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CORPORATIONS — CLOSE CORPORATIONS — METHODS OF RETAINING OWNERSHIP OF STOCK IN SURVIVING STOCKHOLDERS WHEN ONE STOCKHOLDER DIES — The close corporation[1] is generally formed by a small group who take an active part in the business and whose participation is essential to the successful operation of the venture. Thus, a partnership may decide that the corporate form will more effectively protect the interests of its members, or a small number of people interested in the same enterprise may incorporate in order to limit their individual liability in the common endeavor. Whatever the reason for the use of the corporate entity, the active participation of each stockholder is probably of vital importance to the financial welfare of all. To such a group the death of a stockholder is a catastrophe of the greatest magnitude. Not only do the surviving stockholders lose the effort and skill of the deceased in carrying out his share of the duties connected with the venture, but the corporation's very existence is threatened by the possibility that the stock will fall into the hands of someone with little interest in, if not actual hostility to, the corporation and its management. How can the business be managed successfully when the members of the deceased's family or his legatees, who know nothing of the problems of the business, must be accepted as principal stockholders and paid dividends although they contribute nothing to the success of the enterprise? It is the purpose of this comment to suggest an answer to the problem presented by pointing out several possible methods by which the shares of a deceased stockholder can be retained by those surviving. The allied problem of preventing the stockholder from alienating his stock to a stranger during his life will be considered only incidentally.

[1] "A corporation in which the stock is held in a few hands, or in a few families, and wherein it is not at all, or only rarely, dealt in by buying or selling." SHUMAKER, CYCLOPEDIC LAW DICTIONARY, 3d ed., 186 (1940). In England the phrase "close corporation" has a different meaning. The distinction is pointed out in Brooks v. Willcuts, (C. C. A. 8th, 1935) 78 F. (2d) 270 at 273. Cf. Detroit Trust Co. v. The Barlum, 293 U. S. 21 at 30, 55 S. Ct. 31 (1934).

1.

The first method to suggest itself is a contract between the stockholders of the corporation by which each covenants not to alienate his stock interest without giving an opportunity to purchase to the remaining shareholders, and further covenants that on his death his personal representative will give the surviving stockholders an immediate option to purchase at a stated price or at a valuation by a method previously agreed upon. Such a contract could be written into the share certificates or corporate charter and the effects of such procedure will be discussed in section 3, infra. For present purposes the contract will be assumed to take the form of a separate instrument. Under such an agreement the individual stockholder or his personal representative is obligated to give his fellow stockholders the first opportunity to acquire his interest whenever he parts with it, whether voluntarily or otherwise. The validity of such contracts has been upheld,[2] but their ineffectiveness as a plan of retaining control is obvious. It is apparent that if the stockholder, or his personal representative after his death, should transfer his stock to a bona fide purchaser the whole scheme would be ruined.[3] An action at law for damages would be available for the breach of covenant, but the purpose of the contract, the retention of control, would be thwarted. Money damages will not prevent the stock from being held by outsiders, nor will it adequately compensate the surviving shareholders for the damage done.[4] In fact, it is probable that no appreciable damage could be shown; the harm is too intangible to admit of proof in a court of law.[5]

If the covenants of the contract are strictly carried out there is still the possibility that the optionees will not have the cash available at the time to take advantage of their opportunity to purchase. In such a contingency the plan breaks down completely. To avoid this event life

[2] Lawson v. Household Finance Corp., 17 Del. Ch. 343, 152 A. 723 (1930); Krauss v. Kuechler, 300 Mass. 346, 15 N. E. (2d) 207 (1938). In Empire Trust Co. v. Kurrus, 226 App. Div. 554, 235 N. Y. S. 410 (1929), it was held that a provision in a stockholders' agreement that upon the death of any stockholder his stock should be offered to the other stockholders at a price to be fixed in a specified manner required the deceased stockholder's executor to make an offer to the remaining stockholders promptly on the death of the deceased. See also ROLLISON, WILLS, § 190 (1939) and cases cited.

[3] In re Consolidated Factors Corp., (D. C. N. Y. 1931) 46 F. (2d) 561.

[4] New England Trust Co. v. Abbott, 162 Mass. 148, 38 N. E. 432 (1894); 12 FLETCHER, CYCLOPEDIA CORPORATIONS, perm. ed. § 5457 (1932).

[5] Doss v. Yingling, 95 Ind. App. 494, 172 N. E. 801 (1930); New England Trust Co. v. Abbott, 162 Mass. 148, 38 N. E. 432 (1894); Cushman v. Thayer Manufacturing Jewelry Co., 76 N. Y. 365 (1879); Weiland v. Hogan, 177 Mich. 626, 143 N. W. 599 (1913).

insurance is a possible answer, provided the opportunity to purchase comes at the death of the shareholder. There is no doubt that one stockholder in a close corporation has an insurable interest[6] in the lives of his associate stockholders, because the death of one of them will probably cause a loss to the survivors through the introduction of outsiders into the management of the business.[7] Therefore each stockholder could insure the lives of each of the others, with himself as beneficiary, in an amount that would pay for that stockholder's proportionate part of any one of the other stockholder's interests in the business. Such a scheme is complicated in nature but the actual computation is not too difficult.[8] The chief objection is that insurance of this type would be expensive. Moreover, the opportunity to purchase may come during the insured's lifetime, in which case the insurance would not be available.

A variation of this method as a means of retaining corporate control is by a contract between the stockholders and the corporation giving the latter an option to purchase the stock before it is offered for sale to outsiders. The special problems here, in addition to the ones already discussed, involve corporate powers. The contract is void if the corporation is not authorized to purchase its own stock.[9] Even if it is so empowered there may be a limitation, either by statute[10] or judicial decision[11] that such purchases can only be made "out of" surplus. This type of restriction may not only make the contract quite ineffective if no surplus is on hand,[12] but may void it entirely if the contract involves a covenant to purchase instead of a mere option to do so. When the only consideration for the stockholder's promise to sell is the covenant of the corporation to buy, the latter's promise would be illusory be-

[6] Insurable interest has been described by Vance as existing whenever the relation between the assured and insured, whether by blood, marriage, or commercial intercourse, is such that the assured has a reasonable expectation of deriving benefit from the continuation of the life insured, or of suffering detriment or incurring liability through its termination. VANCE, INSURANCE 154 (1930).

[7] Phillips, "Life Insurance Trusts: A Recapitulation for the Draftsman," 81 UNIV. PA. L. REV. 284, 408 at 409-410 (1933); Fleming v. Fleming, 194 Iowa 71, 174 N. W. 946, 180 N. W. 296, 184 N. W. 296 (1921).

[8] See 1 C. C. H., TRUST AND ESTATE LAW SERVICE, § 9014.

[9] Steele v. Farmers' & Merchants' Mutual Tel. Assn., 95 Kan. 580, 148 P. 661 (1915); State ex rel. Howland v. Olympia Veneer Co., 138 Wash. 144, 244 P. 261 (1926); Mancina v. Patrizi, 87 Cal. App. 435, 262 P. 375 (1927).

[10] In re O'Gara & Maguire, (D. C. N. J. 1919) 259 F. 935; Greater New York Carpet House v. Herschmann, 258 App. Div. 649, 17 N. Y. S. (2d) 483 (1940).

[11] Buck v. Ross, 68 Conn. 29, 35 A. 763 (1896).

[12] Greater New York Carpet House v. Herschmann, 258 App. Div. 649, 17 N. Y. S. (2d) 483 (1940). Although a monetary consideration made the contract binding in this case, the court said a lack of surplus at the time the stock was offered to the corporation would be a defence to any action to enforce it.

cause only possible of performance when a surplus exists, a condition within the control of the corporation.[13] Of course, if the corporation has only an option to purchase, the stockholder cannot compel it to take the stock.[14]

2.

Another method for retaining control of the close corporation is a contract between the stockholders, and perhaps the corporation, whereby each stockholder agrees to bequeath his stock by will either to the other stockholders or to the corporation itself[15] on condition that the legatee or legatees pay its value or an agreed sum to the deceased's estate. A contract to make a will is controlled by the same principles and is enforceable as other contracts.[16] Moreover, such a conditional bequest is undoubtedly valid.[17] The disadvantage of the whole plan is that it is relatively ineffective. It is objectionable for the same reasons noted in section 1, supra: lack of effective enforcement, possible inability of the legatee to comply with the condition, and lack of power or surplus on the part of the corporation. There is the further danger that the stockholder will alienate the stock during his life, or that he will change his will or perhaps not make the bequest at all.

3.

The objections encountered so far are principally of two kinds: the danger that the rights of a bona fide purchaser may intervene, and the troublesome contingency that money may not be available to take advantage of the option. The first problem can be eliminated through the use of another device for retaining corporate control. It has generally been held to be a valid restraint on alienation for a corporation to require its stockholders to give the corporation or the other stockholders an option to purchase before offering the stock for sale to strangers.[18] Such limitations are usually stated in the charter or the

[13] 1 WILLISTON, CONTRACTS, rev. ed., § 133 (1936); Topken, Loring & Schwartz v. Schwartz, 249 N. Y. 206, 163 N. E. 735 (1928).

[14] Whiton v. Batchelder & Lincoln Corp., 179 Mass. 169, 60 N. E. 483 (1901).

[15] If the corporation has the power to purchase its own stock; see note 9, supra.

[16] ROLLISON, WILLS, § 188 (1939); Jefferson v. Simpson, 83 W. Va. 274, 98 S. E. 212 (1919).

[17] ROLLISON, WILLS, § 197 (1939). There would seem to be no ground of public policy prohibiting such a conditional bequest. In essence, it is a bequest of an option to purchase.

[18] 12 FLETCHER, CYCLOPEDIA CORPORATIONS, perm. ed., § 5453 (1932), and cases cited. For a general discussion of the validity of corporate restrictions upon the transferability of shares of stock, see 42 HARV. L. REV. 555 (1929). See also annotations in 65 A. L. R. 1159 (1930) and 66 A. L. R. 1182 (1930); 30 MICH. L. REV. 766 (1932).

by-laws[19] and are enforceable even against a purchaser for value if the restriction is printed on the stock certificate.[20]

If the limitation on transfer is in broad enough terms, or if it has specific provisions in relation thereto, on the death of the stockholder his personal representative would be obliged to extend the option to the corporation or the other stockholders, as the agreement might provide. Legal title to the stock would be in the executor or administrator of the deceased stockholder's estate but he would be limited, in disposing of it, to the restriction imposed. Yet if the deceased has bequeathed the stock to a stranger, it has been held that the restriction is not applicable and the legatee takes free of the option.[21] It is doubtful whether many courts would follow this holding, especially if the corporate restriction expressly provides for such a situation. To be safe, however, it would be advisable to provide for this contingency by an agreement between the stockholders to supplement the corporate restriction. Such a contract would be binding on the legatees of the deceased stockholder.[22] The problem of having sufficient cash to take advantage of the option is still present under this scheme, but otherwise it presents an effective and inexpensive method of controlling the ownership of the stock.

4.

The most complicated and expensive plan for solving the control problem, yet probably the most effective in that it has none of the troublesome objections already considered, involves the use of the life insurance trust.[23] In simplified form this method is as follows: Each

[19] 12 FLETCHER, CYCLOPEDIA CORPORATIONS, perm. ed., §§ 5453, 5454 (1932).

[20] New England Trust Co. v. Abbott, 162 Mass. 148, 38 N. E. 432 (1894); Magnetic Mfg. Co. v. Manegold, 201 Wis. 154, 229 N. W. 544 (1930). Section 15 of the Uniform Stock Transfer Act provides: "There shall be no lien in favor of a corporation upon the shares represented by a certificate issued by such corporation and there shall be no restriction upon the transfer of shares so represented by virtue of any by-laws of such corporation, or otherwise, unless the right of the corporation to such lien or the restriction is stated upon the certificate."

[21] Lane v. Albertson, 78 App. Div. 607, 79 N. Y. S. 947 (1903). It should be noted that the paragraph in the corporation articles involved in this case did not provide for the situation in which the stockholder bequeathed his interest to a stranger: "No member of the association, nor his executors, administrators, or other legal representatives, shall sell or transfer any of the capital stock of the association held by him or them, without first offering the same for sale to the association, or, if it decline the offer, to a member thereof. . . ."

[22] See cases cited in note 2, supra. Cf. E. I. Du Pont De Nemours & Co. v. Pathe Film Corp., (D. C. N. Y. 1938) 25 F. Supp. 850.

[23] For an extended discussion of the life insurance trust, see SCULLY and GANSE, BUSINESS LIFE INSURANCE TRUSTS (1930). See also Phillips, "Life Insurance Trusts: A Recapitulation for the Draftsman," 81 UNIV. PA. L. REV. 284, 408 (1933). For forms of life insurance trust agreements see 9 NICHOLS, CYCLOPEDIA OF LEGAL FORMS, § 9.109 (1936); 1 C. C. H., TRUSTS AND ESTATE LAW SERVICE, ¶ 9211 et seq.

shareholder obtains a life insurance policy on the life of each of the other stockholders in an amount that is sufficient to pay for the policyholder's proportionate share of the other stockholder's stock interest, and a designated trustee is named as the beneficiary of the policy. The trust agreement provides that on the death of a stockholder, the trustee will pay the proceeds of the policy to the deceased's estate and will transfer the stock to the corporation or to the other stockholders. The stock is deposited with the trustee along with the policies of insurance and thus the stockholders are prevented from selling their stock to a bona fide purchaser in contravention of their agreement. Under this device, the restraint on the alienation of the stock is effective; the money is available to pay the estate on the deceased stockholder's death; the incidents of ownership such as voting and dividend rights are retained by each shareholder; and disputes as to fair selling price are avoided by providing a specific method of value determination or a stated sale price in the agreement.

The legality of such an insurance trust is now clearly settled.[24] As it was at first used, the corporation took out the policy of insurance and the question arose whether it had an insurable interest in the lives of its stockholders. The courts have not agreed on this question[25] although the trend is toward the validity of such a scheme, especially if the stockholder is actually taking part in the business.[26] It has already

[24] Bohnsack v. Detroit Trust Co., 292 Mich. 167, 290 N. W. 367 (1940); Fitzsimmons v. Lindsay, 205 Pa. 79, 54 A. 488 (1903); Coe v. Winchester, 43 Ariz. 500, 33 P. (2d) 286 (1934); Greater New York Carpet House v. Herschmann, 258 App. Div. 649, 17 N. Y. S. (2d) 483 (1940). In the Fitzsimmons case it was held (syllabus): "An agreement among all the stockholders of a private trading corporation that in the event of the death of any one or more of the parties, the remaining stockholders shall have the option to purchase and acquire the stock of the deceased party at its book value, is not illegal, against public policy, or an improper restraint on alienation." In syllabus 11 to the Coe case, supra, it is said: "Contract providing that each partner should subscribe to life insurance and pay for it from partnership assets and, on death of one, survivor should take over other's interest in business and wife or heirs of deceased should receive insurance, held valid as executory agreement and not invalid as testamentary disposition. . . ."

[25] In Tate v. Commercial Bldg. Assn., 97 Va. 74, 33 S. E. 382 (1899), it was held that a corporation did not have an insurable interest in one of its stockholders. However, the stockholder apparently was not actively engaged in the management of the business. Cf. Keckley v. Coshocton Glass Co., 86 Ohio St. 213, 99 N. E. 299 (1912), where it was held (syllabus 2): "Where a person is the owner of a large portion of the stock of a corporation, and by reason of his skill and experience he is largely relied upon to make the business of the corporation a success . . . such facts disclose an insurable interest in the corporation."

[26] Phillips, "Life Insurance Trusts: A Recapitulation for the Draftsman," 81 UNIV. PA. L. REV. 284, 408 at 409 (1933); Wellhouse v. United Paper Co., (C. C. A. 5th, 1929) 29 F. (2d) 886.

been pointed out that one stockholder in a close corporation has an insurable interest in the lives of the other stockholders because of their value to the enterprise.[27] Therefore, the safer method, unless the matter is clear in the particular jurisdiction, is for each stockholder to take out the policies on the lives of his co-stockholders with a trustee as beneficiary.

There are other reasons why a trustee should be used in connection with the life insurance method. The right of the corporation to carry life insurance on its stockholders and pay the premiums out of corporate funds may be questioned. It would seem that inasmuch as the corporation is merely protecting itself against a known possible loss it should have the same power to pay the premiums as it does in the case of fire insurance. Yet, because the value to the corporation of any one stockholder is largely problematical, there is always the possibility that a creditor might object to this use of corporate funds. The stockholder could not object because he joins in the agreement. Further, although by the great weight of authority a corporation has the right to buy its own stock,[28] if that right does not exist the corporation may be prevented from acting directly.[29]

The primary objection to the use of insurance, whether taken out by the corporation or by the stockholders themselves, is the great expense involved. Necessarily, if the stock has great value, and if the stockholders are middle-aged when the plan is put into effect, the cost of the life insurance will be correspondingly large. Whether the value to be gained by continuity of management is commensurate with the cost of the life insurance is, of course, a question that can be answered only on the basis of the particular facts involved in each case.

Another problem, and one that cuts across any plan that is adopted, is that of minimizing taxation.[30] It should be noted that the $40,000 exemption in the federal estate tax[31] for life insurance on the decedent's life payable to named beneficiaries may have some bearing on the question. Recent decisions[32] of the Board of Tax Appeals have

[27] See note 7, supra.

[28] 6 FLETCHER, CYCLOPEDIA CORPORATIONS, perm. ed., § 2848 (1931), and cases cited.

[29] See note 9, supra.

[30] For a discussion of the tax problems in life insurance trusts, see Paul, "Life Insurance and the Federal Estate Tax," 52 HARV. L. REV. 1037 (1939).

[31] Internal Revenue Code, § 302 (g), 53 Stat. L. 122 (1939), 26 U. S. C. (Supp. 1939), § 811(g); Treas. Reg. 80, art. 25 (1937).

[32] Dobrzensky v. Commissioner, 34 B. T. A. 305 (1936); Estate of John T. Mitchell v. Commissioner, 37 B. T. A. 1 (1938). See also Wilson v. Crooks, (D. C. Mo. 1931) 52 F. (2d) 692; Commissioner v. Bonwit, (C. C. A. 2d, 1937) 87 F. (2d) 764.

indicated that, if named beneficiaries receive the proceeds of the insurance in lieu of the decedent's interest in the firm at his death, the decedent is benefited by having the insurance, subject to its $40,000 exemption, substituted for his interest in the corporation in computing his gross estate. Moreover, if the stockholder retains no incidents of ownership and the corporation pays the premiums, there will ordinarily be no estate tax payable on the proceeds of the life insurance policies.[33] However, payment of the premiums by a close corporation might conceivably be treated as indirect payments by the stockholder and subject his estate to the federal estate tax on that ground.[34]

5.

There are other possible means of perpetuating corporate stock control—the voting trust is an example—but they have highly specialized uses and will not be discussed here. Of the four methods that have been mentioned, the first two seem inadequate to reach the desired end. The last two appear very effective in their result although each has a particular inherent objection that makes it undesirable in certain situations. The advantages to accrue by the judicious use of any one of the methods outlined can be summarized as follows: (1) control of the corporation by the existing management will be continued on the death of one of the principal stockholders; (2) strangers ignorant of, or even hostile to, the business will not gain participation in its affairs; (3) the surviving stockholders will not be forced to earn dividends for those who may not be able to contribute to the successful operation of the business; (4) disputes as to sale price are avoided because of a pre-arranged plan of evaluation of the stock interest.

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[33] Treas. Reg. 80, art. 25 (1937).
[34] Id.