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not the intention of the testator that the court should continue the administration of the estate, the appointment of a testamentary trustee should be made before distribution to him.

Since the writer has to continue amicable relations with both Miss Whitcomb and Mrs. Rowley, he has attempted to maintain a neutral position as to which is the most important—the inventory or the final report. Both documents are very important, and if carefully prepared will save many hours of time.

CONTINUING A BUSINESS AFTER OWNER'S DEATH BY MEANS OF LIFE INSURANCE

HARRY S. BERNSTEIN*

Man finds the thought of dying rather unpleasant, but the man of wealth must find it most repelling. Not only is he barred from Heaven (for he is assured that his entrance will be made with the ease and grace of a camel passing through the eye of a needle), but he is also confronted with the prospect of separating himself from possessions which have given his life so much significance and comfort before he can set forth on his unhappy journey.

Unfortunately the state of the law has not progressed to such an extent that it can give counsel which will aid man in a better world. It will, therefore, be necessary to limit this discussion to comments on how life insurance can be used to aid the man of property in the divestiture of his possessions to the maximum benefits of his survivors and to his own greatest satisfaction.

The business of life insurance has moved farther and more quickly than the law which supports it. The life insurance superstructure is a much more complex and integrated construction than is the legal foundation which supports it, and when examples of insurance contracts are introduced which seem to rest on little or no legal foundation, it is because no decisions are available on which to test these innovations, as statutory law has not yet caught up with this phase of the insurance business.

Business insurance is an extremely useful tool in estate planning. The man who has the greatest portion of his wealth invested in a business faces a much more serious problem in estate planning than does a man who has his wealth in real estate, stocks or bonds.

In order to insure that the full value of his estate is realized, a business man must insure that his business interests will not be liquidated immediately after his death. He must arrange for the continuance of his business, for if he does not the forced liquidation of his business may result in a depletion of his estate

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with the resultant hardship on his dependents. Even planned and careful liquidation will seldom yield the full value of the decedent's interest.

PROBLEMS OF THE SOLE PROPRIETOR AND PARTNERSHIP

The sole proprietor must find someone to whom he can entrust his business, and when he finds the person he can trust he should insure his plans by entering into a binding agreement with him for the sale of the enterprise as a going concern to be carried out on the proprietor's death. Usually this person will be a trusted employee who would wish to insure his livelihood by purchasing the business.

Death of a partner in the case of a partnership either forces liquidation of the business or its complete reorganization by admitting the heirs of the deceased—or a purchaser of their interest—as partners. The surviving partners may buy out the interest of the heirs, or the surviving partners may sell out to the heirs.

None of these alternatives is satisfactory. As in the case of the sole proprietorship, forced liquidation results in the sacrifice of assets, reducing the value of the decedent's estate and bringing hardship to the decedent's heirs.

If the surviving partner proceeds according to law, he will liquidate the partnership's business by selling the partnership property for what it will bring, pay its debts, and divide the remainder, if any, with the estate of his deceased partner. In the process he loses a substantial part of his investment, liquidates himself out of a job, and with it, all his plans for his future. Starting his business career all over again may be impossible, and so he may welcome almost any plan that promises to save his business life; but to do so by coming to an agreement with the heirs of the deceased may be impossible.

Since the surviving partner is in the position of trustee as to the estate of the deceased [1] and must make a fair and complete disclosure of all facts present or prospective affecting the assets of the estate,[2] he must, therefore, exercise great care in reaching any agreement for continuing the business with the heirs of the deceased. If he is not circumspect, he is in danger of having the costly experience of paying out of his own pocket the share which would have belonged to the decedent's estate had the partnership been liquidated at the decedent's death.[3]

In trying to form a new partnership with the heirs, the surviving partner will discover that the heirs cannot join in a partnership with respect to partnership assets until they have received such property from the administrator. Furthermore, there is no

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[1] Joseph v. Herzig, 198 N. Y. 456, 92 N.E. 103 (1910).
[2] Anderson v. Droge, 216 Iowa 159, 248 N.W. 344 (1933).
[3] In re Ducker's Estate, 263 N.Y.S. 217 (1933).

way to compel either the surviving partner or the heirs to form a new partnership. Should either prove unwilling, the liquidation of the partnership must proceed. The surviving partner will be forced to carry the whole load of management, unless the heirs have been active in the business. If the partnership is formed with the widow, there is a divergence of economic interest. The surviving partner will likely be interested in building up the business and plowing back the profits, while the widow may be interested only in the amount of income she can derive from the business. The result can be dissension and eventual dissolution of the partnership.

Should the surviving partner wish to sell his interest to the heirs, he will need the consent of the executor or administrator of the estate and all of the heirs in order to be relieved of his legal duty to liquidate the partnership. Minor heirs cannot give such consent, and the legal representative may find it impossible to concur because of creditors' objections. Here again, the surviving partner may be selling himself out of a job and a career, and the heirs will be taking over a business about which they may know little.

On the other hand, should the heirs decide to sell to the surviving partner, they again confront him with the legal difficulties of his fiduciary capacity. Should any of the heirs ever be dissatisfied with the transaction, the surviving partner will have the burden of proving that the purchase of the partnership assets did not violate his position of trustee.[4] Not only does the surviving partner face the danger of trusteeship laws, but also the executor or administrator may insist on liquidation, or the heirs may refuse to sell. If the heirs and executor or administrator consent, then the creditors may insist on cash or refuse to permit the transfer of the partnership assets.

The surviving partner may not have sufficient cash to acquire the decedent's interest. He may find borrowing difficult, creditors insistent, and the heirs uncompromising. He may decide that the task of acquiring the interest in the partnership for himself is so onerous as to make it seem the lesser evil to suffer the losses of liquidation than to attempt to purchase the assets of the partnership.

Problems of the Closed Corporation

The death of a stockholder in a closed corporation creates problems similar to those discussed above in the case of a sole proprietor and a partnership.

Since a closed corporation practically operates as a partnership, some of the same problems confronting a partnership which

[4] Steinmetz v. Steinmetz, 126 Conn. 633, 7 A. 2d 915 (1935).

has lost a partner face the closed corporation when a stockholder dies. The surviving stockholders, if theirs are minority holdings, are faced with the possibility of loss of their jobs and of being removed from control of the corporation. Most closed corporations began as partnerships and, in order to limit liability, thereafter incorporated. The same informal relationship of the partners is carried forward into the corporation. The partners may not have had equal capital investments, but the services of one partner may have offset his lesser capital contribution. In this informal atmosphere, which is the basis of most small businesses, the problems were met and solved. With the death of a stockholder, this informal relationship is disturbed. The administrator or executor and heirs approach the business appraisingly. Their prime concern is their own interests, and the interests of the business come later. They may insist on active participation without having the necessary experience. They may demand excessive salaries which the firm cannot afford.

As was pointed out above, if the administrator or executor or the heirs represent majority stockholdings, and their interests seem to them to require the elimination of the minority stockholders, who have formerly been active in the direction of the company, the minority stockholders will have little choice but to yield. With no survivorship agreement, they are powerless to oppose the actions of those who now hold the majority stock. Even though the majority stockholders may wish to dispose of their holdings and turn over the business to the minority stockholders, there may be financial problems. The minority stockholders may find that they can't buy the stock for the price which the executor, administrator, or heirs may require. Ordinarily all their funds are tied up in the business, and the outlook of coming to an equitable agreement with the majority stockholders for the price of the stock is never favorable.

If the decedent's estate owns only a minority interest, then the estate may be left without income. The decedent's dependents will fail to realize that the earnings of the decedent were not due primarily to his stock holdings, but rather to his services. With his death, his services must necessarily be replaced, and the salary which he received stops. The minority stockholders may bring action to force the payment of greater dividends, but this is seldom successful in case of a properly managed business. At directors' meetings the minority stockholders may obtain representation and there try to change their position, but these acts are bound to fail if the majority oppose them.

Purchase and Sale Agreement Funded by Life Insurance

The problems confronting the individual who wishes to make the best provision for his dependents and whose wealth is invested in a business have been examined in detail to emphasize their difficulty and complexity. It is well to bear in mind that these problems can be avoided. They occur only when no plan has been formulated prior to the death of the owner of the interest in the business. The usual method of providing for the continuance of the business after death is by means of a purchase and sale agreement. These are of various types, but only the purchase and sale agreement funded by life insurance will be considered here.

For a sole proprietor such an agreement must stipulate the purchase price or a definite valuation formula, and most important, it must assure that the purchaser will have sufficient money to buy the business when proprietor dies. This can be done by funding the purchase sale agreement.[5]

Funding an agreement is accomplished by means of life insurance. The employee takes out a life insurance policy on the life of the employer equal to the amount agreed upon in the purchase sale agreement.[6] The prospective purchaser owns the policy, pays the premiums, and will receive the proceeds of the insurance on the seller's life. Since the ownership of the insurance and all rights with respect thereto are in the purchaser, the estate of the decedent will not be taxed for the insurance proceeds, because he holds no incidents of ownership and has paid no premiums on his insurance contracts. His estate will be taxed only for the business interest.

With a purchase and sale agreement entered into fairly, the proprietor gains the advantage of having his business continued after his death and of knowing that it will be disposed of at its full cash value. He also knows the amount of his estate tax in advance, and can plan for its payment. He is thus able to complete his estate plans, and leave his affairs in an orderly manner and not subject his heirs to a process of forced liquidation resulting in losses, delays, and confusion.[7]

In the case of partnerships and corporations, the insured purchase and sale agreement should contain the following provisions:

1. Each partner or stockholder must agree that he will not sell his interest in the partnership or his stock in the corporation during his lifetime without first offering it for sale to the other partners or stockholders at the agreed price.

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[5] Laikin, *Death Taxes and Your Business*, 86 Trusts and Estates 13 (1948).

[6] Menard, *Life Insurance and Federal Estate Tax*, 27 N. Car., L. R. 43, 56 (1948). The question of insurable interest should be carefully considered by the attorney in anticipation of a possible contest with the insurance company. This question is not discussed herein upon the assumption that insurance companies, eager to sell this type of insurance, will not raise such a defense.

[7] It should be determined whether the insurance policies can be qualified for the Marital Deduction. See Reg. 105, Sec. 81.47a (b) (2); Sec. 81.47a (d); 62 Harvard Law Review 497 (1949); Trachtman, *Estate Planning* 94.

2. Each partner or stockholder on behalf of himself, his heirs, and representatives, should agree to sell and each buyer to buy the partnership interest or the shares of stock of the decedent. This should be a definite commitment to buy or sell, not a mere option.
3. The agreement should state a definite commitment as to the purchase price to be paid by the surviving partners or stockholders for the deceased's interest or stock. This may consist of a fixed amount or may be a valuation formula.
4. The agreement should contain provisions for the purchase of life insurance policies in agreed amounts with which to finance the purchase. The agreement should state that the rights in the policies shall be exercised only for the purpose of carrying out the terms of the agreement.
5. The agreement should provide for the paying of any balance of the purchase price in excess of the insurance proceeds, as well as provisions for the disposition of funds of insurance proceeds in excess of the purchase price.
6. The agreement should also contain a provision that the deceased's estate will be held harmless from claims of creditors of the business.[8]

In addition to the above provisions there should be agreement as to who should pay the life insurance premiums. In determining this the *Legallett* decision [9] should be kept in mind.

Under the plan outlined above, the surviving partners or stockholders are the beneficiaries of the insurance; they will receive the money which will enable them to purchase the deceased's interest. They are protected from control or interference by outsiders; they maintain control of their business and acquire ownership by the most convenient and economical plan.

Furthermore, since the survivors pay the premiums and are the owners of the policy, the proceeds are not subject to estate taxation. The proceeds will also be included in figuring the cost basis of the partnership assets or of the stock acquired should the survivors sell in the future.

To sum up, the following are the benefits of the purchase and sale agreement funded by insurance: (1) The working capital of the business is not disturbed. (2) Survivors are not forced to take inexperienced people into the firm. (3) Survivors are guaranteed the opportunity to buy the deceased's interest. (4) The deceased's estate receives full payment in cash. (5) The deceased's family is not forced out without receiving full compensation for its interest. (6) The deceased's estate can be administered promptly.

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[8] Huebner, *The Beneficiary in Life Insurance*, 178-9.
[9] Legallet v. Commissioner, 41 BTA 294 (1940).