his

personal representative would sell the deceased's respective holdings of 250 shares. The agreement recited that the corporation had purchased life insurance on each and stipulated that the purchase price to be paid by the corporation was to be the net proceeds of this insurance. The corporation agreed to place the proceeds "in a SPECIAL SURPLUS ACCOUNT of the Corporation" until they were paid over as purchase money. Two policies of $25,000 each had been procured upon the lives of the respective stockholders, payable to the corporation.

Herschmann died a few years later. The insurance proceeds were collected by the corporation, placed in a special surplus account, and tendered to the widow and executrix. On her refusal to carry through the transaction, this suit was brought for specific performance. The executrix relied on the Topken case to support her contention that the complaint was insufficient because the contract lacked legal consideration on the part of the corporation. The Appellate Division, however, unanimously affirmed the decision of the lower court in denying the motion of the executrix to dismiss the complaint. Several excerpts from the opinion are very interesting.

> We think that there was a sufficient legal consideration to support the contract. The present agreement was much more than a simple contract for the purchase and sale of stock. It was an attempt by two stockholders who owned all the stock of a corporation to arrange a method whereby the surviving stockholder would acquire complete corporate control. The provision that the corporation would purchase the survivor's stock was merely the means to an end. The agreement, in order to create a fund with which to pay for the stock, provided that the company take out life insurance policies on the lives of both stockholders, payable to the corporation; that the proceeds of these policies were to be set apart as a special surplus account to furnish the purchase price of the stock. While not expressly recited in the contract, we think it is necessarily to be inferred from its terms that the corporation bargained to pay the premiums for the said insurance, and the facts recited in the complaint indicate that the corporation did in fact pay said premiums between the date of the agreement

in 1932 and the death of defendant's testator several years thereafter. This constituted a detriment to the corporation.

Referring to the Topken case, the opinion states:

> We find that the contract now before us is distinguishable from that considered in *Topken, Loring & Schwartz v. Schwartz, Inc.*, supra, for the reason that here, as noted, there was consideration other than the mutual promises to buy and sell the stock. In the Topken case, supra, it was stated, 249 N. Y., at page 211: "If in the case before us the defendant had been given employment and the employment had furnished the price or the consideration for his agreement to return the stock at the end of his employment, we would then have a contract resting not on a mutuality of promises, but upon a consideration given and paid in part by the corporation." . . .
>
> In the present transaction we find a consideration given and paid in part by the corporation, to wit: the maintenance of the insurance policies. . .
>
> It has been stated that the principle enunciated in the Topken case, supra, rested on the reasoning that the corporation's promise was illusory because the existence of a surplus was within the corporation's control. See 1, Williston on Contracts, Rev. Ed. § 133. No such control would exist when, as in the present case, the corporation was required to hold in a special surplus account the money supplied for the purchase of the stock. Therefore, the present case is not one where the plaintiff had a choice to buy or not, as it pleased.

The importance of the role the insurance played in upholding the legality and enforceability of the agreement is shown by the following comments with respect to Section 664 of the New York Penal Law and with respect to corporate creditors:

> It is plain that no violation of this section could have been contemplated here for no illegal intention, as defined in the statute, could have been present when an arrangement was made whereby a special fund was being created with which the stock was to be purchased. The rights of general creditors of the corporation could not have been prejudiced by making this agreement, for this would be no impairment of capital because of said agreement. Even as-

> suming that at the time of the performance of the contract, because the rights of general creditors might have become impaired meanwhile, the contract became impossible of performance, we think that the contract was legal when made, and that it may be enforced, unless the defendant shows the present impossibility of performance.

The Carpet House case was followed by a very similar one in 1946, *Ionic Shop v. Rothfeld,* 64 N. Y. S. 2d 101. Originally, there had been an agreement by which the corporation was to buy a deceased's stock for $15,000, but during the depression the agreement was modified and the price reduced to $10,000, the amount of life insurance then being carried by the corporation on each. When stockholder Rothfeld died, however, some insurance had lapsed and the corporation collected proceeds of only $2,980.76. The corporation paid over this amount and claimed that the agreement had been orally modified so that the price was to be the amount of the insurance proceeds. The executors then contended that the agreement was void, citing the Topken case. The court held that there was no evidence of an oral modification of the agreement as to the price and that the agreement was valid. Again, the presence of the insurance was held to have validated the contract, as shown by the following quotation from the opinion:

> In the instant case, although there was no express provision for the payment by the corporation of the premiums, it is to be implied from the fact that the insurance was payable to the corporation that the corporation was to pay the premium. The allegations of paragraph Eighth and Ninth of the complaint tend to confirm that the corporation did pay the premiums, up to the time that it became unable to do so, as to one of the policies. It follows that there was sufficient legal consideration to support the contract, and that any claim that there was insufficient surplus to pay the full price of the stock would be a matter for affirmative defense. *Greater New York Carpet House, Inc., v. Herschmann,* 258 App. Div. at page 651.

The last quoted sentence above can be taken to represent the present status of the law in New York as to the enforceability of an insured corporation stock purchase agreement. By way of comment on the cases reviewed, however, it may be said that the

parties would have made it easier for the courts had the agreements definitely stipulated that the corporations involved were to pay the insurance premiums.

Enforceability. Assuming a jurisdiction in which a corporation is permitted to purchase its own stock and a valid contract running between the corporation and the stockholders to make such purchase upon the death of a stockholder, there remains the question of the enforceability of the contract upon the occurrence of a death. This question has been answered, however, in the quotations from the New York cases; for it is the law of practically all jurisdictions that even though a valid purchase and sale contract has been set up, it will not be enforced to the prejudice of the creditors of the corporation. The best way, therefore, to assure the enforceability of such a contract is to make sure that the corporation maintains at all times life insurance on each stockholder to the full amount of the purchase price for his stock. With a valid contract and with adequate surplus funds at hand with which to make the purchase, either party, if necessary, can have specific performance decreed.

Enforceability as against preferred stockholders. The ordinary close corporation has only common stock outstanding. Occasionally, however, a close corporation will also issue nonvoting preferred stock, usually to obtain additional capital from outsiders. The rights of preferred stockholders are contractual and differ from one issue to another. In such cases, therefore, care must be exercised to make sure that any plan by which the corporation is to purchase the common shares of an active stockholder upon his death will not conflict with the preferential contract rights of the preferred stockholders. The latter cannot interfere with the plan so long as their rights are properly observed. It is readily apparent, however, that they can interfere with a purchase of common stock at a time when preferred dividends are in arrears; hence, in any case in which this is a possibility, a different purchase plan should be adopted.

INSURANCE ARRANGEMENTS

Under the usual stock retirement plan the corporation will procure, pay the premiums on, and be the beneficiary of, the

life insurance carried to supply the purchase money for a deceased's stock. During the life of the agreement, therefore, the cash values of the policies constitute assets of the corporation and are subject to the claims of creditors of the corporation. But because "A solvent corporation, of course, holds its property as an individual holds his" (*In re Fechheimer Fishel Co.*, 212 Fed. 357), the matter of corporate creditors becomes important only in the event of the insolvency of the corporation.

Some authorities seem to feel that an arrangement by which the insurance policies and the certificates of stock are placed in escrow with a third party trustee is improper, so far as the corporation is concerned. The author fails to share this view. Granted that the corporation has the right to purchase its shares of stock, it is difficult to see any reason why it cannot employ a trustee to act as its agent in consummating the transaction and to act as custodian for it of the insurance policies meanwhile. Under the trust arrangement, it seems to be an open question whether, in the event of the insolvency of the corporation during the executory period, the policy cash values are subject to the corporation's creditors. Most states have statutes protecting insurance payable to a third person beneficiary, but under this arrangement the trustee beneficiary is to act as the corporation's agent in collecting the proceeds. Furthermore, at common law, and by statute in most states, property placed in trust for the use of the grantor remains subject to the grantor's present and future creditors. But regardless of how this question might ultimately be resolved in any particular jurisdiction, the fact remains that employing the services of an impartial trustee, whose only interest in the transaction is to perform faithfully its prescribed duties in the premises, has many advantages.

The naming of personal insurance beneficiaries under a corporation purchase plan, although this is done occasionally, is open to all of the objections to such a designation that were previously noted, and it raises the additional question here as to whether the premiums paid by the corporation might not be considered taxable income to the respective insureds. If the corporation retains the incidents of ownership in the policies, including the right to change the beneficiaries, and if the insur-

ance is "tied in" clearly with the agreement to buy and sell, there seems to be no sound basis upon which the premiums can properly be taxed to the stockholders. In substance, the premiums represent neither compensation nor dividends. But it must be remembered that the courts do not always look to substance where form is favorable to the government's contentions. In the Legallet case, the insurance proceeds, in substance, were part of the purchase price, but for income tax purposes the Board of Tax Appeals held that, based on form, this was not true. Therefore, until the question raised here has been tested in the courts, the possibility of income tax complications arising from the naming of personal beneficiaries under insurance carried by the corporation cannot be ruled out entirely.

Special financial adjustment required at death or retirement of a stockholder. Under the corporation purchase plan, the payment of the life insurance premiums by the corporation is generally the same mathematically as if each stockholder had contributed directly to the premiums in proportion to his stockholdings. This is so because premiums for insurance for the purpose of purchasing the corporation's own stock must be paid out of surplus funds that would otherwise be shared ultimately by the stockholders on the basis of the number of shares owned by each. It is obvious that a stock retirement plan will not function equitably unless the purchase price paid for a deceased stockholder's shares takes into consideration the life insurance owned by the corporation to the extent of his proportionate number of the total shares outstanding. Partial equity is achieved if the purchase price takes into consideration his proportionate share of the value of all policies immediately before a death occurs. Substantially complete equity is achieved if his proportionate share of the insurance on his own life is also taken into consideration.

The agreement, of course, should contain provisions giving the corporation a limited option to buy the stock of any stockholder who desires to sell during his lifetime. The same plan of adjustment as outlined above can be used in setting the final purchase price for his stock. Following such an adjustment, a retiring stockholder can be permitted to purchase the insurance

in force on his own life at its then cash value, or the adjustment and purchase can be handled on a net basis.

SPECIAL TAX CONSIDERATIONS INVOLVED

The Accumulated Earnings Tax. The Internal Revenue Code of 1954 authorizes the assessment in particular instances of a special accumulated earnings tax on the earnings of a corporation that, instead of being distributed, are accumulated for the purpose of avoiding the income tax with respect to its stockholders. The fact that earnings and profits are permitted to accumulate beyond the reasonable needs of the business is proof of the purpose to avoid income tax upon shareholders, unless the corporation proves to the contrary. This penalty tax is the lenient successor to the former Section 102 surtax authorized under the 1939 Revenue Code.

Where the accumulated earnings tax is assessed, it falls only upon the earnings that have been accumulated beyond the reasonable needs of the corporation. In this respect, reasonable needs include reasonably anticipated needs. In order to tax unreasonably accumulated earnings only, a credit is allowed consisting of that part of the earnings and profits of the corporation which is retained for its reasonable needs. The minimum credit is not less than the amount by which $60,000 exceeds the accumulated earnings and profits at the close of the preceding taxable year after deducting any dividends paid within two and one-half months thereafter.

The earnings of a corporation used to pay premiums for insurance on the lives of stockholders under a stock retirement agreement represent undistributed earnings and profits. This raises the question as to whether the financing of a stock retirement plan fulfills a reasonable need of a corporation. There are no cases or rulings bearing directly on this question, dealing with this particular tax. However, an important case dealing with a former excess profits tax held that premiums paid to finance a stock retirement agreement implemented a proper corporate purpose in that the plan provided for continuity of harmonious management. That case was *The Emeloid Co., Inc. v. Commissioner,* 189 Fed. 2d 230, (1951).

In the Emeloid case, the corporation in 1942 purchased $100,000 of single premium insurance on the life of each of its two equal stockholders. Most of the premiums were borrowed from a bank, presumably because at that time the law permitted the deduction of interest paid on money borrowed for such a purpose. In 1946, a trusteed stock retirement agreement was set up, financed by the $200,000 of single premium insurance and $200,000 of new annual premium insurance on the stockholders. In the meantime, the corporation in its excess profits tax return for 1944 had taken a borrowed-capital credit based on the loan. This credit was disallowed by the Tax Court, on the ground that the loan merely served the purposes of the individual stockholders. On appeal, the United States Court of Appeals for the Third Circuit reversed and held that the corporation was entitled to the credit as being based upon a loan which served a proper corporate purpose. The court held that whether the insurance be viewed as key-man insurance—as was concluded on the facts—or as stock retirement insurance, the policies implemented a proper corporate objective. Referring to the corporate function of key-man insurance, the opinion stated:

> What corporate purpose could be considered more essential than key man insurance? The business that insures its buildings and machinery and automobiles from every possible hazard can hardly be expected to exercise less care in protecting itself aginst the loss of two of its most vital assets—managerial skill and experience.

The opinion went on to justify the corporate purpose of stock retirement insurance, both from the standpoint of its direct and immediate functioning as such, and its indirect and ultimate functioning as key-man insurance. As to the latter, the opinion stated:

> Petitioner, in the situation provided for by the trust agreement, would also indirectly have the benefit of key man insurance. There would be no obligation on the corporation to retire the shares of stock purchased from the estate of the decedent. *Borg v. International Silver Co.*, 11 Fed. 2d 143 (D. C. N. Y., 1926). Moreover, retirement of shares which results in a reduction of the capital of a corporation can be effected only by conformance with the

> statutory procedure. See N.J. S.A. 14:11-5. The shares purchased by petitioner would become treasury shares and could be resold in the same manner as other corporate assets. *Borg v. International Silver Co., supra.* The trust agreement provides petitioner with a method of subjecting all potential purchasers to a screening test, thus permitting the corporation to choose its new shareholders in a highly selective manner. Funds derived from the resale would then be available to the petitioner and provide it with needed working capital.

What the opinion had to say of the insurance as stock retirement insurance is this:

> We need not, however, rest this decision on the state of the record in the absence of the trust agreement, as it is not in the least inconsistent with the purpose originally underlying the purchase of the insurance. The trust was designed to implement that original purpose, and, at the same time, add a further business objective, viz., to provide for continuity of harmonious management. Harmony is the essential catalyst for achieving good management; and good management is the *sine qua non* of long-term business success. Petitioner, deeming its management sound and harmonious, conceived of the trust to insure its continuation. Petitioner apparently anticipated that, should one of its key stockholder-officers die, those beneficially interested in his estate might enter into active participation in corporate affairs and possibly introduce an element of friction. Or his estate, not being bound by contract to sell the stock to petitioner, might sell it to adverse interests. The fragile bark of a small business can be wrecked on just such uncharted shoals.

Although the Emeloid case was concerned with the excess profits tax, it must be conceded from its reasoning that the payment of premiums by a corporation for a proper type and amount of life insurance for the purpose of implementing a plan "to provide for continuity of harmonious management" does not result in an accumulation of the earnings and profits of the corporation beyond the reasonable needs of the business and is not a plan designed for the purpose of preventing the imposition of income tax upon its shareholders through the medium of permitting earnings or profits to accumulate instead

of being paid out in dividends. Thus, even though this tax may be assessed against other funds of a corporation that have been unreasonably accumulated, the tax should not reach the funds that have been used to pay premiums for stock retirement insurance.

Distributions in Redemption of Stock. The functioning of a regular stock retirement agreement results in the purchase of all the shares of stock of a deceased stockholder. As a result, the funds received from the corporation in payment of the stock should be treated as purchase price paid and not as a distribution of a taxable dividend. The funds will be so treated under the provisions of Sections 302(b) (1) and 331 of the Code, "if the redemption is not essentially equivalent to a dividend." As this is a general provision which depends upon the facts of each case, it cannot be relied on. Section 302(b)(3) usually can be relied on, however, as it provides that a distribution by a corporation in complete redemption of all of the stock owned by a shareholder will be considered as the purchase price paid for his stock. Nevertheless, exceptions occur in the case of certain family corporations, because under some circumstances the rules of constructive ownership of stock attribute the ownership of stock to the deceased's estate where it is owned by certain other individuals or organizations.

The basic rule of constructive receipt applicable here is that an estate is considered as owning the stock that is owned directly or indirectly by or for a beneficiary of the estate. Therefore, a redemption of all the shares actually owned by a deceased stockholder's estate is not protected by Section 302(b)(3) if the estate is considered as constructively owning any shares in the corporation.

Thus, if a father and son each owned one-half of the outstanding shares of stock of a corporation, then upon the father's death his estate is considered as owning all the shares if the son is a beneficiary of the estate. Under such circumstances, the redemption of the father's previously owned shares would not come within the protection of Section 302(b)(3).

Note that this basic rule of constructive ownership may apply even though the stockholders are unrelated. For example, a

decedent's estate owns 50 shares of stock of a corporation. The decedent bequeathed his golf clubs to an unrelated co-stockholder who owns 20 shares. The estate will be considered to own 70 shares, and the redemption of the decedent's 50 shares under a stock retirement agreement will not be protected by Section 302(b)(3). There is much more likelihood, however, that a redemption will be considered as not essentially equivalent to a taxable dividend, and thus protected under Section 302(b)(1), where the stockholders are unrelated.

The possible application of the rules of constructive ownership should not be overlooked in any stock retirement plan.

The above examples show that the provision covering redemption of all of the shares of a deceased stockholder may not furnish protection to a stock retirement agreement of a family corporation, under certain circumstances. This provision, nevertheless, protects the stock retirement agreements of most other corporations by eliminating the danger that the purchase price for a deceased stockholder's shares will be treated as a dividend to the recipient.

Effect of Stock Redemption on Corporate Earnings and Profits. Although the redemption of the shares of a deceased stockholder is not usually treated as a dividend distribution, it has the effect of increasing the earnings and profits of the corporation. Under the provisions of Section 101(a) of the Code, the death proceeds of the stock retirement insurance are excluded from the corporation's gross income. Nevertheless, the excess of such proceeds over the aggregate sums of the premiums paid will constitute earnings and profits available for later distribution (Rev. Rul. 54-230, I.R.B. 1954-25, 7). Under Section 316, distributions out of earnings and profits are taxable dividends; but Section 312 (e) provides that a distribution treated under Section 302 as the purchase price paid for stock is not to be treated as a distribution of earnings and profits. Therefore, this payment would not offset the increase in earnings and profits created upon receipt of the death proceeds of the insurance by the corporation. This result may be important to the surviving stockholders, for it may make a subsequent

distribution to them taxable as a dividend that otherwise would not be taxable since not made from earnings and profits.

Establishing value of stock for Federal estate tax. As is more fully discussed in a later chapter, it has been held in a long line of decisions that if the purchase price of a deceased shareholder's stock fairly represented its value at the time agreed upon, and if prior to his death he has been prohibited from disposing of his shares from the execution of the purchase and sale contract until his death without first offering them to the corporation or to the other stockholders at the contract price, that price will control for estate tax purposes. This rule should hold whether the purchase and sale agreement runs between the stockholders themselves or between the corporation and the stockholders, with one possible exception as to the corporation purchase plan. If one of the stockholders owns a majority of the shares, it may be argued that under the corporation plan this dominant stockholder possesses sufficient power to force its amendment or abandonment at any time and that he is not in reality bound by such a contract; consequently the purchase price cannot be held to represent the estate tax value of his stock. If the purchase price is fairly set, however, and the agreement is properly drafted so that the mutual agreement of *all* the parties to it is required to effect any changes, it would seem that this argument should not prevail. A corporation is no less bound by its proper contracts than is an individual. The real question should be whether the agreement was entered into "at arm's length," which would appear to be answered satisfactorily if there were several stockholders and if the price set was a fair one.

Effect of corporation stock purchase on value of survivors' shares. Normally, stock purchased by the corporation under a stock purchase plan is retained in the corporate treasury. As long as it comprises treasury stock, it will remain dormant, bereft of voting or dividend or distribution rights. The further effect of this is to increase the book value of the outstanding shares held by the survivors without increasing the cost basis of such shares. Should the survivors subsequently sell any of their stock, therefore, presumably this enhancement in book value

would be reflected in the sale price, in which event an additional and sizable capital-gains tax would be incurred.

Assume, for example, a corporation with $60,000 of capital stock consisting of 600 shares of $100 par value each, contributed equally by three stockholders. If the corporation has $30,000 of surplus, each share will have a book value of $150 as compared with the income tax basis of $100 per share. Assume further, that upon the death of a stockholder the corporation collects $30,000 of life insurance proceeds and pays out the same amount of money to acquire the deceased's one-third stock interest. The capital stock account of the corporation will now show $60,000 issued stock, less $20,000 treasury stock, leaving an amount outstanding of $40,000. The surplus account will show $30,000, plus $30,000 life insurance proceeds and less $10,000 premium over par paid for the deceased's shares, or a net amount of surplus of $50,000. The total book value of the 400 shares of stock held by the survivors, therefore, will be $90,000 and the value per share will be $225, as compared with the unchanged income tax basis of $100 per share.

Had these stockholders arranged an individual purchase plan, the book value of $150 per share would have remained unchanged; and each surviving stockholder would have owned 300 shares, the original 200 of which would have had an income tax basis of $100; and the 100 shares acquired from the deceased stockholder would have had a basis of $150.

To return to our discussion of the assumed corporation plan, the corporation, of course, can sell the treasury stock. If it sold the shares to a new stockholder at $150 per share, it would have no gain or loss on the transaction [I.R.C., Section 1032(a)]. The capital account would then be restored to $60,000 of outstanding stock and the surplus account would stand at $60,000, making the book value $200 per share. The corporation has increased its surplus by $10,000, but there appears to be no way this increased amount can reach the stockholders except through the channel of taxable dividends.

The corporation, instead of selling the treasury stock, can transfer it to the surviving stockholders by declaring a stock dividend. Because of a special exception made in I. R. C., Section 305 for constitutional reasons, such a stock dividend

no doubt is non-taxable, but by the provisions of I. R. C., Section 307, the basis of the old stock held must be allocated between the old and the new stock received. The basis of the old stock of $40,000 would therefore be allocated between the 400 original shares held by the survivors and the 200 shares comprising the stock dividend, with a resulting basis per share of only $66.67. This procedure again restores the capital stock account to $60,000 of outstanding stock; and with the surplus account remaining at $50,000, the book value per share becomes $183.33. The declaration of a stock dividend, therefore, will not solve the problem of the spread between the income tax basis of the survivors' shares and their value.

Note: In the foregoing illustrations showing the effect of the purchase and sale of treasury stock on the balance sheet, the accounting method that seems to be in most general use has been followed, namely, the deduction of the par value of the treasury shares from the stated capital and the deduction from surplus of that portion of the purchase price paid in excess of par, with a reversal of the entries upon sale. From a legal standpoint, treasury shares should be shown on the balance sheet simply as a deduction from the number of shares issued and outstanding, without deduction from the stated capital, and the surplus should be reduced by the purchase price paid. On subsequent sale, the money received should be credited to surplus. For our purposes here, however, it is immaterial which of these two accounting methods is used, for both arrive at the same book value of the remaining outstanding shares.

It is apparent that the corporation stock purchase plan puts the surviving stockholders in an unavoidable position to incur considerable additional capital gains tax liability upon a subsequent sale of their shares, as contrasted with the plan of individual purchase. The importance of this disadvantage depends, in each particular case, upon the entire picture. The purchase of the deceased's stock by the corporation normally will transfer corporate surplus to the deceased's heirs tax free, since the basis of the stock in their hands will be its value at death, which is the price to be received. The survivors may not sell their shares during their lifetimes, thereby avoiding any capital gains tax. But even if a sale is made, the maximum effective rate of tax will be 25 per cent, assuming that the shares will be held for a period sufficient to result in a long-term gain.

These possibilities must be weighed in the light of all the other considerations in choosing the most desirable type of stock purchase plan.

The foregoing discussion of its various phases shows that special considerations are involved in the corporation stock purchase plan that are not present in the individual stock purchase plan. Laws of a few states still prohibit the purchase by a corporation of its own shares. In these states there is no choice of a plan. However, in the majority of states a choice between these plans is offered the stockholders. In most instances in which there are three or more stockholders, circumstances are such that the advantages of the corporation plan will be found to outweigh any inherent disadvantages that cannot be overcome in setting up the arrangement.

COMBINATION PURCHASE PLANS

On rare occasions a combination of the two plans may be found best to serve the purposes of the stockholders. One of these occasions might exist, for example, if all the circumstances pointed to the advisability of a corporation purchase plan except that the surviving stockholders desire a different ratio of stockholdings between themselves after a death occurs. An individual purchase plan for some of the stock can be set up to ensure the proportionate holdings desired, with the remainder of the stock made subject to a corporation purchase arrangement. Another occasion for the use of a combined plan may arise if there are two stockholders, one of whom owns only a small minority interest and whose income is not sufficient to purchase all of the majority stock. An individual purchase plan could be set up to the extent that the minority stockholder could finance it, with the balance of stock to be purchased by the corporation. Combination plans, however, call for carefully worked out adjustments to be made upon death and the arranging of them necessitates double the ordinary amount of "machinery." Their use should be restricted to those situations in which no other solution is satisfactory, and the individual purchase should function ahead of the corporate purchase.

CHAPTER 14

Unusual Stockholder Situations Discussed

THE DISCUSSION OF THE INSURED STOCK PURCHASE and sale plan is predicated largely upon the circumstances existing in the typical close corporation: namely, two or more active stockholders whose stockholdings are not greatly disproportionate, all of whom are insurable and are willing to have their shares sold to the survivors upon death. It is apparent, however, that these typical circumstances do not always prevail and that unusual circumstances require appropriate modifications to be made in the standard purchase and sale arrangement. One of these unusual situations—that of the sole stockholder—has already been analyzed in Chapters 7 and 8. Others are discussed here.

STOCKHOLDERS WITH GREATLY DISPROPORTIONATE STOCKHOLDINGS

Many close corporations are comprised of two stockholders, each owning the same number of shares. For these stockholders, the standard procedure of each contributing to the premiums to purchase insurance on the life of the other appears to be the most satisfactory arrangement. The same holds true if the respective interests, although not equal, are not greatly disproportionate. There remain, however, a considerable number of such corporations in which one man, usually older than the other, owns a large majority interest. In many of these cases it is still possible for the stockholders to follow the standard

procedure of "crossing" premiums; but occasionally the financial circumstances of the smaller stockholder make this method of premium payment out of the question. However, several other methods are available to them, for working out the premium problem.

One plan is for the smaller stockholder to pay as great a portion of the premiums for the insurance on the life of the majority stockholder as his finances permit, with the majority stockholder contributing the balance as a loan to the other. These loans are recorded on a special schedule attached to the agreement, and the agreement should provide for their repayment out of the first insurance moneys collected upon the death of the majority stockholder (or suitable credit allowed him in case the other stockholder predeceases him). If, in the case of the prior death of the majority stockholder, this loan procedure leaves the remainder of the insurance proceeds insufficient to pay the full purchase price, the deficiency will be absorbed by the regular note arrangement set up to cover any balance. Should aggregate loans of this nature grow to substantial proportions over a period of years, they may be hedged with additional insurance. As the junior stockholder advances, however, often the total of such obligations may at least be kept at an insignificant figure, if not discharged entirely during the life of the agreement.

Another plan requires that the smaller stockholder purchase such insurance on the life of the majority stockholder as he is able to finance, the insurance proceeds to constitute a "down payment," with the remainder of the purchase price covered by instalment notes.

If the corporation involved can be depended upon to pay steady and substantial dividends on its stock, the following plan might be adopted: (1) The majority stockholder makes a present sale of enough shares of his stock to the minority holder so that the dividends will cover his life insurance premiums under the plan; (2) the minority stockholder pays for the shares so purchased by giving the majority stockholder his open, interest-bearing notes, callable upon default in payment of insurance premiums or of note interest; (3) the minority stockholder

enters into the regular insured purchase and sale contract covering the remainder of the majority stockholder's shares, with the amount of insurance sufficient to cover the outstanding notes as well.

In the event that none of the foregoing adjustments are feasible, the most suitable plan for the two-stockholder corporation with disproportionate holdings is a stock retirement plan.

Corporations comprised of three or more stockholders will usually prefer to set up a stock retirement agreement, whether or not their stockholdings are disproportionate. Their preference for such a plan stems largely from the fact that the agreement can function beyond the first death without disturbing the insurance on the lives of the surviving stockholders. Should such stockholders set up a buy-and-sell agreement, with cross ownership of the insurance policies, they would have to change over to a stock retirement plan after the first death if they were to continue utilization of the policies on the lives of the survivors. This results from the fact that a transfer for value of such policies to the corporation comes within an exception to the rule that calls for income tax on the death proceeds of a policy transferred for value. As this is written, there is no such exception in the case of a transfer to a co-stockholder, but a future amendment to the Internal Revenue Code may be made in this respect.

As noted in the previous chapter, a stock retirement plan involving stockholders with disproportionate interests will work out equitably if the insurance values owned by the corporation are taken into consideration in valuing the shares of a deceased stockholder.

THE UNINSURABLE STOCKHOLDER

As already noted in the book on Partnerships, approximately one person in every twenty who applies for life insurance is uninsurable. It is to be expected, therefore, that sometimes stockholders who wish to arrange an insured stock purchase and sale plan will find one of their number unable to obtain a policy. This fact should not deter them from going ahead. In view of the undesirable situation that will in all probability develop on

the death of a stockholder in the absence of a plan, an agreement would be worth while even if all the shareholders were uninsurable. There is no doubt but that the life insurance method of financing as applied to the interest of every stockholder is the ideal method. But when this cannot be done universally, life insurance should be used for the insurable stockholders and the ordinary sinking fund method should be used to supply the "down payment" for purchasing the shares of the uninsurable stockholder.

The regular purchase and sale agreement needs only slight modification. It provides that the insurable stockholder will deposit annually into a segregated reserve fund an amount at least equal to the premiums that, had the uninsurable stockholder been able to procure coverage, would have been paid for insurance on his life. If the trust plan is used, these annual deposits may be made to the trustee and the reserve fund built up under the terms of the trust, which affords ideal segregation. If the trust plan is not used, the fund may be placed in a special bank account or invested in government bonds; or, under certain circumstances, it may be placed in discounted premiums paid in advance on the policies of those insured, provision being made for the reversion of the fund to the contributors upon the insured's death or upon the death of the uninsurable stockholder.

Since the reserve fund, unlike the life insurance fund, is not automatically self-completing for the full amount upon the death of the insured, and since the time of death of the uninsurable stockholder cannot be predicted, the agreement must allow the instalment payments covering the remainder of the purchase price to be spread over a period of time sufficient to avoid financial embarrassment to the surviving stockholders in case of an early death. This requirement would be taken care of automatically, however, if the agreement provided that any instalments payable are to be of a specified amount and are to be paid at specified intervals. By this provision, a larger balance would merely require a greater number of payments rather than an increase in the amount of each payment.

Where a stock retirement agreement is used, the corporation

may build up a reserve fund, directly or through a trustee, for the purpose of acquiring the shares of an uninsurable stockholder. The corporation also may find it desirable to own extra key-man insurance on the lives of the insurable stockholders, so that the reserve fund may be enhanced upon the prior death of such a stockholder. In some instances, the uninsurable stockholder will have a surplus of personal insurance, in which event, he may sell some of such insurance to the corporation for purposes of the stock retirement agreement. Such a transfer comes within an exception to the transfer-for-value rule of income taxation of death proceeds.

In the case of an uninsurable stockholder, provisions in the agreement for securing any unpaid balance of the purchase price with suitable collateral assume greater than ordinary importance and should be carefully drafted.

STOCKHOLDERS WITH SONS INTERESTED IN THE BUSINESS

Here and there are found close corporations in which one of the stockholders has a son presently or prospectively employed in the business, to whom the father plans to leave his stockholdings. In such a case, a unilateral purchase and sale arrangement is necessary, that is, an arrangement in which only the stock of the other stockholder or stockholders is the subject matter of the agreement. If the son is already of age and active in the enterprise, he should be made a party to the agreement. The nature of the son's obligations under the agreement, however, depends upon the circumstances of each case. Perhaps it would be an agreement on his part to assume his father's obligation to purchase, should his father die first. Perhaps the circumstances would make it possible and advisable for the son to become a direct rather than a contingent purchaser of some or all of the other stockholder's shares upon the latter's death. If, on the other hand, the son is a minor, he would be brought into the agreement by suitable modification of it at a future date.

Family corporations. *Section 303.* These are corporations in which all or practically all of the shares are owned by one

family—usually the father. If most of the father's assets consist of stock in the family corporation, he finds himself confronted with two special problems: the problem of providing cash in his estate with which to pay death taxes and estate settlement costs, and the problem of providing equitably for the other members of his family while leaving his stock to one or more sons.

The problem of furnishing cash in the estate to pay death taxes, funeral and administration expenses may be solved at the time of death of the principal stockholder by the sale to the corporation of a sufficient number of shares to accomplish this. Even where the father owns all of the shares, such a stock redemption may be made without danger that the cash received from the corporation will be considered a taxable dividend, if the transaction comes within the provisions of Section 303 of the Internal Revenue Code. One of the provisions of that section is that the decedent's stock in the corporation must comprise either more than thirty-five per cent of his gross estate or more than fifty per cent of his taxable estate. Where the decedent owned more than seventy-five per cent of the stock of two or more corporations, they may be treated as one corporation in meeting the above percentage requirements. Another provision of the section is that the distribution in redemption of stock under this section is limited to the aggregate amount of death taxes imposed because of the stockholder's death, plus the amount of funeral and administration expenses allowable as Federal estate tax deductions. Other provisions of the section limit the time after death during which the sale and redemption of the stock must be made. The details of this section should be consulted, as they have been subject to amendment from time to time.

If selling a part of the stock to the corporation under the protection of Section 303 appears desirable, the corporation should own insurance on the principal stockholder's life payable to itself in the amount, at least, of the estimated death taxes, funeral and administration expenses his estate will be called on to pay. In some instances, the stockholder should also enter into a special stock retirement agreement with the corporation,

obligating it to purchase the stock to the extent permitted under the section.

The problem of dividing the father's estate equitably among the members of his family, while leaving his stock to his son, is partially solved by the sale of some of the shares to the corporation under Section 303 and leaving the proceeds of the sale to members of the family other than the son. Often, however, more must be done. Sometimes the estate may be balanced by the purchase of additional personal insurance on the part of the father. In many instances, the problem is solved by an agreement running between the father and son under which the son agrees to purchase the number of shares that will accomplish the purpose. The agreement will be financed by insurance on the father's life, owned and maintained by the son. The proceeds will go through the father's estate to the other members of his family at his death.

CHAPTER 15

Tax Problems Involved in the Insured Stock Purchase Plan

THE FEDERAL INCOME TAX

The life insurance premiums not deductible expense. The general rule is that premiums paid for life insurance made subject to a stock purchase and sale agreement are not deductible as business expense. This is so whether the premiums are paid by the individual stockholders under an individual stock purchase plan or by the corporation itself under a corporation purchase plan. [I. R. C., Sections 264 (a) and 265.]

In this connection, mention should be made of one common situation that furnishes an apparent, but not an actual, exception: when an individual purchase plan is set up under which the stockholders authorize the corporation to pay the insurance premiums and charge them to the respective salary accounts of the stockholders. Premiums thus paid by the corporation are of course deductible; not as premiums, however, but as salary. This is not only a convenient method of paying premiums, but also has the advantage of assuring all the stockholders that the payments will be made when due. The stockholders merely appointed the corporation to act as their agent for this purpose; they will report their full salaries for income tax purposes, including the premium payments charged to them.

The life insurance death proceeds generally not taxable income. Life insurance proceeds paid upon the death of a stockholder insured under a purchase and sale agreement are not, as a general rule, subject to income tax [I. R. C., Section 101(a)

(1)]. An exception occurs, however, if a policy has been transferred for value during the insured's life time to someone other than the insured, a partner of the insured, a partnership in which the insured is a partner, a corporation in which the insured is a shareholder or officer, or other than in a transaction which does not change the basis of the policy; in which event the amount of proceeds received at death of the insured in excess of the sum of the consideration paid for the transfer plus any subsequent premiums paid by the transferee is taxed to him as ordinary income. [I. R. C., Section 101(a)(2).]

This exception obviously militates against the use of old insurance for financing a new buy-and-sell agreement. On the other hand, old insurance may be transferred for value to the corporation and used to finance a stock retirement agreement. This might be done, for instance, where a stockholder is presently uninsurable, but has an ample amount of other personal insurance.

The problem of a transfer may be encountered also if a corporation is owned by three or more stockholders and it is desired to continue a plan after the first death has occurred. Probably the most desirable solution is to transfer the insurance on the surviving stockholders to the corporation and set up a stock retirement plan.

From the foregoing, it seems obvious that the problem of a transfer for value of the insurance is best solved in the case of three or more stockholders by starting out with a stock retirement agreement.

The sale of the deceased's stock by his estate. Before a death occurs under an insured stock purchase and sale agreement there is only a contract to sell, binding the personal representative of a deceased stockholder actually to sell and transfer his stock upon receipt of the agreed purchase price. Consequently, the cost basis of the deceased's stock to his estate will be its value at death, or on the optional valuation date used for Federal estate tax purposes, the statutory basis generally for property passing at death [I. R. C., Section 1014]. The value of the stock to the deceased's estate cannot be other than the price at which he has obligated his estate to sell it; therefore,

the estate, in consummating the sale at that agreed value, has no gain or loss in the transaction.

The cost basis of stock acquired from deceased stockholder. The cost basis to the surviving stockholders of the shares of stock acquired from the deceased's estate should be the purchase price that the survivors have paid for it. There seems to be little doubt of this result if the surviving stockholders have been designated beneficiaries of the insurance proceeds used to finance the transaction, regardless of the method of premium allocation. The insurance proceeds, together with any balance of the purchase price paid in instalments or cash, should also constitute the cost basis of the acquired stock if the insurance proceeds are received by a trustee and paid over by it to the deceased stockholder's personal representative in return for a transfer of the deceased's stock, when the surviving stockholders have paid the premiums and they or their trustee owned the policy. But if the deceased stockholder has owned and paid the premiums on the insurance covering his life, especially if there has been no accompanying provision for reimbursement of premiums paid by the deceased, the surviving stockholders may anticipate that the Treasury Department will challenge the inclusion of the insurance proceeds in the cost basis of the shares acquired. If the insurance proceeds under a stock buy-and-sell agreement are made payable directly to the deceased's estate or to his personal beneficiaries, there is slight reason to believe that such proceeds may be included in the cost basis of the shares acquired from the deceased stockholder, if the deceased has owned and participated in paying the premiums on his own insurance. (*Paul Legallet,* 41 B. T. A. 294. See discussion of this in Chapter 13 of the book on Partnerships.) In respect of the holding in the Legallet case, a distinction based upon the difference in subject matter of the agreement, i.e., shares of stock rather than a partnership interest, would seem to have no probative force. It would seem that such insurance, however, should be includable in the cost basis if the premiums have been paid by the stockholders other than the insured and if the other stockholders have also owned the policies on the life of the deceased, but we know of no holding to that effect.

To sum up, the arrangements that appear to raise no doubt that the insurance proceeds will be included in the cost basis of the surviving stockholders are those under which the survivors have been the premium payers and they, or a trustee in their stead, have been the policyowners and beneficiaries of the deceased partner's insurance.

Special income tax considerations involved in the corporation purchase plan. If a corporation stock retirement plan is set up, special income tax considerations are involved. These were previously discussed in connection with the corporation purchase plan; the reader should refer to Chapter 13 of this Book.

THE FEDERAL ESTATE TAX

No double taxation. The existence of an insured stock purchase agreement does not "double up" on the amount of estate taxes a deceased stockholder's personal representative will be called on to pay. *Estate of Ealy,* 10 T.C.M. 431 (1951). In fact, there is no such possibility if the life insurance is arranged so as to be excluded from his taxable estate. This is the case, if, for example, the deceased has held no incidents of ownership in the insurance in force on his life under the plan and if his estate has not been designated as beneficiary. In such cases nothing could be taxed except the transfer of his shares to their value. Even if the life insurance is arranged subject to estate taxation, the value of the stock for purposes of this tax is held decreased by the amount of insurance taxed and applied to its purchase price. *Estate of John T. H. Mitchell,* 37 B. T. A. 1 (1938).

The Mitchell case is the leading adjudication with respect to the application of the above estate tax rule to close corporation stock. In 1924, Mitchell and Philip W. Lennen organized the advertising corporation of Lennen & Mitchell, Inc., each subscribing to one-half of the 1,800 shares of stock, which each held up to Mitchell's death in 1930. In April, 1929, they executed an individual stock purchase and sale agreement financed in part by $200,000 of insurance on each, payable to the respective insured's estates, "the said sum of $200,000 . . . to be received

on account of the purchase price as if the surviving party had paid the sum." In addition, Lennen owned $400,000 of insurance on Mitchell, not subject to the agreement. The following year Mitchell died and proceeds of the policy subject to the agreement, amounting to $202,666.67, were paid to his estate. It was then agreed between Lennen and the administratrix and the next of kin that Mitchell's shares at death had a value of $313,771.93 in accordance with the purchase and sale agreement, and Lennen paid the balance of $111,105.26 in cash to the administratrix.

In the estate tax return the administratrix reported the shares as having a value of $111,105.26 and reported the $202,666.67 as proceeds of insurance payable to the estate. The Commissioner increased the value of the stock to $313,771.93, made no change with respect to the insurance proceeds and assessed an estate tax deficiency of $35,769.14. Thus we have a clear case of an attempt to "double tax" the amount represented by the insurance proceeds.

The administratrix petitioned the Board of Tax Appeals to set aside the deficiency, and was successful. Some of the reasoning of the Board is as follows:

> In our opinion there can be no doubt that the insurance proceeds in the amount of $202,666.67 must be included in determining the value of the decedent's gross estate, as proceeds of insurance, within the meaning of section 302 (g) *supra* [1926 Revenue Act]. . .
>
> However, such insurance proceeds were received by decedent's estate subject to the terms of a valid and binding contract that they be applied to reduce the purchase price to be paid by Lennen for the decedent's 900 shares of Lennen & Mitchell, Inc. stock which by the same contract Lennen was obligated to buy. These shares, being so burdened, were not subject to the unfettered ownership of the decedent's estate. The effect of the contract was to reduce the value of the estate's interest in such stock by an amount equal to the amount of the proceeds of the insurance policy, and the value of the stock as so reduced must be deemed as its value for estate tax purposes. Cf. *Wilson v. Bowers,* 57 Fed. (2d) 682; *M. W. Dobrzensky, Executor,* 34 B. T. A. 305, 312; *Edith M. Bensel et al., Executors,* 36

> B. T. A. 246, and authorities cited therein. As so reduced that amount was $111,105.26 for which amount the decedent's estate was obligated to and did transfer the said shares to Lennen. In our opinion, the value of such shares at the date of decedent's death was, for the purpose of determining the value of his gross estate, $111,105.26, for we must deal in actualities and such amount was the sale price actually received by the estate after the reduction [sic] of the amount of insurance proceeds from the total sale price of the stock. . .

Aside from the tax feature, it should be noted that not more than two premiums could have been paid on this insurance, again demonstrating the unique value of the life insurance method of financing.

Estate tax cannot be by-passed. It was formerly urged in some quarters that an insured purchase and sale agreement could be designed so that the proceeds of the life insurance credited to the payment of the purchase price would not be subject to the Federal estate tax and at the same time the business interest being purchased would be valued for estate tax purposes at the agreed value *less* these insurance proceeds. The case of *Estate of Herbert G. Riecker*, 3 T. C. M. 1293 (1944), however, has held to the contrary. The court held that, if the insurance was not subject to estate tax, the business interest was taxable at its full value.

Estate of Herbert G. Riecker. In 1937 the printing and binding corporation of Lenz & Riecker, Inc. had eight stockholders, among them William Riecker and his wife, who together owned 1,308 of the 2,200 shares of $50 par value, and his brother Herbert, who owned 474 shares. In February of that year, after William's return to the business from an illness, the brothers discussed what would happen to the business if William should die. William was then aged 51 and Herbert was 43. Accordingly, the two brothers, together with William's wife, entered into an insured stock purchase agreement.

The corporation was made a party to the agreement as trustee (probably *ultra vires,* but apparently no one complained). The purchase price was originally set at $125 per share, with provision for a certificate of valuation to be filed on or before March

15 of each succeeding year. Herbert agreed to finance the purchase price payable, if William predeceased him, by two methods. First, he was required to pay the premiums on $70,000 of insurance on William's life. This insurance was owned by William's wife and was made payable to the corporation. Second, he was required to deposit into a sinking fund held by the corporation as trustee one-half of all dividends paid on his shares of stock, out of which fund he was permitted to buy insurance on William's life. (A year later he purchased $50,000 of this insurance.) William was to finance the purchase price payable if Herbert predeceased him, first, by paying the premiums on $25,000 of insurance on Herbert's life owned by Herbert's wife and made payable to the corporation; and second, by depositing into a sinking fund an amount equal to one-half the amount deposited by Herbert. William was likewise permitted to use the sinking fund to purchase insurance on Herbert, but did not do so. On the death of either, any balance of purchase price was to be paid in quarterly instalments of $1,250 each, with interest at 5 per cent. Each brother had children (Herbert had three between the ages of 13 and 6), and each reserved the right to withdraw shares "in order to give them to a child of such party," but William and his wife were required to leave sufficient shares subject to the agreement to permit Herbert to own at least 51 per cent of the outstanding shares in the event he survived.

In December, 1937, the insurance policies under the agreement were assigned by the corporation and made payable to the respective wives of the insureds.

In March, 1940, William and Herbert executed a certificate of valuation at $140 per share, which certificate was in effect upon Herbert's death early in 1941.

Herbert's widow collected the $25,000 of insurance proceeds, and Herbert's sinking fund of $2,500 was paid over to the executor of his estate. William immediately entered into an agreement with the executor under which he paid the executor an additional $500 to aggregate the purchase price of 200 shares of Herbert's stock, released to the executor his right to the remaining 274 shares and consented that they be sold to Herbert's

widow and to three other interested parties at $140 per share. William then took delivery of the 200 shares and also purchased from the executor for $2,397.03 the $50,000 policy on his life purchased by Herbert out of his sinking fund.

On the estate tax return, Herbert's executor included the 474 shares at a valuation of $41,360. This value was determined by subtracting the $25,000 of insurance proceeds that had gone directly to the widow from the full valuation at $140 per share of $66,360, on the ground that the contract operated to reduce the amount William was required to pay for the shares. The insurance proceeds were not reported, on the ground that they were not taxable under the applicable Revenue Act.

The Commissioner assessed an estate tax deficiency of $2,327.99, based upon the full value of the stock at $140, whereupon the executor petitioned the Tax Court for redetermination. In a memorandum opinion, the Tax Court upheld the Commissioner's determination, saying in part:

> No attention is paid to the fact that of the entire 474 shares owned by the decedent at the time of his death, 274 shares were in fact sold by the executor to four persons other than William at a price of $140 a share, indicating that the figure of $140 per share was not only a figure of value agreed upon by the brothers but also the value at which some of the shares were sold and bought in arm's length transactions. There can be no doubt that the value of the shares in the decedent's estate was $140 per share, or $66,360.
>
> This disposes of the case, for it determines the only question that the petitioner raises. There is no significance for present purposes, in the question whether the 1937 contract of the brothers was enforcible in equity and binding on the executor, and it may be assumed, without deciding, that it was; and it may also be assumed *arguendo* that the "credit" of the $25,000 insurance was a clear burden on the estate which operated to reduce the price which William was required to pay for the 200 shares. However, these propositions do not serve to lower the value of the 474 shares which were in the gross estate below the $66,360 which the Commissioner has determined and which is the only determination which the petitioner assails. Since the shares are included in the gross estate at

> their full value of $140 each, under Section 811 (a), there is no occasion to consider the alternative authority of Section 811 (d), cited also by the Commissioner in the deficiency notice. There may be a collateral question under Section 811 (g) in respect of the place of the $25,000 insurance in the estate, but no such question is raised. Apparently the petitioner did not include this in the estate shown on the return and the Commissioner did not add it as an item of the deficiency. It is not easy therefore to see any justification for saying that, not only is the insurance to be omitted from the gross estate, but that it serves also to reduce the value of the shares which is otherwise included.

The net result of the cases appears to be that, if the insurance is arranged in such manner as to require its inclusion in the taxable estate of the insured, then it will be taxed and will be considered to have lowered *pro tanto* the value of the stock purchased with it for estate tax purposes; but if the insurance proceeds are not includable in the taxable estate, then the stock will be included at its full value, undiminished by any insurance proceeds credited against the purchase price. This result seems to be fair and equitable to all concerned.

The insured purchase plan establishes share value for Federal estate tax. As pointed out in Chapter 12, many cases uphold the rule that, if the purchase price of a deceased stockholder's shares fairly represents their value at the time agreed upon and if prior to his death the stockholder has been prohibited from disposing of his shares from the time of the purchase and sale contract until his death without first offering them to the other stockholders or to the corporation at the contract price, then this price will control for estate tax purposes, even though the actual value of the stock would be much higher at time of death if freed from the agreement. A brief résumé of a few of these cases shows this to be the rule.

Wilson v. Bowers. In 1909, A. R. Wilson, the decedent, contracted with his nephew and one Betts not to sell or assign his 300 shares of stock in Earl & Wilson Company without first offering them to his nephew at $6.667 per share. If the nephew did not accept the offer, a similar offer was to be made to Betts. It was further provided that upon Wilson's death, the nephew

should have the right for four months after the qualification of the personal representative to purchase the stock at the agreed purchase price, and in the event of his failure to exercise the option a similar right of purchase was given to Betts. When Wilson died many years afterward, his will bequeathed his 300 shares to his nephew. On the estate tax return, Wilson's executors reported the value of the shares at $20,000, the option price. The Commissioner increased the valuation to $23.55 per share and assessed an additional estate tax of $3,039. The Circuit Court of Appeals affirmed the lower court in holding that the option price of $20,000 governed for estate tax purposes, the opinion, 57 Fed. 2d 682 (1932), stating in part:

> Since the contract was specifically enforceable, it seems obvious that the sale value of the stock during the testator's life could have been no more than the low price at which he was obliged to offer it, first, to Franklin Wilson, and then to Betts; nor could his executors have sold it for more, unless both the option holders had allowed their options to lapse. Even if each were penniless, money could readily have been borrowed on the stock when it was worth nearly four times the option price. We are to deal with actualities; and the suggestion that the shares may have had a greater market value because of the possibility that the options would not be exercised seems too extravagant to require further refutation. . .
>
> Finally, the appellant argues that the option was never exercised, and that Franklin Wilson took under the will thereby relinquishing his option and leaving the interest which passed by will the full value of the shares. Logically, subsequent events should not be considered in determining value at the time of death. It is true that this court held the contrary with respect to the relinquishment of dower in *Schuette v. Bowers* (C. C. A.) 40 Fed. (2d) 208, 213. But the ruling there made was put squarely on the precedent and was recognized as illogical. We shall not extend it where authority does not compel.

In 1936, two important decisions on this subject were handed down, both also involving option agreements. These were *Helvering v. Salvage,* 297 U. S. 106 and *Lomb v. Sugden,* 82 Fed. 2d 166. The latter case concerned the value for tax pur-

poses of 1,500 shares of Bausch & Lomb Optical Company stock in the estate of Mrs. Carrie B. Lomb. About a year before her death, Mrs. Lomb had entered an agreement with all the other stockholders of the company, under which none of them could sell their stock without first offering the shares to the others at a price that, when computed at the time of her death, amounted to $69.445 per share. The stock, however, could be donated to the other stockholders or could be bequeathed under certain restrictions. On her death, Mrs. Lomb had bequeathed her holdings as part of her residuary estate to her husband. The Commissioner assessed the shares at $100; the executor paid the additional estate tax required and brought suit to recover the alleged overpayment. The Circuit Court of Appeals reversed the lower court's decision and held that the option price of $69.445 governed. The opinion stated as follows:

> . . . As Holmes, J., said in *Edwards v. Slocum,* 264 U. S. 61, 63, quoting from *Knowlton v. Moore,* 178 U. S. 41, the tax is on "not the interest to which some person succeeds on a death, but the interest which ceased by reason of the death." Mrs. Lomb at the time of her death was restricted to a price of only $69.445 because she was obliged either to donate her stock to the other stockholders or to offer it to them at that low price. In either event that price was the most that she could obtain for her stock in the natural course of events. . .
>
> The decision of the Supreme Court on January 13, 1936, in *Helvering v. Salvage,* 56 S. Ct. 375, 377, 80 L. Ed. —, recognizes an option agreement as restricting the market value of stock in the hands of the owner to the option price. There Justice McReynolds said: "Considering the option to repurchase at par, outstanding in 1922, there could be no proper finding of fair market value at that time in excess of $100 per share." Because of the agreement, the decedent could not have secured a price greater than $69.445 at the time of her death. It is as of that time that the value of the stock must be determined. Then she could only give it or sell it to the other stockholders at the price fixed. Its value to the estate can be no greater than that with which the decedent parted. *Edwards v. Slocum,* 264 U. S. 61, 63.
>
> We think that *Helvering v. Salvage,* supra, and *Wilson*

v. Bowers, (C. C. A.) 57 Fed. (2d) 682, govern, and that the judgment should be reversed.

Another important case went through the courts during the following two years: *Edith M. Bensel et al., Executors,* 36 B. T. A. 246 (1937), affirmed as *Commissioner v. Bensel,* 100 Fed. 2d 639 (1938). This case was brought to set aside an estate tax deficiency of $297,101.11 assessed against the estate of F. L. Driver, Sr., based upon the value of 50,830 shares of Driver-Harris Co. common stock that the decedent had transferred to a trustee pursuant to an agreement made with his son. The facts show that the father and son had not been on friendly terms prior to and during the period involved in their stock negotiations. In fact, the father had originally opposed his son's employment by the company.

As time went on, however, the son's unusual business ability was recognized, and in 1924, when the son demanded some guarantee as to his future with the company, an agreement regarding the father's stock was entered into. By this agreement, the father transferred all his common stock in the company to a trustee, reserving the income during his life, with the provision that upon his death the son could purchase the shares from the trustee at $65 per share, although current sales of the stock were being made in 1924 at a much lower figure. The son had endeavored to have the price fixed at less than $65, and in 1925 persuaded his father to reduce it to $34.428 per share. In 1926, during which year sales of the stock had been made ranging from $25 to $65 a share, the father insisted that the price be restored to $65, and it was finally changed to $59.02, or a total of $300,000, with a certain discount allowed if paid in lump sum. In 1929 the share price became $5.902 when the par value of the stock was reduced from $100 to $10 per share.

Upon the father's death in 1930, the son paid the full purchase price at once, which, after a disagreement over the amount of discount had been settled, came to a net payment of $232,500. The father's executors reported this figure as the value of the stock in his gross estate.

The Commissioner, however, determined the value of the 50,830 shares of stock to be $69.75 a share and increased the gross estate by more than three million dollars on the ground that the son was the natural object of his father's bounty, that the price fixed was much less than the value of the stock, and that, to the extent of the excess value, the transfer was taxable under Section 302 as a substitute for testamentary disposition. The parties had stipulated that the fair market value of the stock at date of death was $3,149,800.

The Board of Tax Appeals held, and the Circuit Court of Appeals affirmed, that the value of the stock for estate tax purposes was the contract price at which the son had bought it, namely, $232,500.

With respect to the provisions of Section 302 (c) and (d) [1926 Act], the Board said in part:

> They do not apply where a decedent at the time of his death owns property which is subject to an option to purchase by one not the object of his bounty. In that case the decedent's interest in the property can be included in his gross estate at no more than the option price. *Wilson v. Bowers,* 57 Fed. (2d) 682; *Lomb v. Sugden,* 82 Fed. (2d) 166. Cf. *Salvage v. Commissioner,* 76 Fed. (2d) 112; affd. *Helvering v. Salvage,* 297 U. S. 106; *Omaha Nat. Bank v. Commissioner,* 75 Fed. (2d) 434.

In justification of its holding that the purchase price of the stock was the result of an arm's length transaction, the Board opinion stated:

> . . . If the decedent had entered into the contracts in question with an employee in whom he was interested only because of the man's value as an employee, there would be no justification for including in the decedent's gross estate the fair market value of the shares when in fact this person could obtain the stock from the estate on payment of $232,500. . . . There is reason to believe that the terms which the son obtained in these agreements with his father were no more favorable than he might have obtained had he not been related. The two were constantly bargaining over the price. There is no indication that the decedent had the slightest fatherly interest in or affection for his son. The record as a whole indicates that the father's

only reason for desiring to retain the services of the son was that he recognized, as time went on, that the son was the most able man in the employ of the company. The stock was not dealt in extensively prior to 1929, and such sales as there were indicate that the price agreed upon between the father and son was not too low. That is, it was not lower than the price at which persons with adverse interests dealing at arm's length might have been expected to have agreed. The obvious reason for the contracts was that the son was demanding protection and the father realized that the corporation, in which he was the largest stockholder, would lose the services of a valuable employee unless the agreements were entered into.

. . . Although the actual purchase price was much less than the fair market value of the stock at the date of decedent's death, when the purchase was made, an increase in value was a circumstance which was within the reasonable contemplation of the parties at the time they entered into the agreement. The increase in value of the shares was probably due in this case to the increased use of radios, in which the products of the company were used. The possibility of increase in the value of the shares may have induced the son to enter into the contract. The adequacy of the consideration must be measured at the time the contract was entered into rather than at the time the option was exercised. The consideration in this case was full and adequate in money or money's worth. The contract originally entered into finally ripened into a bona fide sale for an adequate and full consideration in money or money's worth. It was not a substitute for testamentary disposition nor a device for avoiding estate tax. Thus the transfer to the trustee was within neither the letter nor the spirit of section 302 (d) or (c). This is so either because there was a bona fide sale for an adequate and full consideration in money or money's worth or because the circumstances are wholly without the intendment and purposes of the provisions of section 302. This case is like the *Wilson* and *Lomb* cases, *supra*.

The Circuit Court of Appeals affirmed the Board in a very brief opinion, part of which follows:

This is a tax case which depends on its own peculiar decisive facts. . . . As no precedents or principles are involved, and as we find ourselves in accord with its decision

> we might as well limit ourselves to its opinion. In view of this, we confine our opinion to a few brief statements. . .

The court then summarized the facts and continued:

> It will thus be seen that instead of the ordinary creation of a trust by an individual by a unilateral indenture, we have here settlement of a business problem by the contract of two parties hostile to each other and dealing at arm's length, the object of which was the purchase of the father's stock at a price which was lower than full value.
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> Under the proofs, the Board had warrant for holding that the price at which the son was to acquire the father's stock was a proper figure. Such being the case, the appeal of the Commissioner is dismissed and the order of the Board affirmed.

A very important principle may be inferred from the Bensel case, namely, that if the relationship of the contracting parties to an agreement is such that the prospective buyer would be a natural object of the prospective seller's bounty, the agreed purchase price certainly will not hold for estate tax valuation unless the parties, "dealing at arm's length," set up a fair figure (for confirmation, see the quotation from the Hoffman case on page 427). Presumably this would be done if, in such a case, the parties at the time of making the agreement called in an accredited and independent public accountant to appraise and report in writing the value of the stock, and the parties then incorporated the reported value in their agreement as the purchase price. Of course, any subsequent change in the purchase price should be based entirely upon a similar independent appraisal currently made. Any such procedure would have been superfluous in the Bensel case for, as stated in the Circuit Court opinion, "Father and son were hostile to each other; both employed counsel to represent them, and the agreements were only reached after protracted contentions and negotiations."

Another case of interest is *Estate of John Q. Strange,* 1942 P-H BTA Memorandum Decisions, Par. 42, 247. This case involved two brothers. In 1915, J. E. Strange had purchased for $14,625, 40 shares of the 100 shares of stock of the Coca Cola Bottling Company of Greenville, Mississippi, which, under the

by-laws—strangely enough—entitled him to one-half the profits of the company. Shortly afterward his brother John, the decedent, was employed by the company. In 1917, John and his brother entered into an agreement under which the 40 shares were transferred to John for $15,000. As further consideration for the transfer, John agreed to divide equally with his brother any salary received as secretary and treasurer in excess of $150 a month and to divide equally all dividends paid to him. It was also agreed that in the event of the death of either, the survivor was to have a sixty-day option to purchase the stock for $10,000. Some years later, John acquired 40 of the 100 shares of the Coca Cola Bottling Company, Inc., of Cleveland, Mississippi, when that company changed over from a partnership, and it was agreed between the brothers that these shares should also be held and disposed of in conformity with their 1917 agreement.

John died in 1939 and his brother took over the stock upon payment of $10,000 to John's executors. The executors reported this amount as the value of the shares for estate tax. The Commissioner assessed an estate tax deficiency of $47,765.03 based upon a fair market value of $238,126.54, whereupon the executors petitioned the Board of Tax Appeals.

The Board found both agreements bona fide contracts for an adequate and full consideration and held the estate tax value of the shares to be $10,000. The Commissioner did not contend that the price was inadequate when set, which was an item of particular importance in this case because "The arrangements governing the Strange interests exhibited to an unusual degree the fraternal relationship between the brothers." But he raised another vital point in arguing that John had held the stock during his lifetime with no restrictions as to its sale to strangers. In answer to this, the opinion stated in part:

> We do not agree with this view. We have no doubt that if J. Q. Strange had attempted to dispose of the stock in a manner detrimental to his brother's interest, an appropriate action in equity could have been brought and would have prevented his doing so. . .
>
> As stated in *Wilson v. Bowers,* 57 F. (2d) 682, we are

> dealing with actualities. The burden of the option, imposed and continuing on the stock during the decedent's lifetime, necessarily reduced the value of the stock, as an asset of the estate, to the designated option price of $10,000. See *Lomb v. Sugden,* 82 F. (2d) 166; c.f. *Helvering v. Salvage,* 297 U. S. 106.

The Commissioner also invoked the provisions of the predecessor to Section 2036, relating to an interest in property of which the decedent has made a transfer intended to take effect in possession or enjoyment at or after his death, in answer to which the opinion of the Board briefed the facts in the Bensel case, quoted from its opinion in that case, and cited the Mitchell case.

In 1943 we find two more important case decisions on this subject handed down, both of which drew lines of distinction between the types of agreement that will establish share value for estate tax purposes and the types that will fail to do this.

One of these cases was *Worcester County Trust Company v. Commissioner,* 134 Fed. 2d 578, involving the estate tax value of 12,760 shares of stock of the Southwell Wool Combing Company in the estate of James Smith. This company had been organized by the members of a few families, and in order to keep the stock in the hands of these families the articles of incorporation were amended in 1935 to provide that before any stockholder could transfer his stock by way of gift or otherwise, he must first offer it for sale to the corporation at its book value as of the end of the previous month. The directors were given thirty days to accept any such offer, and if not accepted the stockholder was at liberty to sell at any price. It was further provided, however, that the board of directors could in specific instances vote to waive compliance by a seller, and also that the restriction did not apply to any transfer by the executor or administrator of a deceased stockholder to his legatees or next of kin.

Smith died in 1937, leaving his stock to his son. His executors reported the value of the shares in the estate tax return at $15.46 per share, the book value as prescribed in the articles of incorporation. The Commissioner determined the value to be $35 per share, a figure exactly ten times the average net earnings

of the company over the previous five years, and assessed a deficiency accordingly. The executors petitioned the Board of Tax Appeals for a redetermination. The Board in 46 B. T. A. 337 upheld the Commissioner's valuation on the ground that the restrictions imposed on the sale of the stock did not affect its value and that the executors had not shown some other value to be correct. The Board's opinion, however, stated that cases which hold that restrictions obligating the owner to sell at a fixed price do provide a ceiling for valuation and are distinguishable, citing *Helvering v. Salvage, Commissioner v. Bensel, Wilson v. Bowers* and *Lomb v. Sugden.* The executors then appealed the case to the Circuit Court of Appeals.

The Circuit Court reversed the decision and sent the case back to the Board for further proceedings to establish the correct value of the stock. It held that the Board's determination of value, based upon the formula used by the Commissioner, was "without rational foundation and excessive" and should not have been taken even though the executors had failed to prove some other value to be correct. It stated that "the question of fair market value is ever one of fact and not of formula." It held further that the restrictions in the articles necessarily depressed the value of the stock and were among the relevant factors to be considered, although not restrictive to a degree that would establish value. Quotations from the opinion cast some light on the court's reasoning:

> We cannot agree with the taxpayers that the amendment set the value of the shares at their book value on the critical date. The amendment did not prohibit sales of the stock except at book value, nor did it fix book value as a call price at which at the behest of the corporation the stock must be sold. It fixed a limitation on the price obtainable by a shareholder for his shares only if he wished to sell and if the corporation at that time wished to buy. . . . But we do not believe that the Board was correct in saying that the "restriction leaves the value unaffected" for the reason that it "only restricts the field of available purchase in the first instance." In our view it must be said that the restriction necessarily has a depressing effect upon the value of the stock in the market.
>
> A commodity freely salable is obviously worth more on

> the market than a precisely similar commodity which cannot be freely sold. To be sure the restriction does not affect the value of the stock so long as the owner does not wish to sell, but it is not this value which, under the regulations, is to be used as the basis for computing the tax. The value to be used for this purpose is "the fair market value," at the critical date, that is the "price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell." While it may be true that stock of the Company was so held that decedent's son could, and maybe would, force a vote of the directors waiving compliance with the restrictions in the event that the petitioners wished to sell, still the fact remains that the stock in a buyer's hands would be subject to the restriction and there is nothing to indicate that in his hands the directors would be disposed, or could be forced, to waive for his benefit. Upon purchase, then, a buyer would own a stock which if he ever elected to sell, he might well have to sell at book value, and this undoubtedly would tend to reduce its value on the market. . .

Thus we see that a "first offer" or "first refusal" restriction or agreement depresses the value of the shares affected but does not establish their value in the owner's estate. To accomplish the latter, the agreement must as a minimum grant to others on the critical date (at the owner's death) an enforceable option to purchase the stock at the agreed value. An insured stock purchase agreement goes even further; it requires the actual sale of the stock as of the critical date at the agreed value. It is significant, indeed, that the cases bearing on the option and the purchase agreements were clearly distinguished in the Board's opinion and were not even mentioned by the Circuit Court.

The second important case in 1943 was that of *Claire Giannini Hoffman,* 2 T. C. 1160. There, the decedent during his lifetime had given his brother the option to acquire, upon his death, whatever interest he might then have in a securities business operated as a partnership, and in certain notes of the nominal partners, upon the payment of the balance then due on a promissory note of the decedent and the payment to his

estate of a sum equal to 20 per cent of the value of the assets of the partnership. The Court held that because the restriction imposed by the option agreement did not become effective until the decedent's death, the fair market value of the property and not the option price was the measure of value for estate tax. The opinion briefly reviewed the Wilson, Lomb, Bensel, Mitchell and Salvage cases and distinguished the agreements involved in those cases from the option here, as follows:

> In view of some of petitioner's arguments it will not be amiss to refer briefly to the effect of what he refers to as the "option" given by Virgil to Lawrence. In the cases cited by him the optionee had been given an unqualified right to purchase at a designated price and the optioner could not dispose of the property during the continuance of the option. Such an option restricts the market value of the property in the hands of the owner. *Helvering v. Salvage,* supra; c.f. *Edwards v. Slocum,* 264 U. S. 61. Virgil, however, could have disposed of his interest in Walston & Co. and the note of Hoffman upon any terms or conditions he saw fit to impose and at any time he saw fit to do so. No argument is required to show that such an option did not restrict or limit the value of the property in his hands.

There were other important angles to this case, namely, the fact that the optionee was the natural object of the bounty of the optioner and the fact that there was some question as to the enforceability of the "option" involved. The court commented on this as follows:

> The opinion of the Board in the Bensel case suggests the reason for, though we do not intend to imply that it completely delimits the extent of, the rule relied upon by petitioner. Thus the fact that the option is given to one who is the natural object of the bounty of the optioner requires substantial proof to show that it rested upon full and adequate consideration. Whether an unilateral agreement made by an unmarried man to his brother constitutes an enforceable contract is at least a debatable question. There is no showing that Virgil was indebted to his brother in any amount, nor was the brother required to do more than elect whether he would take the property upon the terms specified. If the agreement were fair and reasonable when originally entered into, would it be upheld by the court—

> no reciprocity being shown—when the actual investment of the donor or optioner had been more than quadrupled? In the event of litigation between the other heirs at law of the optioner and the optionee, would the court have upheld the agreement? Was the so-called option a valid substitute for testamentary disposition of property? While none of these questions need be answered, they suggest that there must be some limit to the passage of substantial property rights under a unilateral agreement granting to the natural object of the bounty of a deceased an option to purchase at a grossly inadequate price. In other words, we are of the opinion that while a bona fide contract, based upon adequate consideration, to sell property for less than its value may fix the value of the property for the purposes of the estate tax, a mere gratuitous promise to permit some favored individual, particularly the natural object of the bounty of the promissor, to purchase it at a grossly inadequate price can have no such effect.

This comment would seem to bear out very clearly the rule inferred from the Bensel case.

The Hoffman case as a whole shows that an agreement calling for purchase and sale at death, standing alone, is not sufficient to establish estate tax value; the agreement must also contain restrictions on the disposal of the stock prior to death. The opinion, as previously noted, distinguished the main line of cases in this respect. For instance, it said: "In the Lomb case an agreement had been made by the stockholders whereby none could sell his stock without first offering it to the others who were to have the right to purchase in proportion to their common stockholdings at approximately $69 per share." A fair inference from this comment, and from the facts in the other cases, is that a "first offer" restriction during life is sufficient, when coupled with an obligatory purchase and sale (or binding option) effective at death.

In 1944, the Tax Court held in the much more clear-cut case of *Estate of James H. Matthews,* 3 T. C. 525, that restrictions must be imposed on the parties during life if their option agreement or their agreement to purchase at a stipulated price at death is to establish estate tax value. In this case, shares of stock were the subject matter of the agreement and there were ques-

tions neither with respect to close relationship nor as to the enforceability of the contract. Matthews, president and a large stockholder in the James H. Matthews Company, had entered into an agreement with William Jenkins, another officer and stockholder, in which reciprocal options were given for the survivor within three months after the death of the other to purchase from the estate of the deceased all the shares of stock of the company that might be owned by the deceased at the time of his death. The corporation carried life insurance on each party independent of the agreement, except that if a dividend were paid by the corporation within the option period from the proceeds of the policy on the life of the decedent the option price per share was to be $75; otherwise it was to be $90. Matthews confirmed the agreement in his will.

Matthews died in 1938 owning 785 shares. No dividend was paid by the corporation from the insurance proceeds of the policy on his life and Jenkins purchased his shares from the executor for $90 per share, paying $70,650. The executor reported this figure as their value on the estate tax return, but the Commissioner determined their value to be $120 per share or a total of $94,200 and assessed a deficiency accordingly. The executor petitioned the Tax Court for a redetermination.

The Tax Court held that the fair market value of the stock, rather than the option price, governed, because the agreement did not impose restrictions during the decedent's lifetime. The court's opinion related this case closely to the Hoffman case, first, by "briefing" the basic facts and the opinion handed down in that case, and then continuing:

> . . . The restrictions there imposed upon the property by the option agreement did not become effective until the decedent's death and did not affect its value until after his death. That was the situation in the present case. The option agreement was to apply only to the stock which might be owned by the decedent at the time of his death and decedent was under no obligation to retain ownership of any of the shares until his death. He was free up to the very moment of his death to sell or otherwise dispose of the shares for the best price obtainable. That right terminated with and by reason of his death. Likewise the right

of the optionee to purchase the shares came into existence at the time of and by reason of decedent's death.

The opinion went on to distinguish the main line of cases as follows:

> The instant case, like the *Hoffman* case, is distinguishable from the cases relied upon by the petitioner, such as *Wilson v. Bowers,* 57 Fed. (2d) 682; *Lomb v. Sugden,* 82 Fed. (2d) 166, and *Edith M. Bensel et al., Executors,* 36 B. T. A. 246, affd. 100 Fed. (2d) 639. In all of those cases the option agreement, or other restriction on the sale of the property, became effective during the lifetime of the decedent and the value of the property was not affected by his death. In *Lomb v. Sugden,* supra, for instance, the court said:
>
> ". . . Because of the agreement, the decedent could not have secured a price greater than $69,445 at the time of her death. It is as of that time that the value of the stock must be determined. Then she could only give it or sell it to the other stockholders at the price fixed. Its value to the estate could be no greater than that with which the decedent parted. *Edwards v. Slocum,* 264 U. S. 61, 63."

In 1951, the value of the stock owned by a deceased stockholder and sold to the corporation under a stock retirement option agreement was held to be the option price in the agreement (*Estate of Albert Salt,* 17 T.C. 92). The decedent, a retired president of Graybar Electric Company, Inc., held a voting trust certificate representing 4,000 shares of the company stock. He had acquired the shares in an exchange upon consolidation at par value of $20 a share, subject to a restrictive agreement whereby he was required to offer the shares to the corporation if he desired to sell them during life, and whereby at his death his estate was required to offer them to the corporation at $20 a share. All of the common stock of the corporation was subject to this restrictive agreement, and the corporation followed its practice of exercising its option by doing so at the death of Salt. The Commissioner determined that the value of the stock for Federal estate tax purposes was $60 a share, but the Tax Court held such value to be the $20 a share option price paid under the agreement. In so holding, the opinion stated in part:

> Not only was the estate required to offer the stock to Graybar after decedent's death for $20 per share but also, if during decedent's lifetime he had desired to dispose of the stock, he was required to offer it to Graybar at $20 per share. The stock being subject to this restrictive agreement and which in practice had always been adhered to by Graybar we conclude that the value of the stock for estate tax purposes was $20 per share. *Lomb v. Sugden,* 82 F. (2d) 166; *Wilson v. Bowers,* 57 F. (2d) 682. Cf. *H. A. May et al., Exrs. v. McGowan,* 97 F. Supp. 326, decided December 27, 1950.

The case of *May v. McGowan,* cited in the opinion in the Salt case, was affirmed by the United States Court of Appeals for the Second Circuit in 1952 (194 Fed. 2d 396). Prior to taking his son into partnership, May had borrowed extensively from his bank for business purposes. This indebtedness was assumed by the partnership, but as between father and son the father agreed to pay it. A corporation was organized subsequently, to which was transferred all of the assets of the partnership in consideration of the assumption by the corporation of the bank indebtedness up to $161,500 and of the issuance of 500 shares of stock to each partner. Thereupon the stockholders entered into an agreement providing that neither would dispose of his shares without first offering them to the other at $100 a share. But because the son had personally agreed to guarantee to the bank its loans to the corporation, the price per share as to him was to be reduced by 1/500 of the indebtedness due the bank at the date of exercise of his option. The agreement further provided that upon the death of either, the survivor would have an irrevocable option to purchase on the above terms.

When the father died, the indebtedness to the bank exceeded $50,000, with the result that under the agreement the son was entitled to acquire his father's stock for nothing. The executors reported the value of the stock at zero in the estate return, but the Commissioner determined its value to be $50,000. The lower court upheld the executors. The Commissioner appealed the case to the United States Court of Appeals for the Second Circuit in the hope that this court, which had decided

the leading cases of *Wilson v. Bowers* and *Lomb v. Sugden* many years previously, would change its position. The court saw no reason to question its prior decisions and affirmed the lower court. The following quotation from the court's opinion is of particular interest:

> It seems clear that with the option outstanding no one would purchase the stock of the decedent at its value unrestricted by the option when it was subject to call by Harry A. May at zero. This was the rationale of our decisions in *Wilson v. Bowers,* 2d Cir., 57 Fed. 2d 682, and *Lomb v. Sugden,* 2d Cir., 82 Fed. 2d 166. In *Lomb v. Sugden supra* (at p. 168), we said that this view was supported by the Supreme Court's decision in *Helvering v. Salvage,* 297 U. S. 106, to the effect that an outstanding option to purchase restricts the market value of stock in the hands of the owner to the option price. We see no reason for questioning the foregoing decisions. If they leave a loophole for tax evasion in some cases, here the district court found that there was no purpose to evade taxes. Such a loophole, if important, should be closed by legislative action rather than by disregarding the cases we have cited.

The foregoing completes the examination of the important cases that have litigated the question of the binding force of agreements in establishing the value of close corporation stock at the time of the owner's death. In addition to these cases, however, and directly related to the subject here, are some of the cases involving insured stock purchase and sale agreements previously examined under other headings. In the Mitchell case, for example, the contract price was accepted by the Commissioner as a base figure of stock valuation without question, the litigation there having to do with whether the stock should be taxed either in full at the base figure or as reduced by taxable insurance received by the estate as part of the purchase price for the sale of the stock under the terms of the agreement. And in the Riecker case, the contract price was taken as the value of the stock by the Commissioner in his deficiency assessment and was accepted as the correct value by the Tax Court after the executor had unsuccessfully attempted to have non-taxable insurance proceeds deducted from the agreed value. True, the

court took into consideration the fact that some of the shares had been sold at the same price by the executor in a new transaction entered into after the taxpayer's death, but this would seem to have been open to question in view of the statement made by the Circuit Court in the Wilson case that "Logically, subsequent events should not be considered in determining value at the time of death."

All of these cases, taken as a whole, confirm the rule that an insured stock purchase and sale agreement establishes share value for Federal estate tax purposes as well as for the purposes of the agreement if the price fairly represented the value of the shares at the time agreed upon and if prior to death each stockholder has been prohibited from disposing of his shares from the time of the agreement until his death without first offering them to the other stockholders or to the corporation at the same contract price. The rule is sound in principle, because the stock cannot be worth any more to the estate than the estate is bound to accept for it. It is beneficial alike to Government and to stockholders, for it saves both the trouble and expense of ascertaining the value of close corporation stock as "a fact," in the light of the company's net worth, earning power, dividend paying capacity, and all other relevant factors, including consideration of values of listed stock of other corporations engaged in a similar line of business—a difficult and discouraging task usually ending in disagreement.

CHAPTER 16

Specific Benefits of the Insured Stock Purchase and Sale Plan

BENEFITS TO THE SURVIVING STOCKHOLDERS

Survivors protected from control or interference by outsiders. We have seen that in the absence of an agreement, the surviving stockholders stand unprotected against the intrusion into the corporate affairs of unacceptable or hostile outsiders. We have noted that surviving minority stockholders, unable as a last resort to liquidate the business, are placed in a worse position than they would have occupied as surviving minority partners. We have observed cases in which surviving equal stockholders have become deadlocked in attempting to continue a corporate business with the stockholding heirs. And we have followed the litigation that has resulted in holding surviving majority stockholders accountable to the heirs of a deceased minority stockholder in such vital matters as the salaries and expenses of those remaining in control. The trouble that develops in these different situations springs from a common generating cause, the separation of the ownership of a block of the stock from the active management. When any shares in a close corporation go out of the hands of the active managers, the spirit of harmony and efficient cooperation that formerly existed cannot help but be impaired. As stated in the Emeloid case: "The fragile bark of a small business can be wrecked on just such uncharted shoals." Active management and ownership in a

small corporation are like "Siamese twins"; they must be kept together for it to live and thrive.

The insured stock purchase agreement keeps active management and ownership together in the hands of the surviving stockholders. By acquiring ownership of all of the shares through the functioning of the plan, they have every opportunity to continue the thriving business enterprise free from the control or interference of outsiders.

Survivors guaranteed the opportunity and ability to purchase deceased's stock. In the absence of an agreement, the surviving stockholders have no assurance that they will be able to acquire the shares of stock owned by the deceased. If he has bequeathed them to specific legatees, the shares may be unprocurable. Even if the executor or administrator is obliged to sell them, the survivors must outbid all competitive offers. With a purchase and sale agreement, the survivors are enabled to acquire complete ownership in their corporation; the transaction will be specifically enforced against the estate, if such step becomes necessary. The agreement has made the transfer of ownership certain, and has made the purchase price definite. And when insurance of the purchase price is added to the agreement to buy and sell, the survivors not only are guaranteed the opportunity to purchase the deceased's shares, but also are assured that they will have the purchase money at hand at the precise time they are called upon to pay.

Survivors acquire full stock ownership by most convenient and economical plan. The life insurance plan of financing not only eliminates the hazard that the surviving stockholders will not have the purchase price for the deceased's stock ready when death occurs, it equips the survivors with the most convenient and economical method of acquiring the necessary funds. It constitutes an advance instalment purchase plan. Since these instalment payments are only about half the legal rate of interest and are self-completing upon death for the full amount, they are convenient to make and rarely indeed do the total payments made aggregate the purchase price money made available to the survivors. Under the insurance plan, therefore, the sur-

viving stockholders have the opportunity of acquiring the purchase money for the deceased's shares with discounted dollars.

BENEFITS TO THE DECEASED STOCKHOLDER'S ESTATE AND HEIRS

The deceased's estate receives payment in full, in cash, at once. Prompt consummation of the fully insured stock purchase and sale agreement puts into the hands of the executor or administrator of the deceased stockholder the full amount of the sale price of the decedent's shares. Nothing remains over which to bicker and bargain in a setting in which the survivors would have all the advantages. The money is forthcoming immediately and, if the preferred procedure is followed, the insurance proceeds will constitute the minimum amount the estate will receive as the purchase price.

Speculative business interest converted into a cash certainty for deceased's family. While all the primary stockholders are alive, the efficient and harmonious blending of their combined talents and industry equips them well to cope successfully with the inherently speculative nature of a small business enterprise. Indeed, they relish the hazards, knowing that success will usually bring profits commensurate with the risks taken and that failure can be followed with another attempt. Far different, however, is the situation of the family of a deceased stockholder. Risky stocks in an inherently hazardous undertaking have no proper place, let alone a predominating place, among the investments of a widow and children. No stockholder in a small corporation can possibly foresee what the future destiny of the organization will be after his death. And as for the widow, any failure will be permanent. The insured stock purchase plan recognizes these fundamental truths by providing for the prompt disposal of the deceased's close corporation stock for its full value in cash in the interests of the welfare of his family.

Deceased's family protected against "freezing-out" process. If, in the absence of a stock purchase plan, the surviving stockholders are able to continue the business successfully, they will not long submit to the task of doing all the work and dividing

the profits with the deceased's family. Then the customary pattern is an attempt to "freeze out" the widow by raising salaries and lowering or eliminating dividend payments on the stock. Perhaps the widow will be able to uphold her rights in a court of equity. She has only an outside chance of interfering with the dividend policy of the survivors—and costs of litigation are high. Consequently, assuming the continued success of the enterprise, the deceased's stock nevertheless fails to prove a suitable investment for his widow. With the prompt sale of this stock under an insured purchase plan, the widow is saved from the possibility of being subjected to the "freezing-out" process, with its attendant costs, anxieties, disappointments, and the personal animosities certain to be engendered. Far superior is a plan that recognizes the undeniable fact that the profits of an enterprise belong to those who earn them and that saves the widow from a situation in which her livelihood would be dependent upon her ability to sustain an unnatural financial arrangement.

Deceased's estate can be administered promptly and economically. The executor or administrator has need for a substantial amount of cash to discharge the ante-mortem and post-mortem obligations of the deceased stockholder. Among his anti-mortem obligations will be the cost of last illness, current bills, unpaid property and income taxes, and outstanding special debts such as bank loans or mortgages. His post-mortem obligations will include funeral and burial expenses, estate and inheritance taxes, and the fees and costs attendant upon the probate and administration of his estate. In the aggregate, these items loom large, totaling 20 per cent to 30 per cent of the average moderate estate.

Ready cash with which to pay these obligations saves the shrinkage and loss inevitably suffered if it is necessary to liquidate a substantial portion of the general estate property or the close corporation stock quickly. Furthermore, the possession of ready cash enables the executor to take advantage of any discounts allowed for prompt payment of bills and taxes and to avoid any penalties for delinquent payment. New York, for example, allows 5 per cent discount for estate taxes paid within

six months from date of death. Conversely, under the New York law, interest is charged against any estate taxes remaining unpaid after eighteen months, and under the Federal law, interest is charged after eighteen months against unpaid Federal estate taxes, assuming that proper extensions are procurable.

An insured purchase and sale agreement gives the executor ample cash to pay all obligations of the deceased stockholder, which eliminates any possibility of a disastrous liquidation of assets in a depressed market or the incurring of any penalties. Instead, discounts are saved, liquidation is avoided, and a prompt, efficient, and economical administration of the deceased stockholder's estate is assured.

BENEFITS DURING THE LIFETIME OF THE STOCKHOLDERS

The corporation's business is profitably stabilized. An insured purchase and sale agreement tends to stabilize the business of the corporation on a more profitable basis while all the stockholders are alive. Employees, knowing that the continuance of the business in the hands of the survivors among their present employers has been assured, and with it, their jobs, are welded into a more stable and efficient organization. The corporation's bankers—knowing that the plan has eliminated any possibility that undesirable or "drone" stockholders will be able to inject themselves into its future management, that the personnel has been stabilized by the arrangement, that the plan facilitates the purchase of a deceased's shares without draining one cent from the corporate treasury, and that the stockholders each year are building larger cash values in their business insurance policies—will extend a more favorable line of credit over the years. These beneficial factors increase the earnings of the corporation during the lifetime of all the stockholders.

An attractive savings medium is provided. The insured purchase and sale arrangement has often been referred to as an advance instalment method of purchasing the shares of a deceased stockholder. This being a fact, each premium paid on

the insurance under such a plan represents a current saving for future benefit. From the standpoint of a close corporation stockholder, no other savings plan can match it. Among the many attractive features offered, the most important to him is the fact that the savings program is automatically completed for the full amount needed on the death of the insured, no matter how little savings actually have been made in the form of premium payments. Among other desirable characteristics, the amount required to be saved each year is convenient in size, is made with regularity, and has an element of compulsion (without which few savings plans ever amount to anything). Almost from the start the policies contain guaranteed cash and loan values quickly accessible in a financial emergency. In short, it comprises a convenient, effective savings program focused directly on one of the vitally important future objectives of the stockholders: the retention of the full ownership of the corporation in the hands of the survivors, with full payment in cash to the family of the deceased, when a death occurs among the stockholders.

The future of the stockholders is made predictable. The insured stock purchase agreement enables each stockholder to predict what will occur upon the death of any stockholder. If fate decrees that he becomes a surviving stockholder, he knows that he and the other surviving stockholders will be the full owners of the corporation, with the shares acquired from the deceased paid for in full. Conversely, he knows that if he should die first, a dependable continuous market has been provided for his stock and that his estate will receive promptly the full value of his shares in cash. Each stockholder, therefore, is justifiably inspired to contribute his best talents and industry to the promotion of the corporate business, secure in the knowledge that if he lives his future career will be assured and his ownership in the corporation will be enlarged, and that, if he does not survive his associates, his estate and heirs will receive full value for his stock enhanced by his hard work. Furthermore, each stockholder, cognizant of the fact that if he is first to die his estate will receive a specified amount in cash, is able to plan his estate efficiently for the welfare of his family.

Contrast this picture with that of close corporation stockholders without a purchase plan—faced with interference or actual control by outsiders, possible loss of careers, unknown liquidation losses, unknown and speculative estate values for the support of dependents, bickering and dissension, and possible lawsuits between widow and survivors. The conclusion is inescapable that close corporation stockholders can ill afford to deprive themselves and their families of the far-reaching benefits of an insured stock purchase and sale arrangement.

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