

# EXISTING RULES OF TRUST ADMINISTRATION: A STRANGLEHOLD ON THE TRUSTEE- CONTROLLED BUSINESS ENTERPRISE

## II. THE INCORPORATED BUSINESS \*

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In Part I of this article I urged that the rules of trust administration be brought into line with the financial needs of a going enterprise, that a recognition of accepted accounting practices is insufficient for this purpose, and that a trustee-operated enterprise should be encouraged, if not required, to make provision for its own survival out of its own income, subject to the trustee's dual obligation to be impartial towards successive beneficiaries and to make the trust assets productive.<sup>1</sup> If this proposal is not acceptable, estate planners will have to contend with a law which at best recognizes the use of "accepted" accounting principles for the determination of distributable income. Since such principles, admittedly, do not purport to measure funds necessary for the survival of the enterprise, only a carefully drawn trust instrument can relieve the resulting pressures for its improvident strangulation. The question left to be explored is whether incorporation will serve to insulate the enterprise from these pressures.

On this question we have the pioneer work of Edmund Cahn in this *Review*,<sup>2</sup> as well as more recent writings.<sup>3</sup> Despite this work, the courts have failed to furnish any clear guidance in this area. The decisions abound with broad generalities on which reliance by the trustee, one way or the other, is fraught with danger. For example, in *In the Matter of Koretzky*,<sup>4</sup> the Supreme Court of New Jersey, echoing Professor Scott,<sup>5</sup> declared that "where a fiduciary holds sufficient shares to control actually or substantially the conduct of the corporation he is

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<sup>1</sup> Krasnowiecki, *Existing Rules of Trust Administration: A Stranglehold on the Trustee-Controlled Business Enterprise—I. The Unincorporated Business*, 110 U. PA. L. REV. 506 (1962) [hereinafter cited as Krasnowiecki].

<sup>2</sup> Cahn, *Estate Corporations*, 86 U. PA. L. REV. 136 (1937).

<sup>3</sup> Note, *The Fiduciary Aspects of Estate Corporations*, 57 MICH. L. REV. 738 (1959); Note, *The Trust Corporation: Dual Fiduciary Duties and the Conflict of Institutions*, 109 U. PA. L. REV. 713 (1961).

<sup>4</sup> 8 N.J. 506, 86 A.2d 238 (1951).

<sup>5</sup> 2 SCOTT, TRUSTS § 193.2, at 1462 (2d ed. 1956).

under a duty to exercise that control for the benefit of the trust,"<sup>6</sup> and, further, that "in voting shares of stock fiduciaries are under a duty to vote in such a way as to promote the interests of the beneficiaries."<sup>7</sup> If this broad proposition is to be controlling, it would appear that the conduct of an incorporated enterprise controlled by a trustee is governed by the same outmoded principles of trust law inveighed against in Part I of this article. The facts in *Koretzky* suggest, however, not only that the stated principle may be of narrow application, but that the problem we have set ourselves is one of considerable subtlety.

In *Koretzky*, the testator had left all of the outstanding shares of stock in Bright Star Warehouse Company (ten shares) and 30,600 shares of stock in Bright Star Battery Company (out of a total of 39,000 outstanding shares) to his executors in trust for certain members of his family. The gravamen of the complaint against the executors, seeking their removal as trustees, was that they had approved a fraudulent issue of twenty-four additional shares by the warehouse company—an issue which reduced the estate's control of that company from 100% to 29.4%—and had falsified the company's books for this purpose; that they had approved and participated in an unauthorized gift of \$25,000 by the battery company to the testator's son-in-law; and that they had voted to elect to the battery company's board of directors certain directors of the warehouse company who they knew had participated in the fraudulent stock issue.

The trial court, finding these allegations to be true, ordered the trustees removed and appointed another in their stead. It also ordered that the trustees resign as directors of both companies, and that "management and operations" of the two corporations be "vested exclusively" in the substituted trustee.<sup>8</sup> Two points are significant to our discussion. The broad generalization concerning the trustees' duties, quoted earlier, is to be found in that part of the supreme court's decision which affirmed the removal of the trustees. Since the conduct of corporate affairs complained of by the beneficiaries of the trust was clearly conduct for which relief could be granted under corporate law,<sup>9</sup> the court may be requiring no more of the trustee than that he prevent, if he can, conduct of corporate affairs which violates corporate law.

The key to the court's decision on the question which concerns us is to be found in its reversal of that part of the trial court's decree which ordered that management of the corporations be vested in the substituted trustee. Here the court stated: "The corporations were

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<sup>6</sup> 8 N.J. at 526-27, 86 A.2d at 248.

<sup>7</sup> *Id.* at 526, 86 A.2d at 248, citing 2 SCOTT, TRUSTS § 193.1, at 1459 (2d ed. 1956).

<sup>8</sup> 8 N.J. at 520, 86 A.2d at 245.

<sup>9</sup> See 3 FLETCHER, CORPORATIONS § 1011 (perm. ed. rev. repl. 1947).

not made parties defendant. The business of a corporation is operated by its board of directors, and ownership by the estate of the controlling interest of the outstanding stock confers no power upon the fiduciaries of the estate (whether they be executors or trustees) to bind the corporation."<sup>10</sup> In this connection, it is significant that the court cited *D'Arcangelo v. D'Arcangelo*.<sup>11</sup> In that case, the testator had bequeathed fourteen shares out of a total of twenty outstanding in his jitney bus business to his two sons, directing them to "engage my brother Federico . . . as one of the drivers of said jitney bus and pay him a salary of Fifty (\$50.00) Dollars per week, until he is able [sic] to work . . ." <sup>12</sup> This provision was held unenforceable and void for the reason that "a contract by the two sons, acting by virtue of their ownership of a majority of the outstanding stock, with Federico, would not bind the corporation, since our Corporation Law gives to the board of directors the power and duty of managing the business of the corporation."<sup>13</sup> However, the court noted: "If testator had been the sole owner of the corporation and all the capital stock had devolved on [the two sons] . . . , subject to the direction that they engage Federico, I take it that the direction would have been effective and enforceable."<sup>14</sup>

*D'Arcangelo* refers to a well-known body of corporate law governing the extent to which shareholders may, by agreement, tie the hands of directors in advance on matters normally within their discretion.<sup>15</sup> The case involved an express direction by the settlor to his legatees, as controlling shareholders, affecting the conduct of corporate affairs. But the rules of trust administration are based on the settlor's presumed intent and thus constitute implied directions to the trustee. Therefore, the question whether the trustee is bound to cause declarations of dividends in accordance with what section 7 of the Uniform Principal and Income Act regards as income<sup>16</sup> is, in the last analysis, the same as the question of whether effect could be given to an express provision in the trust instrument directing that the trustee cause distribution of all the earnings of the corporation.

Edmund Cahn took the position that the question whether the trustees must cause the corporation to follow the rules of trust admin-

<sup>10</sup> 8 N.J. at 532, 86 A.2d at 251.

<sup>11</sup> 137 N.J. Eq. 63, 43 A.2d 169 (Ch. 1945).

<sup>12</sup> *Id.* at 65, 43 A.2d at 171.

<sup>13</sup> *Id.* at 66-67, 43 A.2d at 171-72.

<sup>14</sup> *Id.* at 66, 43 A.2d at 171.

<sup>15</sup> Delaney, *The Corporate Director: Can His Hands Be Tied in Advance*, 50 COLUM. L. REV. 52 (1950); Hornstein, *Stockholders' Agreements in the Closely Held Corporation*, 59 YALE L.J. 1040 (1950).

<sup>16</sup> See Krasnowiecki 511-13.

istration turns on an interpretation of the settlor's intent. He was willing to admit that "the courts have never been particularly sympathetic with the predicament of a minority stockholder in a close corporation. In the absence of proof of fraud or waste he is usually remediless."<sup>17</sup> And while he saw in the cases some support for the view that the trustee may not have a duty to cause the distribution of all of the income of a corporation, he urged that trustees exercise their discretion with "considerable caution."<sup>18</sup> This is undoubtedly an accurate summary of the cases and, as such, it offers to the trustee little in the way of concrete guidance. It exposes him to the shifting applications of mere generalities and tends, at the very least, to turn the trustee-controlled corporation into a timid, inhibited operation.

It therefore seems essential to consider whether, in the cases circumscribing the power of shareholders to bind the corporation in advance on matters normally within the discretion of the directorate, there may be found a refuge for the trustee who desires that the vitality of the enterprise go unimpaired.

### I. THE TRUSTEE WITH WORKING CONTROL

As is indicated in *D'Arcangelo*, when a trustee has working control of a corporation whose stock is owned in part by persons who are not trustees of the trust, his actions are governed by the normal rules of corporate law. Although there are a number of recent cases sustaining agreements by less than all of the shareholders on matters not normally within the province of shareholder action,<sup>19</sup> a careful reading of these cases reveals that the agreements sustained in them, far from sapping the vitality of the corporation, were essential to it. For example, *Hart v. Bell*<sup>20</sup> involved an agreement under which Bell, as a condition to making a loan to the corporation bailing it out of insolvency, acquired from the controlling stockholder a sufficient number of shares to give him control and which provided that no dividends should

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<sup>17</sup> Cahn, *supra* note 2, at 145. It has been suggested that adherence to principles of trust administration by the controlling trustee, whether he be director or shareholder, may involve a breach of fiduciary duty to the corporation or the other shareholders. Note, 109 U. P. A. L. REV. 713, 726-28 (1961). But this duty comes into play only in extreme cases of fraud and oppression and would seem to furnish rather limited protection to the trustee who desires that the vitality of the enterprise go unimpaired. See text accompanying notes 30-32 *infra*.

<sup>18</sup> Cahn, *supra* note 2, at 144.

<sup>19</sup> *Merlino v. West Coast Macaroni Mfg. Co.*, 90 Cal. App. 2d 106, 202 P.2d 748 (Dist. Ct. App. 1949); *E. K. Buck Retail Stores v. Harkert*, 157 Neb. 867, 62 N.W. 288 (1954); see *Delaney, supra* note 15, at 59-61, urging that such agreements should not be held invalid merely because some shareholders did not participate, citing dictum in *Manson v. Curtis*, 223 N.Y. 313, 320, 119 N.E. 559, 561 (1918), and other authorities. *But see* *Abercrombie v. Davies*, 123 A.2d 893, *modified*, 125 A.2d 588 (Del. Ch. 1956), *revid'd on other grounds*, 130 A.2d 338 (Del. 1957).

<sup>20</sup> 222 Minn. 69, 23 N.W.2d 375 (1946).

be declared or paid by the corporation until the loan was repaid. The minority shareholders sought a declaration that the agreement was invalid and a return of the stock transferred to Bell. The court sustained the agreement, stressing the value of it to the business. Yet it felt impelled to engage in sophistry. The agreement, said the court, "that no dividends shall be declared or paid", in the absence of a further provision implementing an intent of performance through a dummy directorate, is reasonably to be construed as merely a declaration of desirable corporate policy . . . . [The parties to the agreement] . . . (and in fact Bell alone) controlled a majority of the common stock and were therefore in a position to elect directors friendly to corporate policies in which they believed without making any effort to throttle their official discretion."<sup>21</sup> If Bell alone had not acquired sufficient control to secure the action desired, if the issue had been whether he could *enforce* the agreement against the transferor (rather than whether the agreement was void for the purpose of an action seeking the return of the shares transferred to Bell), this ground for sustaining the agreement would have posed an insuperable obstacle to enforcement.

We are concerned with the question whether a court could enforce those provisions of the trustee's agreement with the settlor which are implied through the rules of trust administration—provisions which are hardly conducive to the vitality of the enterprise. There can be little doubt that this enforcement would run counter to all the authorities in the corporate field—even those which occasionally sustain agreements between less than all of the shareholders. Fortunately, we need not labor the point, for there is strong authority in the trust field itself that normal rules of trust administration will not be enforced where the trust owns less than all of the outstanding shares of the corporation.

The strongest case is *Rosencrans v. Fry*.<sup>22</sup> By his will, the settlor left 3,025 shares (slightly less than half of all outstanding shares) in a plumbing corporation to his wife and to Fry, a trusted friend and a director of the company, as trustees, directing them to pay the income to the wife for life, the corpus to be distributed among named nephews. The will gave Fry the option to purchase the stock left in trust at \$25 per share—a price which was slightly more than one-third of the book value on the testator's death. For five years following the settlor's death, the widow received on the average approximately \$6,500 annu-

<sup>21</sup> *Id.* at 77, 23 N.W.2d at 379-80.

<sup>22</sup> 21 N.J. Super. 289, 91 A.2d 162 (Ch. 1952), *aff'd*, 12 N.J. 88, 95 A.2d 905 (1953). For other cases to the same effect, see *Long v. Rike*, 50 F.2d 124 (7th Cir.), *cert. denied*, 284 U.S. 657 (1931); *Dailey v. Wight*, 94 Md. 269, 51 Atl. 38 (1902) (trustee's accountability for salary as director); *Perry v. Perry*, 339 Mass. 470, 160 N.E.2d 97 (1959); *Matter of Doelger*, 164 Misc. 590, 299 N.Y. Supp. 565 (Surr. Ct. 1937), *rev'd*, 254 App. Div. 178, 4 N.Y.S.2d 334, *aff'd mem.*, 279 N.Y. 646, 18 N.E.2d 42 (1938).

ally in dividends from the corporation, in addition to her salary as a corporate officer. Fry then exercised this option to purchase the 3,025 shares held by the trust, whereupon the widow claimed that he must account to her for all the income retained by the corporation in respect of the trust shares since the death of her husband.

Since her husband had placed Fry in a position of divided loyalty, the widow was not able to rest her claim solely on this ground. To succeed she had to show that the trustee was under a duty, during the years the stock was held in trust, to secure larger dividend distributions. It is important to note that a decision in her favor could not have affected the operations of *this* business. Furthermore, since the trustee stood to gain personally by the accumulation of earnings, the facts presented the strongest case for the recognition of such a duty. The trial court admitted that "in some settings a trustee situated as was Fry might equitably be required, as between himself and the beneficiary, to account for a portion of the earnings even though in a stockholder's suit against the corporation the facts would not demonstrate that arbitrary conduct which is the *sine qua non* of judicial interference with the directors' judgment as to dividend action."<sup>23</sup> This, however, the court held, was not such a case. The retention of earnings was justified in the light of the company's needs, and the widow had received a reasonable income from the dividends which were declared. The court noted that the widow was a director and "voted for the course pursued" and that Fry had offered to exercise his option three years earlier, before much of the allegedly improper accumulation, but had been dissuaded by the widow's opposition.

The decisive point, however, is to be found in the court's discussion of the principle stated in *Koretzky* concerning the trustee's duty to exercise his control so as to favor the beneficiaries of the trust. "But the quoted principle," said the court, "does not embrace a duty to advance the interests of a beneficiary at the expense of the corporation and other outstanding stockholders' interest."<sup>24</sup>

Thus the court stressed Fry's duty as a director. It is often stated that "it is the duty of a board of directors to manage the corporate affairs solely in the interest of the corporation, quite regardless of the effect of its policies and management upon the fortunes of individual stockholders in the corporation."<sup>25</sup> While the courts pay lip service to this principle, the cases merely support the view that a director cannot join in a fraudulent effort by the controlling shareholders to take

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<sup>23</sup> 21 N.J. Super. at 300, 91 A.2d at 167.

<sup>24</sup> *Id.* at 301, 91 A.2d at 168.

<sup>25</sup> *Henry L. Doherty & Co. v. Rice*, 186 Fed. 204, 218 (C.C.M.D. Ala. 1910), *aff'd*, 184 Fed. 878 (5th Cir. 1911).

the property of the minority.<sup>26</sup> The line drawn here appears to be the same as the line drawn on the question of the majority shareholders' supposed fiduciary obligation to the minority. Professor Gower, comparing English and American positions, well summarized the cases:

In both countries lip service is paid to the alleged rule that the majority stockholders must exercise their powers as fiduciaries.<sup>27</sup> But in neither country do the decisions appear really to support this.<sup>28</sup> In both the true rule seems to be that the majority must not expropriate the property of the company or the minority, and here again the American courts have been more ready to apply the principle.<sup>29</sup>

A court of equity is, of course, free to expand the principle in order to furnish a rationale for protecting a trustee in Fry's position. But the trust rule in question, which would simply require the trustee to pursue an absurdly liberal dividend policy, does not immediately fall within the normal run of cases finding an abuse of a director's fiduciary duties to the corporation.<sup>30</sup> As we shall see, unless the dividends impair capital or are followed closely by insolvency, corporate law neither views excessively liberal dividend policies as unlawful nor renders the

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<sup>26</sup> *Green v. National Advertising & Amusement Co.*, 137 Minn. 65, 162 N.W. 1056 (1917); *Schmid v. Lancaster Ave. Theater Co.*, 244 Pa. 373, 91 Atl. 363 (1914); *Newcomer v. Mountain Springs Ice & Cold Storage Co.*, 63 S.D. 81, 256 N.W. 359 (1934).

<sup>27</sup> See, e.g., *Pepper v. Litton*, 308 U.S. 295 (1939); *Southern Pac. Co. v. Bogert*, 250 U.S. 483 (1919); *Zahn v. Transamerica Corp.*, 162 F.2d 36 (3d Cir. 1947). In England this duty is generally expressed in the formula of Lindley, M.R., in *Allen v. Gold Reefs, Ltd.*, [1900] 1 Ch. 656, 671 (C.A.), that the majority must exercise their voting powers "bonâ fide for the benefit of the company as a whole." For the latest discussion of the meaning of this formula, see *Greenhalgh v. Arderne Cinemas, Ltd.*, [1951] Ch. 286 (C.A. 1950).

[Original footnote renumbered.]

<sup>28</sup> "Cf., e.g., *Lebold v. Inland Steel Co.*, 125 F.2d 369 (7th Cir. 1941), *cert. denied*, 316 U.S. 675 (1942); *Lebold v. Inland S.S. Co.*, 82 F.2d 351 (7th Cir. 1936). For a review of the English cases, see GOWER, *MODERN COMPANY LAW* 498-518 (1954)." [Original footnote renumbered.]

<sup>29</sup> Gower, *Some Contrasts Between British and American Corporation Law*, 69 HARV. L. REV. 1369, 1383 (1956). [Some of the original footnotes renumbered and others omitted.] See also Note, *Fiduciary Obligation of Majority Stockholders*, 51 YALE L.J. 1034 (1942), discussing *Blaustein v. Pan Am. Petroleum & Transp. Co.*, 174 Misc. 601, 21 N.Y.S.2d 651 (Sup. Ct. 1940), *aff'd in part, rev'd in part*, 263 App. Div. 97, 31 N.Y.S.2d 934, *aff'd*, 293 N.Y. 281, 56 N.E.2d 705 (1944).

<sup>30</sup> Directors may become liable for loss occasioned by mismanagement or failure to exercise due care. See generally 3 FLETCHER, *CORPORATIONS* §§ 1010-64 (perm. ed. rev. repl. 1947). But the cases involve asset loss occasioned by grossly imprudent undertakings or by employee defalcations. Excessive dividends leading to an orderly winding up of the enterprise do not seem to fall within this category. *But see* note 31 *infra*. *Metropolitan Casualty Ins. Co. v. First State Bank*, 54 S.W.2d 358, 359-60 (Tex. Civ. App. 1932), the case closest on point, held that a declaration of dividends out of profits lawfully available for this purpose by directors whose sole motive was to secure sufficient cash (for themselves as shareholders) to meet outstanding personal obligations did not constitute self-dealing. But the court stated by way of dictum that the directors may be charged with mismanagement.

directors liable therefor.<sup>31</sup> This principle of dividend law has disturbed those who see that failure to retain an adequate surplus in an inflationary economy is bound to result in a failure of the business.<sup>32</sup>

Thus trustees who desire to see the vitality of the business go unimpaired are best supported by the rationale of the cases protecting the corporation against agreements by controlling shareholders which expressly seek to deprive the directors of their right (fictitious though it may be in fact) to exercise their best judgment. The point I am trying to make here is that the principles which govern the trustee who is willing to cause the corporation to operate in accordance with the outmoded rules of trust administration are totally different from the principles applicable to the trustee who, in the exercise of his honest judgment, prefers to see the corporation run like a corporation. In the former case, the point at which the trustee, as controlling shareholder or director, would become liable to the minority shareholders, the corporation, or creditors may not be reached until most of the vitality has gone out of the enterprise. In the latter case, the trustee's protection against suit by the income beneficiaries of the trust is to be found in the cases which refuse to enforce any agreement by the majority shareholders to tie in advance the hands of the directors on

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<sup>31</sup> Even when the challenged dividend involved a clear capital impairment, courts have not been consistent in allowing recovery by the corporation against the directors beyond what may be needed to satisfy creditors. See *Spiegel v. Beacon Participants, Inc.*, 297 Mass. 398, 426-29, 8 N.E.2d 895, 912-13 (1937); *Manning v. Campbell*, 264 Mass. 386, 162 N.E. 770 (1928). The Pennsylvania courts have consistently allowed recovery of the entire capital impairment dividend. See *Cochran v. Shetler*, 286 Pa. 226, 133 Atl. 232 (1926) (by receiver); *Loan Society v. Eavenson*, 248 Pa. 407, 94 Atl. 121 (1915) (by corporation). In *Hochman v. Mortgage Finance Corp.*, 289 Pa. 260, 137 Atl. 252 (1927), the court speculated that such a recovery, to the full amount of the dividend, "may, perhaps, be invoked for the protection of the minority stockholders of a 'going concern' when the impairment of capital while not rendering the corporation insolvent, interferes with its activities and endangers its existence." *Id.* at 267, 137 Atl. at 254. But the court denied recovery in that case because the corporation was then in the process of voluntary liquidation. The *Hochman* dictum may indeed support the view that even lawful dividends may be questioned by the minority when they impair the "going concern" nature of the enterprise. However, in the absence of statute declaring capital impairment dividends illegal, it has been held that the common law does not render directors liable except to the extent of amounts necessary to pay creditors and that "a mere distribution of the property of the corporation among its stockholders would not, at common law, be such a waste or misappropriation of its property as would justify the corporation in maintaining a cause of action against the directors for the amount thus distributed." *Hutchinson v. Stadler*, 85 App. Div. 424, 431, 83 N.Y. Supp. 509, 514 (1903); *De Raismes v. United States Lithograph Co.*, 161 App. Div. 781, 146 N.Y. Supp. 813 (1914). If this view holds good for capital impairment dividends, in the absence of statute, a fortiori it does so for dividends out of earnings legally available for this purpose even though they impair the business as a going concern and lead to liquidation. However, as suggested later, see text accompanying note 71 *infra*, a program for declaring all earnings in dividends, if sustained over a long period, is as likely to lead to insolvency as are capital impairment dividends.

<sup>32</sup> See Dean, *Provision for Capital Exhaustion Under Changing Price Levels*, 65 HARV. L. REV. 1339 (1952); Kiley, *Some Legal Problems Arising from Profit Determination in Periods of Rising Prices*, 24 U. CINC. L. REV. 519 (1955); Spear, *Dividend Policies Under Changing Price Levels*, 27 HARV. BUS. REV. 612 (1949).



matters normally within their discretion. Most of the cases deny the validity of such agreements, even though beneficial to the enterprise, on the ground that the minority is, at least in theory, entitled to the free discretion of the directorate.<sup>33</sup> No case has been found in which such an agreement has been sustained where there was even the slightest suggestion that it might sap the vitality of the business.

As was recognized by the trial court in *Rosencrans v. Fry*, the conduct of the trustee should be carefully scrutinized—not to see that he followed the rules of trust administration but to see that he acted honestly for the benefit of the corporation, particularly where, as in Fry's case, the trustee stands to gain by the expansion of the business.<sup>34</sup> But the position of the courts seems quite clear that where the trustee does not hold all of the shares of the corporation he will not be held in breach of trust merely because he has failed to prevent accumulations of surplus necessary to the continued vitality and growth of the business. The effect of these decisions is to liberate the trustee and the enterprise from the stifling application of trust rules as to principal and income and to focus the trustee's duty to make the assets productive of income, not on the corporate surplus, but on the continued retention of the business interest by the trust. This is a sound position, and one which I would like applied to all business enterprises held in trust.

The position taken by the courts in actions by the beneficiaries against a trustee who merely holds a controlling interest in a corporation finds its exact counterpart in the cases involving actions by the beneficiaries or one of several trustees against the corporation for a declaration of dividends. In *Murray v. Beattie Mfg. Co.*,<sup>35</sup> one of the trustees of three trusts which held 950 out of a total of 3,000 outstanding shares in the company also held 700 shares in his own right and was a corpus beneficiary of the trust. Moreover, his son, the holder of 200 shares, served as a director of the corporation and was a corpus beneficiary under the terms of the trusts. The income beneficiaries of the trust brought an action against the company for a declaration of dividends.<sup>36</sup> The vice-chancellor stated firmly that the corporation need not respond to the peculiar interests of an income beneficiary of a

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<sup>33</sup> See *Odman v. Oleson*, 319 Mass. 24, 25, 64 N.E.2d 439 (1946) ("there was one stockholder not a party to the contract who might be injuriously affected by it"); *Woodruff v. Wentworth*, 133 Mass. 309, 314 (1882); Annot., 45 A.L.R.2d 799, 815 (1956).

<sup>34</sup> See *Perry v. Perry*, 339 Mass. 470, 160 N.E.2d 97 (1959); *Matter of Moot*, 285 App. Div. 785, 141 N.Y.S.2d 439 (1955).

<sup>35</sup> 79 N.J. Eq. 322, 82 Atl. 1038 (Ch. 1911).

<sup>36</sup> Although the more common procedure is for the trustee to bring the action on behalf of the beneficiaries, they are not without remedy when he refuses to do so. From the earliest days, beneficiaries could obtain relief in equity to compel an unwilling trustee to sue third parties on behalf of the trust. Today, the action against the trustee and against the third party may be combined in one proceeding. 3 SCOTT, TRUSTS § 282.1 (2d ed. 1956). But in such an action, all the beneficiaries are neces-

trust, where the interests of its other shareholders would not be served thereby.<sup>37</sup> But noting that the trustee and his son, as corpus beneficiaries of the trusts and controlling directors of the company, were unable "to act fairly" with the shares of stock held in trust,<sup>38</sup> subjected their dividend policy to special statutory scrutiny and decreed a substantial distribution. In this he was reversed. There is language in the opinion on appeal suggesting that the strong presumption in favor of the board of directors, established in dividend cases in general, should not give way even in cases such as this. But the decision appears to rest more on a disagreement with the chancellor's view of the company's need for additional capital.<sup>39</sup> It seems obvious that, whatever the language employed, the courts tend to scan the dividend policies of the directorate with a jealous eye in the context of close corporations.<sup>40</sup> The fact that the increased value of the business may not inure to the benefit of minority shareholders who do not have a market for their shares has been given weight.<sup>41</sup> And the peculiar plight of a life tenant has caused one court to state expressly that the actions of the directors will be subjected to special scrutiny.<sup>42</sup>

It is important to note that the plight of the life tenant has been exacerbated by the abandonment of the Pennsylvania rule of apportionment.<sup>43</sup> This point is suggested by *Schmitt v. Eagle Roller Mill Co.*,<sup>44</sup> in which a trustee's claim, on behalf of his income beneficiaries, for a declaration of dividends was denied. Because of the peculiar facts of the case, the denial itself is not significant.<sup>45</sup> But what is interesting

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sary parties. *Matthies v. Seymour Mfg. Co.*, 270 F.2d 365 (2d Cir. 1959), *cert. denied*, 361 U.S. 962 (1960), 108 U. PA. L. REV. 1231 (1960) (arguing that a beneficiary of a trust should be recognized as a shareholder for purposes of a shareholder's derivative action). On the question of whether an action for the declaration of dividends is derivative in the right of the corporation, see *Gordon v. Elliman*, 306 N.Y. 456, 119 N.E.2d 331 (1954) (holding it derivative); *Knapp v. Bankers Sec. Corp.*, 230 F.2d 717 (3d Cir. 1956) (not derivative); 2 HORNSTEIN, CORPORATION LAW AND PRACTICE § 602 (1959).

<sup>37</sup> "The situation of corporations would be hard indeed if they had to act or refrain from acting not only with their stockholders in view, but also with regard to the interests of all the beneficiaries of stock held in trust under wills or deeds." 79 N.J. Eq. at 336, 82 Atl. at 1045.

<sup>38</sup> *Id.* at 336-37, 82 Atl. at 1045.

<sup>39</sup> *Murray v. Beattie Mfg. Co.*, 79 N.J. Eq. 604, 610-11, 82 Atl. 1038, 1040-41 (Ct. Err. & App. 1912).

<sup>40</sup> See, e.g., *Gaines v. Long Mfg. Co.*, 234 N.C. 331, 67 S.E.2d 355 (1951).

<sup>41</sup> *Raynolds v. Diamonds Mills Paper Co.*, 69 N.J. Eq. 299, 60 Atl. 941 (Ch. 1905).

<sup>42</sup> *Ochs v. David Maydole Hammer Co.*, 138 Misc. 665, 246 N.Y. Supp. 539 (Sup. Ct. 1930). See generally Note, *Minority Shareholder Suits to Compel Declaration of Dividends*, 64 HARV. L. REV. 299 (1950).

<sup>43</sup> See *Krasnowiecki* 539-41.

<sup>44</sup> 199 Minn. 382, 272 N.W. 277 (1937).

<sup>45</sup> The trust held a controlling interest in the corporation during the years 1912 to 1933. Since 1912 the company had paid on an average over 15% annually in dividends on its common stock. In 1933 the trust lost control of the corporation because of a deadlock between its two trustees. Nevertheless, in 1934 the company paid dividends of \$254,016.28, although current earnings were only \$145,992.12.

is that the trustee sought declaration of a stock dividend, should his claim to a cash dividend be denied. The trustee, acting on behalf of the income beneficiaries, had in mind the Pennsylvania apportionment rule which was then in force in Minnesota.<sup>46</sup> The court, in denying this claim on the ground that the interest of the other shareholders of the corporation must be considered, pointed out that the income beneficiaries were not without a remedy.<sup>47</sup> The court was obviously thinking of the possibility that the trustee might sell the stock and thus obtain for the income beneficiaries the benefit of the corporate accumulations—again through the apportionment rule.

With the adoption of the Uniform Principal and Income Act, the possibility of selling some of the shares or of securing a distribution of stock dividends as a solution to the current income beneficiary's claim to the corporate earnings is no longer open to the trustee. Because under the act the proceeds of sales and stock dividends are corpus and are not apportioned.<sup>48</sup> Thus, with the abolition of the apportionment rule, the pressures for larger distributions by a trustee-controlled corporation may be significantly increased.<sup>49</sup> This point is of the utmost importance when the trustee owns all of the stock of a corporation, since in these cases, as we shall see, he is not as well protected against the pressure to distribute all income as he is when he merely holds a controlling interest.

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<sup>46</sup> *Id.* at 395, 272 N.W. at 283.

<sup>47</sup> *Id.* at 397, 272 N.W. at 283-85.

<sup>48</sup> UNIFORM PRINCIPAL AND INCOME ACT §§ 3(2), 5(1).

<sup>49</sup> It should be noted that the Uniform Revised Principal and Income Act § 5(1) (Tent. Draft No. 2, 1961) provides that stock dividends of 6% or less per annum are to be treated as income. This qualification to the existing Uniform Act was recently adopted judicially in Pennsylvania. *Catherwood Trust*, 405 Pa. 61, 173 A.2d 86 (1961). Thus, in Pennsylvania, in jurisdictions in which the prestatutory "Pennsylvania" apportionment rule is still in force, or where the Revised Act is adopted, the trustee who is in a position to cause the corporation to declare stock dividends may find therein a solution to the problem of keeping the corporation going and the current income beneficiary's claim on the earnings satisfied. There are some rather serious problems with this solution. The current income beneficiary may not be expected to remain satisfied with small distributions of stock unless he can convert them into cash. If the stock is freely transferable and has a good market (which is unlikely) the trustee must be prepared to justify a gradual loss of control. Even if the current income beneficiary is satisfied to retain the stock, there will be a gradual shift of control from the trust to the beneficiary. In *Steele Estate*, 377 Pa. 250, 103 A.2d 409 (1954), remaindermen charities brought suit to prevent the trustee from apportioning (in accordance with the prestatutory apportionment rule) a stock dividend to herself as life tenant. The apportionment would have reduced the trust holding in the corporation from 49% to 39%. The court held against the remaindermen charities, stressing, however, the fact that the life tenant-trustee, while a director of the corporation, "could not have prevented the stock dividend." *Id.* at 257, 103 A.2d at 413. The case offers little encouragement to the trustee who actively employs his control of the corporation to cause the distribution of a stock dividend which, when apportioned to the life tenant, results in loss of control—particularly if the remaindermen are close members of the settlor's family rather than charities. Yet twelve years of 6% stock dividends would cut the trust's control in half. To avoid loss of control, the trustee might offer to purchase the stock from the life tenant. In fact, this would be the effect of the New Jersey rule under which the life tenant

## II. THE TRUSTEE WITH SOLE CONTROL<sup>50</sup>

### A. *The Effect of Corporate Law*

When the trustee owns all of the outstanding capital stock of the corporation (or all the stock except the qualifying shares of the board of directors) in trust, or owns some of the stock in trust and the remainder in his own right, it is obvious that the rationale of *Rosencrans*

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is merely entitled to a lien in the trust corpus for an amount which is equal to the amount of earnings capitalized to support the stock dividend distribution to the trust. In *re Wehrman's Estate*, 41 N.J. Super. 158, 124 A.2d 334 (1956). If the trustee has other assets that may be liquidated for such repurchase or satisfaction of a lien, this solution is reminiscent of the solution offered by trust law in connection with the sole proprietorship held in trust—namely, that all necessary improvements and replacements in the business must come out of trust corpus. See *Krasnowiecki* 522-29. This is the solution to which I object.

As will be noted in the remainder of this article, the rules governing a wholly trustee-owned corporation appear to be quite different from those governing the trustee's conduct when the corporation has minority shareholders whose interests continue to be protected by the normal rules of corporate law. One additional result of a stock dividend of such a wholly owned corporation which ends up in the hands of the income beneficiaries may be that the law governing the trustee's conduct would be changed to protect their interests, and many of the complex problems discussed in the remainder of this article may be avoided.

<sup>50</sup> The situations in which the trustee does not hold sole control in his capacity as trustee include two which deserve specific mention:

*Balance of outstanding shares owned by trustee individually.* The duties of the trustee in the conduct of the corporation should be the same whether he owns all of the outstanding shares in trust or part in trust and part in his own right. In the latter situation, the courts are normally willing to presume that the settlor was aware of the potential conflict of interest and condoned its *existence*. See, *e.g.*, *Anderson v. Bean*, 272 Mass. 432, 172 N.E. 647 (1930); *Steele Estate*, 377 Pa. 250, 257-58, 103 A.2d 409, 412-13 (1954); *Flagg Estate*, 365 Pa. 82, 73 A.2d 411 (1950). These cases indicate that his conduct may not be questioned *solely* on the ground that he occupies conflicting positions. It is obvious, however, that a trustee will not be permitted to justify conduct objectionable as a matter of trust administration by a showing that such conduct was necessary to the protection of his personal interests. This distinction comes out very clearly from a comparison of cases such as *Rosencrans v. Fry*, 21 N.J. Super. 289, 91 A.2d 162 (Ch. 1952), *aff'd*, 12 N.J. 88, 95 A.2d 905 (1953), and *Matter of Hubbell*, 302 N.Y. 246, 97 N.E.2d 888 (1951) (trustee owned 50% of the outstanding shares in trust and 50% in his own right). *But cf.* *Dailey v. Wight*, 94 Md. 269, 51 Atl. 38 (1902), where the court was willing to absolve the trustee from a duty to account for his salary as director on the ground that he did not need the trust stock to secure his election. Of the 300 outstanding shares of the company, 67 were owned by the trust, 100 by the trustee, and 133 by members of the trustee's immediate family.

*Balance of outstanding shares owned by corpus beneficiaries of the trust.* While beneficiaries owe greater duties to each other than do third parties dealing with the trust, they do not occupy the same fiduciary position to the trust as does the trustee. Thus, if the trustee sells trust property to a beneficiary of the trust, the sale is voidable only if the price is unfair or the trustee had no authority to sell. 3 *Scott, Trusts* § 257A (2d ed. 1956). *But cf.* *Headley v. Headley*, 226 Ky. 483, 11 S.W.2d 123 (1928). While the beneficiaries may not be as well protected as third parties in their dealings with the trust property, the protection which might be extended to them as individual shareholders in a trustee-controlled corporation is a protection in respect of their *individual property*. The acceptance of this argument seems implicit in *Dailey v. Wight*, *supra*, when taken in the light of the fact that the position of the immediate family of the trustee vis-à-vis the trust is not unlike the position of the beneficiaries of the trust. See *Strudthoff v. Yates*, 162 P.2d 845, 851 (Cal. Dist. Ct. App. 1945), *rev'd on other grounds*, 28 Cal. 2d 602, 170 P.2d 873 (1946); *Tyler v. Sanborn*, 128 Ill. 136, 145, 21 N.E. 193, 195 (1889). Compare *Noonan Estate*, 361 Pa. 26, 63 A.2d 80 (1948); *Yetzer Estate*, 3 Fid. Rep. 469 (Pa. Orphans' Ct. 1952).

*v. Fry*, resting as it does on the duty of the directors to minority shareholders, would do little to protect a trustee who permitted the corporation to depart from the principles which govern the administration of trust estates.

Furthermore, it seems clear that a trustee who holds all of the outstanding shares of the corporation and who in fact has plenary control over its activities cannot contend, in an action by his beneficiaries, that the decisions are made by the board of directors. In the first place, some courts have implied that he has a duty to assume personal management of the corporation.<sup>51</sup> Even though the better view is that this duty arises only in special cases,<sup>52</sup> there is no evidence at all that the courts will accept a contention that the decisions are made by the board when this is contrary to fact. The most that can be said is that the courts are reluctant to enter an order against a shareholder fiduciary, affecting the conduct of a corporation, unless the corporation is made a party to the proceedings.<sup>53</sup> This, it will be recalled, was the principal objection of the appellate court in *Koretzky* to the lower court's decree ordering removal of the directors of warehouse company. The trustees in that case no longer owned all of the company's outstanding capital stock. But it is interesting to note that the upper court, after stating that the trustee's duty is to conduct the corporation for the benefit of the trust, cited with approval *Latorraca v. Latorraca*,<sup>54</sup> which involved the duties of an executor who had received from the decedent 100% of the capital stock of a wholesale grocery business,

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<sup>51</sup> In *Elias v. Schweyer*, 13 App. Div. 336, 340, 43 N.Y. Supp. 55, 58 (1897), the court appeared to recognize such a duty, apparently without exception. In *In re Peabody's Estate*, 218 Wis. 541, 547-48, 260 N.W. 444, 447 (1935), the duty is offered as a rationale for allowing the trustee to retain compensation paid to him as a director of the corporation. On this basis, cases which allow the trustee to retain such compensation tend to support the existence of such a duty. See *Stone v. Baldwin*, 348 Ill. App. 225, 238, 109 N.E.2d 244, 250-51 (1952), *rev'd on other grounds*, 414 Ill. 257, 111 N.E.2d 97 (1953); *Wax v. Wax*, 78 Pa. D. & C. 213 (C.P. 1951); *Estate of Teasdale*, 261 Wis. 248, 52 N.W.2d 366 (1952). Cases which require the trustee to account to the trust for such compensation tend to deny the existence of such a duty. See, e.g., *Mangels v. Tippet*, 167 Md. 290, 173 Atl. 191 (1934); *Pyle v. Pyle*, 137 App. Div. 568, 122 N.Y. Supp. 256, *aff'd*, 199 N.Y. 538, 92 N.E. 538 (1910). Compare *Matter of Block*, 186 Misc. 945, 60 N.Y.S.2d 639 (Surr. Ct. 1946). The trustee, of course, has a duty not to delegate the administration of the trust, 2 SCOTT, TRUSTS § 171 (2d ed. 1956), and there has been some question, based on this duty, whether trustees may properly invest in regulated investment company shares, 3 *id.* § 227.9A.

<sup>52</sup> Trachtman, *Closely Held Businesses: Responsibilities of the Executor or Administrator*, 90 TRUSTS & ESTATES 668, 674 (1951), concludes: "As a practical matter, for the fiduciary to oust the management of a successful commercial enterprise, and substitute untried hands, may be the height of imprudence. On the other hand, when the business of the corporation was conducted by the decedent as the principal officer and the other members of the board were only 'dummies'—there is a case for saying that the fiduciary should put himself on the board."

<sup>53</sup> *Rossi v. Davis*, 345 Mo. 362, 394, 133 S.W.2d 363, 380 (1939); *Goetz's Estate* (No. 1), 236 Pa. 630, 633-34, 85 Atl. 65, 66 (1912). *But cf.* *Wax v. Wax*, 78 Pa. D. & C. 213, 220 (C.P. 1951).

<sup>54</sup> 132 N.J. Eq. 40, 26 A.2d 522 (Ch. 1942).

under a will which also contained a specific devise of land held by the corporation. Notwithstanding that the corporation was not a party defendant, the court not only ordered the executor "to cause the corporation to take such action as may be suitable to carry out the testator's intention in respect of the land"<sup>55</sup> but ordered him to conduct the corporation in accordance with the provisions of the will. The will directed that the capital committed to the business not exceed \$80,000 and that the corporation pay dividends of 6% on such capital to the trust annually.<sup>56</sup> Cases requiring an executor to cause the corporation to convey land which was specifically devised to another may be explained on the basis that a sole shareholder who has power to liquidate a corporation may direct the executor to cause a partial liquidation, so long as creditors are protected.<sup>57</sup> But the court's order in *Latorraca*, requiring the executor to adhere to a testamentary direction concerning capital and dividends, cannot be explained on this basis. The direction is a continuing harness on managerial discretion.<sup>58</sup>

Its enforcement against the executor suggests that a settlor who conveys sole ownership to a trust may set the dividend policy of his corporation through directions to the fiduciary. If this suggestion is acceptable as a matter of corporate law, the trustee-owned corporation is thrown open to the application of the principles we have found applied to the sole proprietorship held in trust.<sup>59</sup> I believe, however, that *Latorraca* is not controlling and that an express direction to the fiduciary requiring him to distribute all the earnings of a corporation determined by "accepted" accounting practices would be invalid as a matter of corporate law.

*Clark v. Dodge*,<sup>60</sup> the leading case on the permissible scope of agreements among all of the shareholders of a corporation, contains an interesting suggestion on this point. The agreement provided that Dodge, who held 75% of the outstanding shares in two corporations, would so vote as shareholder and as director as to retain Clark, who held the remaining 25% of the shares, as general manager so long as he should be "faithful, efficient and competent." In addition, the agreement provided that Clark should receive during his lifetime one-fourth of the "net income" of the corporations as salary or dividends. The

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<sup>55</sup> *Id.* at 42, 26 A.2d at 524.

<sup>56</sup> *Id.* at 48, 26 A.2d at 527.

<sup>57</sup> See *Miles v. Odom*, 3 N.J. Super. 376, 65 A.2d 754 (Ch. 1949); *Fidelity Union Trust Co. v. Roest*, 113 N.J. Eq. 368, 375, 166 Atl. 918, 921 (Ch. 1933).

<sup>58</sup> Compare *Jackson v. Hooper*, 76 N.J. Eq. 592, 75 Atl. 568 (Ct. Err. & App. 1910), with the discussion of *Clark v. Dodge*, 269 N.Y. 410, 199 N.E. 641 (1936) in text accompanying notes 60-65 *infra*.

<sup>59</sup> See *Krasnowiecki passim*.

<sup>60</sup> 269 N.Y. 410, 199 N.E. 641 (1936).

court ordered specific performance of the agreement against Dodge and the corporations—without paying attention to the fact that Dodge was only one of a board of directors<sup>61</sup>—, using oft-quoted language: “If the enforcement of a particular contract damages nobody—not even, in any perceptible degree, the public—one sees no reason for holding it illegal, even though it impinges slightly upon the broad provision of . . . [the state’s corporation law].”<sup>62</sup>

The negative of the last clause has, of course, been made pregnant by later decisions of the same court.<sup>63</sup> But the subsequent position of the court, that substantial departures from the “corporate norm” are not acceptable, even where nobody is injured, has been so severely criticized by writers<sup>64</sup> that it is doubtful how far one might rely on that position alone for guidance in other jurisdictions. From the point of view of corporate lawyers, the subsequent history of *Clark v. Dodge* is one of agreements affecting the personnel composition of management and, where dividends are involved, of agreements *restricting distribution*. Because of the peculiarity of trust law, however, we happen to be interested principally in the validity of agreements *requiring distribution* of dividends. From this point of view, it is significant to note that, in upholding the agreement that Clark should receive one-fourth of the corporation’s “net income,” the court was impelled to state: “For the purposes of this motion, it is only just to construe that phrase as meaning whatever was left for distribution after the directors had in good faith set aside whatever they deemed wise . . . .”<sup>65</sup>

In *Dejonge v. Zentgraf*,<sup>66</sup> an earlier decision, the court, while accepting the position that “all the stockholders in a private corporation

<sup>61</sup> “Dodge took no active part in the business, although he was a director, and through ownership of their qualifying shares, controlled the other directors of both corporations.” *Id.* at 413, 199 N.E. at 641.

<sup>62</sup> *Id.* at 415, 199 N.E. at 642. N.Y. GEN. CORP. LAW § 27 provides that “the business of a corporation shall be managed by its board of directors . . . .” Similar provisions are to be found in most states. See, e.g., N.J. STAT. ANN. § 14:7-1 (1939); PA. STAT. ANN. tit. 15, § 2852-401 (1958).

<sup>63</sup> See *Long Park, Inc. v. Trenton-New Brunswick Theatres Co.*, 297 N.Y. 174, 77 N.E.2d 633 (1948); *Benintendi v. Kenton Hotel, Inc.*, 294 N.Y. 112, 60 N.E.2d 829 (1945). The New York development is traced in Delaney, *supra* note 15, at 55-59.

<sup>64</sup> See 1 O’NEAL, CLOSE CORPORATIONS § 5.06, at 237 (1958); Delaney, *supra* note 15, at 65-66; Hornstein, *Judicial Tolerance of the Incorporated Partnership*, 18 LAW & CONTEMP. PROB. 435, 442 (1953); Comment, 44 CALIF. L. REV. 590 (1956). “The owners of 100% of the stock of a corporation may do with it as they will, even to giving it away, provided the rights of creditors are not involved and the public policy of the State is not offended.” *Benintendi v. Kenton Hotel, Inc.*, *supra* note 63, at 124, 60 N.E.2d at 834 (Conway, J., dissenting). *Accord*, *In re Feinson’s Estate*, 196 Misc. 590, 92 N.Y.S.2d 87 (Surr. Ct. 1949). The court in *Baran v. Baran*, 59 Pa. D. & C. 556 (C.P. 1947), in adopting the view in *Clark v. Dodge*, does not appear to state any limitation for departures from the “corporate norm.” Instead, the court said that such agreements remain valid so long as what the parties have contracted to do they might do “lawfully,” *id.* at 560—a limitation of undefined scope and significance.

<sup>65</sup> 269 N.Y. at 417, 199 N.E. at 643.

<sup>66</sup> 182 App. Div. 43, 169 N.Y. Supp. 377 (1918).

can contract among themselves and with the company to control the action of directors in managing the affairs of the company, so long as such control violates no law and does not impair the rights of creditors," seriously doubted that an agreement requiring the distribution of all the company's earnings could be sustained.<sup>67</sup> It preferred to interpret the agreement before it, as did the court in *Clark v. Dodge*, to permit the directors to set aside whatever is needed. In support of this the court stated that "an interpretation which compels the directors to distribute all profits would be . . . subversive of the company's best interests, and, as could easily be foreseen, would probably lead to bankruptcy . . . ." <sup>68</sup>

It is reassuring to find that the court in *Dejonge* foresaw what I have argued in Part I of this article is the fate of a business run in accordance with the rules of trust administration. A great many corporation statutes contain, in addition to or in lieu of prohibitions against capital impairment, dividend provisions rendering illegal dividends declared "when the corporation is insolvent or when payment thereof would render the corporation insolvent."<sup>69</sup> It would be hard to argue that a shareholder agreement requiring the distribution of all the earnings legally available for dividends is violative of these provisions as to any year or any series of years.<sup>70</sup> Such distributions need not lead to bankruptcy. But because, as the court in *Dejonge* saw, bankruptcy is probable and this probability is manifestly increased in an era of rapid obsolescence and inflation<sup>71</sup>—at least for enterprises whose capital is a substantial income-producing factor—it may be argued that such contracts are invalid because they *tend* toward a violation of the dividend law and *tend* to impair the rights of creditors.

I am not unmindful of the authorities which sustain mandatory contractual provisions requiring distribution of dividends to noncumulative preferred shareholders if there are any earnings available for this purpose.<sup>72</sup> But these cases, I believe, should be sharply distinguished

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<sup>67</sup> *Id.* at 47, 169 N.Y. Supp. at 378-79. The court relied on *Drucklieb v. Sam H. Harris, Inc.*, 209 N.Y. 211, 102 N.E. 599 (1913). Now, *Lindgrove v. Schluter & Co.*, 256 N.Y. 439, 444, 176 N.E. 832, 833 (1931), lends support to the court's doubts.

<sup>68</sup> 182 App. Div. at 48, 169 N.Y. Supp. at 380.

<sup>69</sup> See, e.g., PA. STAT. ANN. tit. 15, § 2852-702A (1958).

<sup>70</sup> The few cases on the subject suggest that the courts are extremely reluctant to find a causal relationship between the distribution and a subsequent insolvency (where the distribution did not impair capital). See *Hofkin v. United States Smelting Co.*, 266 Fed. 679 (3d Cir. 1920); *Ellis v. French-Canadian Co-op. Ass'n*, 189 Mass. 566, 76 N.E. 207 (1905); *Slaymaker's Adm'r v. Jaffray & Co.*, 82 Va. 346, 4 S.E. 606 (1887).

<sup>71</sup> See articles cited note 32 *supra*.

<sup>72</sup> See *Burk v. Ottawa Gas & Elec. Co.*, 87 Kan. 6, 123 Pac. 857 (1912); *Crocker v. Waltham Watch Co.*, 315 Mass. 397, 53 N.E.2d 230 (1944); cf. *New England Trust Co. v. Penobscot Chem. Fibre Co.*, 142 Me. 286, 50 A.2d 188 (1946). *But see Morse v. Boston & M.R.R.*, 263 Mass. 308, 160 N.E. 894 (1928), a case erroneously distinguished in *Crocker*.



from our case. They involve preferred stock entitled to dividends in a specified percentage—normally 6%. Business enterprises in general may be expected to maintain a level of earnings greater than the average rate of interest. Nor does the preferred stock normally represent the major portion of a corporation's capitalization. Recognition of mandatory dividend provisions in respect of preferred stock is not authority for the validity of a shareholder contract or bylaw requiring the distribution of all the earnings of a company. The latter necessarily denies to management any right to make provision for the survival of the enterprise whereas the former does not. In fact, in *Crocker v. Waltham Watch Co.*,<sup>73</sup> the Supreme Judicial Court of Massachusetts, sustaining the validity of a mandatory dividend provision in respect of 6% non-cumulative preferred, rested its decision squarely on this distinction. It is therefore inappropriate, though common,<sup>74</sup> to cite cases<sup>75</sup> suggesting that a shareholder contract or bylaw requiring the distribution of all earnings is invalid, as opposed to the preferred shareholder cases. Neither line of authority impairs the other. If this point be acceptable, it is interesting to note that *Latorraca* fits in part into the distinction suggested, since in that case the settlor merely directed a distribution of 6% on the capital of his corporation—if the earnings would support it.<sup>76</sup>

Perhaps the best that can be said is that there is enough support in corporate law for the view that contracts requiring the disbursement of all of a corporation's earnings are invalid to furnish a useful argument to the trustee who, owning all of the shares of a corporation, is pressed to distribute more than he believes healthy for the enterprise.

### B. *The Cases in the Trust Field*

It should be made clear at this point that the cases in this field, on the whole, do not support the view that the courts are willing to apply trust administration rules to a wholly trustee-owned corporation. But an examination of the cases does reveal a marked confusion and a failure on the part of the courts to arrive at a sound, clear-cut position. In every field of argument there is one case which helps to illustrate

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<sup>73</sup> 315 Mass. 397, 409-10, 53 N.E.2d 230, 236-37 (1944).

<sup>74</sup> See 12 FLETCHER, PRIVATE CORPORATIONS § 5447.1 (perm. ed. rev. repl. 1957).

<sup>75</sup> See, e.g., *Lindgrove v. Schluter & Co.*, 256 N.Y. 439, 444, 176 N.E. 832, 833 (1931) (dictum).

<sup>76</sup> *Lydia E. Pinkham Medicine Co. v. Gove*, 303 Mass. 1, 30 N.E.2d 482 (1939), often cited for the validity of bylaw and contractual provisions requiring the distribution of earnings, involved a bylaw which required distribution of earnings in excess of a net surplus of \$1,000,000. It is hardly authority for a bylaw or contract prohibiting the creation of any surplus.

the horrors of a world in which one's argument is not heeded. Here, such a case is *Matter of Estate of Adler*.<sup>77</sup>

Some years before his death, Samuel Adler organized Relda Realty Corporation for the purpose of acquiring land and erecting thereon a twelve-story building for commercial rental. Adler was the owner of the entire capital stock which he left by his will to trustees, directing them to continue the business. The income of the trust was payable to certain beneficiaries during their lives, the remainder to others. When Adler died in 1927, the land and building, valued at \$865,000, were subject to a first mortgage of \$325,000, and the corporation's books carried an account in Adler's name which showed a credit balance in his favor of \$128,507.75. The directors authorized the corporation to discharge this debt out of earnings, and between 1927 and the time of suit, the corporation paid \$103,507.75 to the trustees of Adler's estate. The corporation had also built up reserves of \$88,000 against depreciation and payment of the principal on the mortgage.

Some of the current income beneficiaries brought an action challenging both the trustees' right to retain the payments made on account of the debt owed the testator and the validity of the reserves created by the corporation. The surrogate held that retention by the trustees of the amounts paid in discharge of the debt constituted an invalid accumulation of income.<sup>78</sup> To reach this result, he had to—and did—disregard the corporate entity, view the assets and debts of the corporation as assets and debts of the trust, and apply the well-known trust rule that the principal on debts owed by a trust must be paid out of principal.<sup>79</sup> Up to this point, there was no need to reverse the corporate actions taken, since only the character of the payments received by the trustee was at issue. The surrogate, however, went further. He held that a trustee may not set up reserves against depreciation and ordered that the corporate action in this regard be reversed.<sup>80</sup> The trustees argued vainly that the reserves were needed to discharge the principal of the mortgage on the corporate building. The surrogate answered that had the settlor left the land and building in trust and directed that the mortgage be discharged out of income, the direction would have been invalid as requiring an unlawful accumulation of income.<sup>81</sup> No different principle, in the opinion of the surrogate, could be applicable to a corporation wholly owned by the trustee.

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<sup>77</sup> 164 Misc. 544, 299 N.Y. Supp. 542 (Surr. Ct. 1937).

<sup>78</sup> See N.Y. Sess. Laws 1915, ch. 670, § 2, as amended, N.Y. Sess. Laws 1959, ch. 453, § 1 (now N.Y. PERS. PROP. LAW § 16).

<sup>79</sup> See 3 SCOTT, TRUSTS § 233.3, at 1756 (2d ed. 1956).

<sup>80</sup> 164 Misc. at 548, 556-57, 229 N.Y. Supp. at 558-59. The prohibition against reserves for depreciation is discussed in Krasnowiecki 529-32.

<sup>81</sup> See *Hascall v. King*, 162 N.Y. 134, 56 N.E. 515 (1900); Krasnowiecki 547-48.

*Adler* has not been expressly overruled by a higher New York court. But in an interesting recent decision, *Freeman v. Farmers Bank & Trust Co.*,<sup>82</sup> the Supreme Court of Arkansas had occasion to consider and distinguish it. There, the decedent left all of the capital stock of an incorporated farm to a trustee, directing him to control and manage it and to pay the income to the plaintiff for life with gifts over. The farm was subject to a mortgage of \$200,000. For various reasons, including tax considerations, the trustee, with the consent of all concerned, dissolved the corporation and continued to operate the farm in sole proprietorship. At this point, the income beneficiary of the trust brought this action challenging the trustee's right to amortize the mortgage out of current income. The court held that the normal rule of trust administration—requiring that the principal on debts of the trust estate be amortized out of principal—was displaced by a manifestation of a contrary intention on the part of the testator. The court found this intention in the fact that the farm was left incorporated and that the settlor must have been aware that corporations may not declare dividends until current obligations are paid.<sup>83</sup> The court distinguished *Adler* on the ground that there the then-existing New York rule against accumulations was involved.<sup>84</sup>

In connection with *Freeman* it should be observed that by a combination of good sense and the inexorable logic of the corporate balance sheet, current earnings used in the reduction of the principal of a corporate obligation do not vanish but, instead, find their way into the corporate surplus. So that the critical question in *Freeman* was not (as the court supposed) whether the settlor may be said to have intended that the corporation pay its debts but rather whether he may be said to have intended that every reduction in its liabilities be attended by a corresponding contraction in his business. The *Freeman* court's apparent reluctance to embrace the obvious answer to this question without some reference to an irrelevant point of corporate dividend law is fairly discouraging for the view that it rejects the *Adler* philosophy out of hand. At least, under this decision, the trustee-owned corporation is put in a better position for borrowing than is the sole proprietorship.<sup>85</sup>

Furthermore, the surrogate's views on depreciation reserves appear to have lost all their force. As we have seen, the trust rule against depreciation reserves was strongest in New York in connection with

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<sup>82</sup> 339 S.W.2d 427 (Ark. 1960).

<sup>83</sup> *Id.* at 429, citing 11 FLETCHER, PRIVATE CORPORATIONS § 5340 (perm. ed. rev. repl. 1957).

<sup>84</sup> 339 S.W.2d at 429.

<sup>85</sup> See Krasnowiecki 519.

real estate.<sup>86</sup> After some hesitation, the New York Court of Appeals has approved such reserves for wholly trust-owned real estate corporations,<sup>87</sup> and, in general, courts now seem ready to approve depreciation by trustees on assets used in business.<sup>88</sup> Moreover, the weight of opinion, based on a number of inconclusive cases, is that dividends to the full amount of surplus, without provision for depreciation, would constitute an impairment of capital.<sup>89</sup>

How much then is left of *Adler*? On this question there are cases which may be given optimistic construction, but one can hardly say that they present a firm position. Perhaps the clearest and soundest position was taken by a Massachusetts court in *Anderson v. Bean*,<sup>90</sup> a case antedating *Adler*. There, the testator left half of the outstanding capital stock of a corporation engaged in manufacturing electrical appliances to a trustee who owned the remaining stock in his own right. Upon an accounting by the trustee, objection was made to the fact that the trustee permitted the accumulation of \$400,000 surplus in relation to \$200,000 capital. In his defense the trustee prayed in aid the philosophy of the Massachusetts rule as to stock dividends. This rule rested on a relatively unreasoned assertion that the income of a corporation is not income of the beneficiary.<sup>91</sup> The beneficiaries contended, however, that this philosophy is inapplicable when the trustee holds all of the corporation's capital stock. The court rejected the beneficiaries' claim against the trustee. Had the court simply reiterated the sterile proposition that income of the corporation is not income of the trust its decision would have left something to be desired. However, the court went to the heart of the problem, stating that the dividends actually distributed to the beneficiaries were probably "enhanced

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<sup>86</sup> See Krasnowiecki 532 nn.104 & 105.

<sup>87</sup> See *Matter of City Bank Farmers Trust Co.*, 306 N.Y. 733, 117 N.E.2d 910 (1954) (approval per curiam); *Matter of Hubbell*, 302 N.Y. 246, 257, 97 N.E.2d 888, 893 (1951) (refusal to pass on question). *But cf.* *Rossi v. Davis*, 345 Mo. 362, 390, 133 S.W.2d 363, 378 (1939) (trustees willing to discontinue reserves).

<sup>88</sup> See Krasnowiecki 532 n.109.

<sup>89</sup> FINNEY & MILLER, *PRINCIPLES OF ACCOUNTING—INTERMEDIATE* 356 (5th ed. 1958); see *People ex rel. Jamaica Water Supply Co. v. State Bd. of Tax Commrs.*, 128 App. Div. 13, 17, 112 N.Y. Supp. 392, 395 (1908), *modified*, 196 N.Y. 39, 57-58, 89 N.E. 581, 586 (1909); *Pardee v. Hardwood Elec. Co.*, 262 Pa. 68, 105 Atl. 48 (1918). Other cases are reviewed in Fitts, *Relation of Depreciation to the Determination of Surplus and Earnings Available for Dividends*, 33 VA. L. REV. 581 (1947).

<sup>90</sup> 272 Mass. 432, 172 N.E. 647 (1930).

<sup>91</sup> The leading Massachusetts decision of *Minot v. Paine*, 99 Mass. 101 (1868), is the source of the "Massachusetts" rule that all stock dividends go to corpus. The court there confined itself to the following propositions: (1) that since improvement made by directors out of earnings would constitute capital and would inure to the benefit of the remainderman if there had been no stock dividend, the accident of a stock dividend should not change matters; (2) that shareholders have no clear claim to the earnings of a corporation until a dividend is declared; and (3) that the "trustee needs some plain principle to guide him." *Id.* at 107, 108. Except for the last proposition, these are somewhat circular reasons for the adoption of the rule.

by the surplus accumulated above what they would have been if the earnings had been distributed in dividends year by year.”<sup>92</sup> Nevertheless, this basis for the decision does not aid the trustee when the situation is such that distribution of the earnings will result in a higher level of income during the period of the trust, leaving at the end an enterprise which is fit for the scrap heap. Moreover, *Anderson v. Bean* is a special case in that the trust was to continue only until the trustee decided “to retire from the management of the business,” at which time the corpus was to be distributed to the current income beneficiaries in the same proportions as they were entitled to income. Accumulation of surplus could not, therefore, be as decisive an economic blow to them as in the case of a gift over to others.

Optimistic views are often taken of *Boyle v. John Boyle & Co.*<sup>93</sup> This again is an ambiguous, not to say curious, case. The plaintiffs were three trustees of a trust holding all of the capital stock of the corporation and also directors of the corporation. There appear to have been three other directors. The action was against the corporation seeking distribution of a surplus of \$80,045.79 accumulated during the years 1907 and 1908. No dividends were declared during these years, but the settlor appears to have expected this, for he provided that if the company failed to pay a dividend of at least 5% per annum for three consecutive years, the stock should be sold. The lower court ordered the distribution sought. The appellate court, finding that the distribution would have imperiled the enterprise during the “embarrassing times of 1907 and 1908,” reversed.<sup>94</sup> Although the court also stated that the testator must be presumed to have intended that the corporation be run like a corporation,<sup>95</sup> the context does not encourage the view that a trustee is justified in holding back more income than is absolutely necessary to save the corporation from immediate disaster.<sup>96</sup>

<sup>92</sup> 272 Mass. at 445, 172 N.E. at 650.

<sup>93</sup> 136 App. Div. 367, 120 N.Y. Supp. 1048 (1910); see Cahn, *Estate Corporations*, 86 U. PA. L. REV. 136, 142-43 (1937).

<sup>94</sup> 136 App. Div. at 370, 120 N.Y. Supp. at 1051.

<sup>95</sup> *Id.* at 371, 120 N.Y. Supp. at 1052. It might be noted that the court was not sure whether the surplus represented profits or resulted from writeups in the value of existing assets. Such revaluation should find its way into capital surplus account. New York is one of the few states in which dividends may be distributed on the basis of unrealized appreciation of fixed assets. See *Randall v. Bailey*, 288 N.Y. 280, 43 N.E.2d 43 (1942). Compare *Berks Broadcasting Co. v. Craumer*, 356 Pa. 620, 52 A.2d 571 (1947). PA. STAT. ANN. tit. 15, § 2852-702A(1) (1958) provides that dividends may be paid “only out of unreserved and unrestricted earned surplus.” On the problem created in New York in connection with stock dividends, see *In re Tereshune*, 50 N.J. Super. 414, 142 A.2d 684 (Super. Ct. 1958); *In re Bingham's Will*, 7 N.Y.2d 1, 163 N.E.2d 301, 194 N.Y.S.2d 465 (1959).

<sup>96</sup> In *Matter of Doelger*, 254 App. Div. 178, 4 N.Y.S.2d 334, *aff'd mem.*, 279 N.Y. 646, 18 N.E.2d 42 (1938), the testator left a brewing business to trustees in sole proprietorship, directing them to incorporate and to adopt certain bylaws. Among other things, the bylaws were to provide that the corporation might invest proceeds from the sale of its real estate only in investments on the legal list. The trustees

Two Pennsylvania cases are often cited for the proposition that a settlor, sole owner of a corporation whose shares he transfers in trust, may not dictate in the trust instrument the dividend policies to be followed by the corporation. On close examination, however, those cases offer less than adequate encouragement to the trustee who, in the exercise of his honest judgment, would permit such a corporation to retain some of its earnings.

In *Green v. Philadelphia Inquirer Co.*,<sup>97</sup> the plaintiff, John Green, was not a life beneficiary of a trust. His claim against the company was that he had succeeded under the will of his sister-in-law to all the rights to which she had succeeded under the will of her husband, James Elverson, Jr.; that James Elverson, Jr., was a life income beneficiary of a trust which owned all of the shares of the *Inquirer*; and that, in spite of the fact that James Elverson, Jr., was the sole trustee of the trust and made no claim to larger distributions, the plaintiff was entitled to all of the surplus of the corporation which should have been distributed to James Elverson, Jr. It is hard to find a more fantastic claim. The plaintiff also presented a similar claim as to the surplus accumulated during the life of the mother of James Elverson, Jr., who, under the will of her husband, was a sole legal life tenant of all of the shares of the *Inquirer* until her death. In connection with this claim the plaintiff had to trace his right through his sister-in-law to her husband and through him to his mother who was, as was her son after her, quite content with the dividend policy of the *Inquirer*. Green's complaint against the corporation was dismissed as, indeed, it should have been. He was neither a shareholder of the corporation at the time of the suit, nor a beneficiary of a trust holding shares in the corporation. His only claim to the corporate surplus must have rested, therefore, on the theory that the possible claim of the life beneficiaries,

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incorporated and adopted the bylaws specified. With the advent of national prohibition, the trustees caused the corporation to sell the brewing assets and to reinvest in real estate. The beneficiaries sought to surcharge the trustees for certain investments made by the corporation—concededly out of the proceeds of personalty. The surrogate allowed the claim, despite the fact that some of the shares of the corporation had been distributed to the corpus beneficiaries. *Matter of Doeiger*, 164 Misc. 590, 299 N.Y. Supp. 565 (Surr. Ct. 1937). Compare discussion in note 50 *supra*. The appellate division reversed. Because the testator made express provision for real estate owned by the corporation (in the bylaws), the court found an implicit intention on his part that the legal-list requirement should not apply to proceeds of personalty. Despite broad language in the opinion to the effect that a settlor must be taken to have intended the corporation to possess its normal powers, the case obviously rests on a subtle application of the maxim *expressio unius (as to real estate) est exclusio alterius* (as to personalty). If anything, it supports the view that the settler may provide what he will concerning the investments of a wholly owned corporation. On the extent to which the rules of trust administration may be applicable to a trustee-owned corporation, the law of New York continues to be uncertain. See *Matter of Shupack*, 1 N.Y.2d 482, 136 N.E.2d 513, 154 N.Y.S.2d 441, *reversing* 1 App. Div. 2d 841, 149 N.Y.S.2d 20 (1956).

<sup>97</sup> 329 Pa. 169, 196 Atl. 32 (1938).

a claim they did not enforce, was a property interest of the kind which would pass under the wills of the life tenants; that those who took under the wills could pass it on to others; and that such others could assign the rights to Green.

In affirming the decree dismissing the complaint, the Supreme Court of Pennsylvania stressed the point that plaintiff could not assert against the corporation a claim of life beneficiaries now deceased which was not asserted by the beneficiaries during their lifetime.<sup>98</sup> However, it went on to state that James Elverson, Sr., the original testator, "did not direct that all of the net earnings should be paid out in dividends, nor was there any such intention on his part. Furthermore, it is clear that James Elverson, Sr., had no power, even had he so intended, to dictate by will the dividend policy of the corporation of which he was the sole stockholder."<sup>99</sup>

The position that a testator, sole stockholder of a corporation, may not dictate anything at all to his fiduciary concerning the conduct of the enterprise is hardly tenable today. It has been argued earlier that he may validly dictate as much but not more than what would be acceptable as a valid subject matter of unanimous shareholder agreement. In this connection it is interesting to note the recent case of *Scholler Trust*.<sup>100</sup> In 1939, the settlor, the sole owner of all the capital stock of three corporations (with the exception of qualifying shares of the directorate), created the Scholler Foundation by an inter vivos deed of trust. To the trustees he transferred all of his stock in the three corporations. Certain heirs of the settlor brought the action for a declaration that the Foundation was not a charity and therefore invalid under the rule against perpetuities. Among the contentions made by the heirs were that certain provisions of the trust deed governing the conduct of the corporations were in violation of corporate law and were contrary to public policy, and that the vice of these provisions infected the character of the trust sufficiently to prevent it from being charitable. The trust deed contained covenants on the part of the trustees binding them in considerable detail on matters involving the conduct of the corporations. The trustees undertook to vote their stock in favor of the election as directors of persons nominated by the then board of directors, provided that the nominations were made in good faith. Furthermore, they undertook to vote the stock "to the end that [the settlor and his sister, Ida M. Scholler] continue as directors of said corporations for life." Increases in officers' salaries

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<sup>98</sup> *Id.* at 174, 196 Atl. at 34.

<sup>99</sup> *Id.* at 175, 196 Atl. at 34.

<sup>100</sup> 403 Pa. 97, 169 A.2d 554 (1961).

were to be made subject to approval by the trustees. The trustees covenanted that the directors would set aside out of the net earnings of the corporations an amount determined to be necessary "for purposes of expansion or other form of capital outlay," and that they would then set aside \$4.00 per share to be paid out as dividends before any bonuses could be paid.<sup>101</sup> There were detailed covenants concerning the bonuses.

The position taken by the trustees and by the state attorney general as *parens patriae* was that if there was any vice in this provision of the trust deed it did not impair the charitable character of the trust. With this, the Pennsylvania courts, I believe quite properly, agreed. It is interesting to note, however, that on exceptions to the adjudication of the orphans' court, Judge Bolger stated: "In her brief, the Deputy Attorney General, as *parens patriae* for charitable trusts, expresses this view [that the vices of the instrument were of no effect on the charitable aspect of the trust] and declares her intention to test these provisions in due course in appropriate proceedings."<sup>102</sup> When this matter is litigated, I very much doubt that the near dictum in *Green v. Philadelphia Inquirer Co.* will be vindicated.<sup>103</sup>

For its position that the settlor has no power at all to dictate the dividend policy of a trustee-owned corporation, the court in *Green* relied on *Goetz's Estate (No. 1)*.<sup>104</sup> This case is an enigma. The testator left his entire estate to his executors in trust to pay the income to his wife for life with remainders over. He died a partner in a tanning business. The executor, with the consent of the beneficiaries, purchased the interest of the surviving partner and incorporated the business. Except for the qualifying shares, all the stock was issued to the trustees. For five years the corporation paid no dividends at all. On an accounting by the executors, to which the corporation was not made a party, the orphans' court determined the profits of the corporation for that period (\$171,144.02) and ordered them distributed to the widow. This order was reversed by the supreme court. There appear to have been two possible grounds for the court's action. First, the court objected that the orphans' court had no jurisdiction to enter

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<sup>101</sup> Brief for Appellant, p. 7, Scholler Trust, 403 Pa. 97, 169 A.2d 554 (1961).

<sup>102</sup> Scholler Estate, 20 Pa. D. & C.2d 318, 333 (Orphans' Ct. 1960).

<sup>103</sup> Since the decision in *Green*, there has been a marked shift of opinion in favor of shareholder agreements in closely held corporations. See note 64 *supra*; Ballard, *Arrangements For Participation in Corporate Management Under the Pennsylvania Business Corporation Law*, 25 TEMP. L.Q. 131 (1951). If the *Scholler* covenants do not exceed the tolerance of the corporate norm, the charitable character of the foundation may then well be questioned. It is one thing to accept foundation control of business enterprises, it is another to provide a vehicle for the perpetuation of the founder's business policies. See generally SIMES, PUBLIC POLICY AND THE DEAD HAND (1955).

<sup>104</sup> 236 Pa. 630, 85 Atl. 65 (1912).



its order "without having before it the . . . company."<sup>105</sup> This objection is obviously sound. Computation of earnings is a difficult matter on which the court should have given corporate management a chance to speak. Furthermore, an order requiring distribution of all of the earnings, I have argued, affects the rights of creditors, and the corporation should be made a party to afford them some degree of notice of what is afoot. However, the court went on to state a second ground for its decision: "The affairs of a corporation are managed by a board of directors, who, in the first instance, are to determine whether profits have been earned and whether, in their discretion, they ought to be divided among the shareholders; and, if such discretion is abused, the remedy for its correction is not to be found in an Orphans' Court."<sup>106</sup>

The orphans' courts of Pennsylvania are, of course, courts of limited jurisdiction. Prior to 1917, they did not have, as they have had since that date, exclusive jurisdiction over the administration of testamentary trusts.<sup>107</sup> Speaking in 1912, the court in *Goetz*, in stating that the orphans' courts had no power to enter an order against the executor-trustee affecting the conduct of a wholly owned corporation may have meant merely that such an order was solely within the competence of a court of general jurisdiction. The quoted language, however, suggests that the court believed that such an order would be an improper one for any court to enter and that the current income beneficiary's only remedy would be to bring, or to cause his trustee to bring, an ordinary shareholders' suit for the declaration of dividends—a suit which would be subject to the normal rule that the directors' discretion will not be questioned unless plainly abused. Such a limited view of the equitable jurisdiction of the courts would certainly make it impossible for any court to enter a decree of the sort which was entered by the New Jersey chancery court in *Latorraca*.<sup>108</sup>

If this is the conclusion to be drawn from *Goetz*, it would appear that the orphans' courts, which now have exclusive jurisdiction of both testamentary and inter vivos trusts, could not even order a trustee removed when the complaint against him was that he, as sole shareholder of a corporation, had failed to secure distribution of any dividends although the corporation could readily pay them. It is hard to believe that the reach of equity could be so circumscribed by technicalities.<sup>109</sup> Moreover, if the court in *Goetz* held this view, it is difficult to explain

<sup>105</sup> *Id.* at 634, 85 Atl. at 66.

<sup>106</sup> *Id.* at 635, 85 Atl. at 67.

<sup>107</sup> See Orphans' Court Act of 1951, § 301, as amended, PA. STAT. ANN. tit. 20, § 2080.301(2) (Supp. 1961).

<sup>108</sup> See text accompanying notes 54-58 *supra*.

<sup>109</sup> Cf. *Freihofer Estate*, 405 Pa. 165, 174 A.2d 282 (1961).

its soothing assurance that "if profits have been earned by the . . . company, to which the widow of the testator is entitled through dividends paid, or to be paid, to his executors, she will receive them."<sup>110</sup>

It is hard to say that these cases assure the trustee of protection if he determines that some income must be retained in the business. The grounds upon which these cases appear to rest—that a sole owner of the corporation has no power at all to direct his trustee on the manner of its operation, or that (in theory) the decisions are made by the board of directors—are probably untenable today.

I have argued here that for the protection of the trustee we must look, in the first instance, to the cases dealing with the power of shareholders and directors to agree on matters involving the conduct of the corporation. This approach was taken on the theory that no court would be justified in overstepping the line drawn in those cases to subject the trustee to liability for failing to follow the express or implied provisions of the trust agreement. But in those cases, as we have seen, a sharp distinction is drawn between agreements involving all of the shareholders and agreements involving less than all. Although not supported by the New York cases, the opinion of most authorities is that all of the shareholders of a corporation may do what they please with it so long as creditors are not injured. This would leave the trustee who owns all of the shares of a corporation unprotected by the suggested approach—unless an argument can be made that to require him to distribute all of the earnings impairs the rights of creditors.

That the existing state of the law should lead me to pursue a hair-line distinction between the position of the trustee who does not own all of the outstanding shares of the corporation and one who owns all of the shares may suggest some weakness in my analysis. I hope, however, that it also suggests some absurdity in the existing law. It may be that the trustee who happens to own all of the outstanding shares of a corporation is as well shielded from the application of the normal rules of trust administration in the conduct of corporate affairs as is the trustee who happens to own less than all. But if this is so, I have failed to find the shield. Perhaps it is secreted in the interstices of procedure, or locked in the good-natured bosom of most beneficiaries, or found in the quiet persuasiveness of competent trustees. It is not to be discovered in the cases.<sup>111</sup>

### III. TAX PROBLEMS AND THE TRUST INSTRUMENT

To relieve possible pressure for improvident distributions, a clause giving the trustee broad discretion in the conduct of the business may

<sup>110</sup> Goetz's Estate (No. 1), 236 Pa. 630, 636, 85 Atl. 65, 67 (1912).

<sup>111</sup> See note 49 *supra*.

be helpful.<sup>112</sup> Although one cannot be certain what interpretation the courts might give to such a clause in any particular case, it has an advantage from the tax viewpoint over a clause which makes specific reference to the retention of earnings in the corporation. If the trust is sought to be qualified for the life-estate-with-testamentary-power-of-appointment marital deduction, a clause authorizing the trustee to retain earnings in the corporation may be fatal.<sup>113</sup>

If the marital deduction is not involved, the settlor may wish to give more specific directions concerning the financial policy of the corporation. I have argued that directions to the trustee affecting the conduct of a corporation should be given effect to the same extent as, but no greater than, that given to agreements between shareholders involving the same matters. In determining what directions may appropriately be given to the trustee, the authorities dealing with shareholder agreements should be more carefully considered than was possible in this article.<sup>114</sup> It seems clear, however, that the sole owner of a corporation may validly direct his trustee to cause distributions of a fixed percentage on the net assets of the business, if earnings will support it.<sup>115</sup> I would argue that if this percentage exceeds the normal return on preferred stock the direction should be held invalid—as should a direction to distribute all of the earnings.

Alternatively, the sole owner of a corporation may direct that a specific percentage of the earnings be retained in surplus and that the balance be distributed.<sup>116</sup> *D'Arcangelo* suggests, and the cases following *Clark v. Dodge* support the validity of directions requiring the employment of family members by the corporation when the trustee is given all of the shares in the corporation.<sup>117</sup> Directions requiring the

<sup>112</sup> See *Anderson v. Bean*, 272 Mass. 432, 445, 172 N.E. 647, 653 (1930).

<sup>113</sup> See Krasnowiecki 546-47.

<sup>114</sup> See generally 1 O'NEAL, CLOSE CORPORATIONS §§ 5.01-.39 (1958).

<sup>115</sup> See note 72 *supra*; *Latorraca v. Latorraca*, 132 N.J. Eq. 40, 48, 26 A.2d 522, 527 (Ch. 1942), *aff'd mem.*, 133 N.J. Eq. 298, 31 A.2d 819 (Ct. Err. & App. 1943).

<sup>116</sup> *Lydia F. Pinkham Medicine Co. v. Gove*, 303 Mass. 1, 11-14, 20 N.E.2d 482, 489-91 (1939); *In re Trust Under Will of Koffend*, 218 Minn. 206, 218-20, 15 N.W.2d 590, 597-98 (1944). The latter case, however, rested partly on the fact that the direction pertained to assets donated to the corporation by the testator, the court holding that the direction must be followed or the assets returned by the corporation.

<sup>117</sup> See discussion of *D'Arcangelo* in text accompanying notes 11-14 *supra*; *Matter of Will of Feinson*, 196 Misc. 590, 92 N.Y.S.2d 87 (Surr. Ct. 1949); *In re Trust Under Will of Koffend*, 218 Minn. 206, 216-18, 15 N.W.2d 590, 596-97 (1944) (direction that testator's widow be employed as an officer and voted a salary of \$3,600 upheld, although she was dead at time of suit); *cf. Boyle v. John Boyle & Co.*, 136 App. Div. 367, 120 N.Y. Supp. 1048 (1910), *aff'd mem.*, 200 N.Y. 597, 94 N.E. 1092 (1911); *Edson v. Norristown-Penn Trust Co.*, 359 Pa. 386, 59 A.2d 82 (1948). See generally O'NEAL, CLOSE CORPORATIONS, § 5.17 (1958).

None of these cases, however, involved the question whether the person designated by the settlor to be elected, employed, or continued in office with the corporation has any right to enforce the provisions of the trust instrument. In *D'Arcangelo* the court stated in dictum that a direction to cause a wholly owned corporation to employ

trustee to vote for certain individuals as directors, if they are persons whose competence cannot be questioned, would appear to be valid even when the trustee holds less than all of the shares.<sup>118</sup> It should be noted that employment of family members by the corporation, if the compensation is reasonable and justifiable as a business expense,<sup>119</sup> is a useful device for reducing the double tax factor present in the taxation of small corporations.

If the settlor's main fear is that the current income beneficiary of the trust may not be adequately protected, particularly in the light of cases such as *Green* and *Goetz*, the facts of a recent decision of the Supreme Court of Pennsylvania in *Commonwealth Trust Co. v. Austin Givens, Inc.*,<sup>120</sup> suggest an approach which should be used with great caution, if at all. Shortly after the death of Austin Givens, his widow and her five sons incorporated the decedent's business, pursuant to an agreement approved by the orphans' court as part of the settlement of his estate. The five sons placed the common stock issued to them in trust, appointing their mother as trustee and making the income payable to her for life. By the terms of the trust instrument, the mother was to continue as chairman of the board of directors and to have "complete control over the affairs of the corporation." In addition, she was given the power, in her sole discretion, to determine the dividend policy of the corporation. During her lifetime, the corporation paid no dividends; she wrote a letter explaining to her sons that it was her intention that the earnings retained by the corporation be theirs as corpus beneficiaries of the trust. Upon the death of the mother, her administrator c.t.a. brought the present action claiming that the corporate surplus belonged to her estate. The court, stressing the letter

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a designated person may be "enforced"—but it does not state by whom. In *Feinson*, upon a petition for instructions filed by the executor-trustee, the court, while holding the direction valid, noted that it is not called upon to enforce the obligation. A holding that the settlor's direction in the matter is valid under corporate law does not dispose of the question whether the designated prospective employee or officer may sue the trustee. Indeed, directions in a will or trust instrument to employ a designated person as attorney in matters involving the estate or trust are obviously valid but are generally held unenforceable by the attorney. See Note, *Testamentary Designation of an Attorney*, 1958 WIS. L. REV. 322. The courts here draw the distinction between directions to employ which evidence merely an intention to guide the trustee in the exercise of his discretion and directions which are intended to give a beneficial interest to the prospective employee. It seems clear that the courts are reluctant to find an intention of the latter sort. It may be that if the prospective employee is a close member of the settlor's family or is a trusted old friend, skilled in the work intended for him, such an intention will be found to exist. See *Hand Estate*, 349 Pa. 111, 36 A.2d 485 (1944); *Will of Platt*, 205 Wis. 290, 237 N.W. 109 (1931); 2 SCORR, TRUSTS § 126.3 (2d ed. 1956). Discussion of this question is perhaps unrealistic since, if the direction is valid and the designated employee competent, the trustee is better protected in following the direction. See *Will of Platt*, *supra*. It may, however, be wise to spell out the settlor's intention in the matter at some length.

<sup>118</sup> See generally O'NEAL, CLOSE CORPORATIONS § 5.12 (1958).

<sup>119</sup> See INT. REV. CODE OF 1954, § 162(a).

<sup>120</sup> 399 Pa. 649, 161 A.2d 10 (1960).

to the sons, held that the administrator's claim must fail because the mother, knowing of her rights to the surplus intentionally failed to exercise them.<sup>121</sup> It is interesting to note that the court avoided stating that the mother made a gift of the earnings; nor did the court say, as it might have if *Green* and *Goetz* were given their broadest interpretation, that the provisions of the trust instrument giving the mother sole right to determine what earnings should be distributed as dividends were invalid and that, therefore, she had no more right to the earnings than any other life beneficiary of a trust whose trustee holds all of the shares of the corporation. Thus, at least inferentially, the opinion of the court suggests that a settlor-sole-owner of a corporation may give to the current income beneficiary of a trust the powers over the corporate earnings possessed by the mother in this case.

But the vesting of such a power in the life income beneficiary of the trust, if valid and enforceable as a matter of local law, may be extremely unwise from the tax viewpoint. The power is a general power of appointment over the corporate surplus causing a corresponding part of the value of the business to pass through the life beneficiary's gross estate,<sup>122</sup> unless the power is disclaimed or renounced.<sup>123</sup> However, if the power is an annual noncumulative power restricted so as to qualify under the \$5,000 or 5% rule of sections 2041(b)(2) and 2514(e) of the Internal Revenue Code of 1954, no adverse estate or gift tax consequences will be incurred. It should be noted that the exceptions of these provisions are not to be found in section 678,<sup>124</sup> which taxes income to the beneficiary of a trust when the beneficiary has a power, exercisable solely by himself, to vest the income or the income-producing property in himself. While section 678 is in terms applicable to the income or assets of a trust, it would not seem possible to argue for a different result when, as in our case, the power is over the income of a corporation whose stock is owned solely by the trust.<sup>125</sup>

If the income beneficiary of the trust is given a power to determine what amount of the current earnings of a corporation shall be distributed in dividends—rather than a power over all of the surplus

<sup>121</sup> *Id.* at 654-56, 161 A.2d at 12.

<sup>122</sup> See INT. REV. CODE OF 1954, § 2041. Compare Treas. Reg. § 20.2041-1(b)(1) (1961).

<sup>123</sup> See INT. REV. CODE OF 1954, § 2041(a)(2); Treas. Reg. § 20.2041-3(d)(6) (1954). For the corresponding gift tax provision, see INT. REV. CODE OF 1954, § 2514(b); Treas. Reg. § 25.2514-3(c)(5) (1958).

<sup>124</sup> Such an exception was suggested in *Hearings on Recommendations of the Advisory Group on Subchapters C, J, and K of the Internal Revenue Code Before the House Committee on Ways and Means*, 86th Cong., 1st Sess. 298-99 (1959). However, it was dropped from the committee version of these recommendations. See H.R. 9662, 86th Cong., 2d Sess. § 109 (1960).

<sup>125</sup> *Cf.* Rev. Rul. 56-431, 1956-2 CUM. BULL. 171.

or a power confined to a noncumulative right to \$5,000 (or 5% on the value of the assets) annually—the tax problems seem even more acute. Such a power will cause a fraction of the value of the business existing at the death of the income beneficiary, computed by reference to the amounts by which the earnings retained by the corporation in any year in which they were subject to the power exceeded the \$5,000 or 5% limitations of section 2041(b)(2),<sup>126</sup> to be included in the gross estate of the income beneficiary. Furthermore, during his lifetime, the latter amounts retained by the corporation in any one year would appear to be subject to the gift tax, unless it can be shown that in permitting the retention of earnings, the life tenant was actuated by business considerations rather than by the intention to benefit the members of his family who are corpus beneficiaries of the trust.<sup>127</sup> There is support for the view that the gift here would be a gift to the shareholders rather than to the corporation and that, especially where the ultimate donees are future beneficiaries of the trust corpus, the gift is of future interests thus not entitled to the annual exclusion of section 2503(b) of the Code.<sup>128</sup>

The gift tax questions should serve as a warning to trustees who, pressed by the fear of later objections to their dividend policy, rely on written consent obtained from income beneficiaries authorizing the retention of earnings. If it cannot be established that the consent was actuated by the financial needs of the corporation—and the cases suggest that the needs must be clear and pressing—such consent may result in gift tax liability. The liability will depend on the answer to the question whether and to what extent the rights of the income beneficiaries to the earnings of the corporation, viewed as a matter of local law, were compromised by the consent. But since, as we have seen, the local law situation defies any clear statement, it may be that, in

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<sup>126</sup> A release of a general power of appointment is treated as a transfer of the appointive property by the holder of the power and is subject to the provisions of INT. REV. CODE OF 1954, §§ 2035-38. INT. REV. CODE OF 1954, § 2041(a)(2). A lapse of a power is considered as a release. INT. REV. CODE OF 1954, § 2041(b)(2). Since the income beneficiary of the trust retains a right to the income from the transferred property (through his power to draw down the current earnings of the corporation in subsequent years), § 2036 is applicable. As to the computations which have to be made in relation to the \$5,000 or 5% exception of § 2041(b)(2), see Treas. Reg. § 20.2041-3(d)(4) (1958). An interesting question would arise if his power is a noncumulative power to draw down a stated amount of such earnings (e.g., \$10,000), an amount which is less than the average current earnings of the corporation but exceeds the \$5,000 or 5% exception of § 2041(b)(2). The question then would be whether this power, as to future earnings, can be treated as a retention of the income from the transferred property (i.e., the earnings which are not withdrawn pursuant to this power).

<sup>127</sup> Compare Florence S. Hyman, 1 T.C. 911 (1943); Emily Coles Collins, 1 T.C. 605 (1943); Rev. Rul. 56-431, 1956-2 CUM. BULL. 171.

<sup>128</sup> Heringer v. Commissioner, 235 F.2d 149 (9th Cir.), cert. denied, 352 U.S. 927 (1956).

this instance, the confusion will aid the beneficiaries against whom such a liability is asserted.<sup>129</sup> In any case, it would seem that blanket consents to the retention of all earnings present and future should be avoided, since in such a case the Commissioner may rely on his tables for the valuation of the life interest given away through such consent.<sup>130</sup>

#### IV. CONCLUSION

The abject failure of the law of trusts to provide a workable rule on the question of retention and distribution of earnings of a business held in trust—a matter vital to the success of any business—makes it almost impossible to plan for the retention of a business in trust except in an incorporated form. The line drawn between principal and income, based on distinctions between repairs and improvements, between “temporary” and “permanent” improvements, between “wasting assets” and not-so-wasting assets, between “amortization” and “depreciation,” along with countless other confused ideas,<sup>131</sup> impose singly and collectively a rigid stranglehold on the trustee-controlled business enterprise of the kind which often cannot be avoided, even by careful draftsmanship, without incurring adverse tax consequences.

One may contemplate with horror a world in which all big businesses are run by pension and profit-sharing plans and all small businesses by trustees. But it seems unlikely that the advent of the second part of this world would be greatly hastened by allowing—for the few cases in which it makes sense to retain a business in trust—that the law ought not to furnish the testator with a vehicle which, without some expensive repairs, is headed, with his business, for the scrap heap.

<sup>129</sup> When it is uncertain what amount of the earnings, if any, would be required to be distributed by a trustee if the beneficiary pressed his right to such distribution, it may be impossible to value the gift made by him when he has released such right.

<sup>130</sup> *Treas. Reg. § 25.2512-5* (1958). The tables do not appear to be conclusive. See MERTENS, *FEDERAL GIFT & ESTATE TAXATION* § 7.08 (1959). But the Commissioner has pressed them so hard when the actual return was less than 3½% (the return postulated in the tables) that it would be fascinating to see what would happen should the current income beneficiary release all of his rights in the earnings in excess of a return of 3½%.

<sup>131</sup> Even the relatively modern provisions of § 7 of the UNIFORM PRINCIPAL AND INCOME ACT, with its blind faith in “accepted” accounting practices, offers little solace to the settlor or trust lawyer. See Krasnowiecki 508-15.