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CORPORATE CONTROL AND BUSINESS INSURANCE TRUSTS

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THIS is an age of efficiency. Everywhere the tendency is toward more efficient management and organization of business enterprises. Mergers, consolidations and reorganizations follow each other in rapid succession and it is natural, therefore, in such an age, that every effort is being made to evolve ways and means whereby the control of business organizations may not be disturbed in the event of the death of one of the principal owners, whether his interest be that of a large stockholder in a corporation or a partner in a partnership.

At the risk of stating too many elemental principles, I want first to call attention to some rules of corporation and partnership law, and wherever stock or stockholders is used herein reference is made to voting stock or stockholders holding voting stock.

" 'Close' corporations have been named such because the members work closely together and do not have to answer to outside stockholders who have invested nothing but their capital in the enterprise. It is a matter of record that conditions in 'close' corporations after the death of one of the stockholders often are such that the welfare of the business is imperiled because the members are not accustomed to being associated with those who do not or cannot contribute their services along with their capital.

"Many 'close' corporations are doing business today where the stockholders are mutually working in harmony but without any preparation against the sudden and unforeseen introduction of new stockholders. None of the stockholders would deliberately sell his stock to outsiders because he feels that he is a partner in a common enterprise and is bound to the others by ties of friendship, understanding and experience. But what about the future?

"At the death of a stockholder his estate passes to the executor named in his will, or, if he has made no will, to an administrator appointed by the probate court. Among the assets of the estate is the stock which he owned. Unless the will gives directions as to the disposition of the stock the executor may follow one of two courses. He may turn the stock over to the beneficiaries of the estate or he may sell to the highest bidder." If the will does not grant him specific authority to hold the stock he should, under the law, dispose of the same. "In case the executor needs funds to pay debts, administration expenses, inheritance, estate, income and property taxes and money legacies, he may be forced to sell in order to raise the cash.

"The surviving stockholders, then, are" faced with "the immediate problem of purchasing the stock if it is offered for sale and they must be prepared to outbid competitors. In the absence of authority an executor has no power to offer terms of purchase over a long period of time. The surviving stockholders will have to sell their own property to raise the cash or borrow the funds," if they do not have independent resources. "Otherwise the stock will go to an outsider who may or may not be acceptable to them.

"If the stock is not put up for sale, but is turned over to the" legatees or heirs, "four courses are open to the surviving stockholders: (1) To work for the beneficiaries, i. e., see that the latter get regular dividends; (2) to work with the beneficiaries, i. e., take them in as officers or employes who will actively participate in the management; (3) to buy out the beneficiaries at a price they can agree upon; (4) to freeze out the beneficiaries, i. e., keep them out of the active management, raise salaries, build up surplus, expand the business, increase expenditures and thereby reduce dividends to such a point that the stock will produce no income for the beneficiaries. The latter will be forced to appeal to a court of equity where they may or may not succeed in getting relief.

"On the other hand, if the surviving stockholders are disposed to be satisfied to work for the beneficiaries or outside purchasers from the estate they may find their efforts frustrated by ill advised interference." As a matter of law the beneficiaries or any outside purchasers from the estate will have the rights of stockholders and can vote their stock at annual meetings. "A stockholder who does not work in harmony with the other stockholders can cause confusion and disruption to such a degree that more time will be spent in friction than in promoting the business."

"In the absence of an agreement to the contrary, the death of one of the members of a partnership causes its dissolution, and three alternatives are presented to the survivor. He may wind up the business and pay the decedent's estate his share of the proceeds. The objections to this from the survivor's point of view are too obvious to need elaboration. He may make an agreement for the continuance of the business with the heirs and representatives of the decedent; this brings a new element into the firm which may make further harmonious work impossible. Or thirdly, he may buy the decedent's share and continue the business, if he is financially able to do so and can reach a satisfactory agreement as to price.

"From the viewpoint of the deceased partner's estate the situation is just as bad. Each partner has a proportionate interest in the partnership assets, and the interest of the" deceased "partner naturally passes to his estate. But his estate is not entitled to the partnership assets,—it is only entitled to its share of the assets liquidated by the surviving partner. All partnership assets remain to be administered by the surviving partner. He cannot incur any obligations except those necessary to liquidate, but in the liquidation he is the czar and his judgment is final unless the decedent's estate can show fraud or incompetence. It is frequently necessary for a competent * * * executor to stand by, unable to expedite or hasten the liquidation, while a somewhat dilatory and none too competent surviving partner works out the liquidation."

The foregoing rules of corporation and partnership law emphasize the desirability of avoiding such possible situations if this can be done with reasonable safety and expense. The best method is provided by the Business Insurance Trust Agreement, or if that is too elaborate or expensive, then by modifications thereof, which to the average lawyer may be of greater importance than the complete form.

A Business Insurance Trust provides a means whereby the value of a decedent's interest in a business will be secured to his estate, while the interest itself passes on to others who generally are the survivors of the controlling group in the business.

"With a stock" or partnership "retirement plan in force," through a business insurance trust, "each stockholder" or partner "knows definitely what will become of his interest in the event of his death. He knows he will leave a liquid asset, probably in cash"—that the amount thereof will represent his own idea of the value of his interest in the business, and that he and his heirs or legatees will be protected whether he lives or dies.

In the average business insurance trust agreement between partners or principal stockholders, a definite value is placed upon the interest of each partner or stockholder, or a definite means of arriving at the same is provided, and it is agreed that upon the death of any of the parties to the agreement the interest of the deceased partner or stockholder shall pass to the survivors upon the payment to a trustee of a definite sum.

In the case of a partnership the trustee delivers the deceased partner's bill of sale to the survivors, whereas in the case of a corporation, the trustee delivers the stock certificates of the deceased stockholders to the survivors, and in either instance, the survivors take the decedent's interest in the proportions prescribed by the agreement. The net result is that the surviving partners or stockholders pay a definite amount for the deceased partner's or stockholder's interest and the amount paid by the survivors represents the deceased person's own estimate of the value of his interest in the business. The trustee then pays to the representatives of the estate of the deceased person the money received by it for the deceased person's share in the business. The estate receives in cash or securities, almost immediately after death, without legal complications and without difficulty, what is most apt to represent the true value of the deceased person's interest in the business, and the business continues its orderly course.

The Probate Court acquires no jurisdiction over the deceased person's interest in the business in question because the only claim of the estate is to the fund to be received by it from the trustee under an agreement which by its terms is made binding upon heirs, executors, administrators, assigns, etc.

Such an agreement is called a Business Insurance Trust because the necessary funds to purchase the interest of the deceased partner or stockholder through the trustee generally are provided by life insurance on the lives of the interested parties.

I shall now discuss some of the most important elements of the average business insurance trust agreement.

FIRST:—PAYMENT OF PREMIUMS ON INSURANCE.

Premiums on the life insurance may be paid in three ways: (1) By each partner or stockholder paying the premiums on his own life; (2) by the partnership or corporation paying all of the premiums; (3) by each partner or stockholder paying his proportionate share of the premiums on the lives of the other parties, based upon the amount of stock held by each. There are many objections to the first and second plans which I have not time to discuss here. The third plan, however, whereby each partner or stockholder pays his share of the premiums on the lives of the other partners or stockholders in proportion to his interest in the business is most widely favored and generally followed.

Under this plan each stockholder or partner is the insurer of the lives of his co-partners or co-stockholders, but not his own, and the other parties to the agreement are the co-insurers of his life. Logically, therefore, when a party to the agreement dies, the survivors are actually furnishing the funds to buy the deceased party's interest. The partnership or corporation is not a party to the agreement. In this way, the proceeds of the insurance are put beyond the reach of the creditors of the corporation or partnership, and the plan of liquidation cannot be frustrated by them. Also, this plan does not subject any part of the insurance proceeds to the Federal estate tax as a part of the estate of the deceased partner or stockholder. Payment of the premiums is assured by a provision directing the corporation to make the payments and charge them to each stockholder's account.

A sample paragraph in Business Insurance Trust Agreements relating to payment of premiums is as follows:

"The stockholders agree to pay all premiums on the insurance policies subject to this agreement promptly as they become due and agree that the insurance proceeds shall be used for the purposes as herein provided. The proportion of the total premiums on the foregoing policies to be charged to each stockholder shall be equal to the ratio of the shares standing in his name to the total shares standing in the names of all of the stockholders who are parties to the agreement, as set forth in the Schedule. The stockholders hereby authorize and direct the John Doe Corporation to pay any such amounts as they become due and deduct the sums so paid from the compensation, dividends or other amounts payable to them."

SECOND:—METHOD OF DETERMINING VALUE OF DECEDENT'S INTEREST.

Various methods are used to determine the value of a deceased person's interest in a corporation or partnership. The more commonly used methods may be described briefly as follows:

(1) The price for the first year is stated in the agreement with a provision that a new price be agreed upon at the end of each year and filed with the trustee, and a provision for arbitration or for holding over the last price in case of failure to agree.

(2) The price to be arrived at by a certified public accountant or appraisal company after the death of a party to the agreement.

(3) The price to be arrived at, after the death of a party, by appraisers to be selected by decedent's executor or administrator, the surviving stockholders and the trustee.

(4) The price to be fixed by multiplying the average net earnings for the last five years by ten or fifteen or some other figure as agreed upon.

(5) Another method, known as the New York method, is to take out of the average earnings what is regarded as a fair return, say 7%, on the capital invested or book value, and then capitalize the balance of the earnings at a higher percentage, say 15%, and thus arrive at a valuation of good will to be added to the book value.

The agreement should specify whether or not good will is to be considered as an asset, and if so, at what figure, and if no figure is specified, some provision should be made for arriving at its value. Various methods of computing the value of good will are used by tax appraisers and accountants, but an exact method should be agreed upon.

The most satisfactory method by which to arrive at the value of a partnership interest or the price of each share of stock seems to be to have the parties bind themselves to revise the value or price or reaffirm the last preceding price at each six month or yearly period, but with the further provision that if they fail or neglect to do so for a designated period preceding a party's death, say one year, 18 months or two years, then a Board of Arbitration or appraisers shall be appointed, whose sole duty it shall be to determine the then value of the partner's interest or the price of the stock, using the figures previously fixed by the parties as a basis and taking into consideration only an increase or decrease in the value from that time until the date of the party's death.

THIRD:—DISPOSITION OF STOCK WHERE INSURANCE PROCEEDS ARE GREATER OF LESS THAN THE VALUE OF THE INTEREST TO BE PURCHASED.

Many agreements provide that all of the insurance shall be paid to the deceased party's estate by the trustee, in the event and even though the amount of insurance proceeds is greater than the value of the decedent's interest, but in the event the insurance proceeds do not equal the value of the decedent's interest, the survivors generally are given the right to give their collateral notes for the difference, payable over a period of time, whereupon all of the decedent's stock is divided among the survivors in proportion to their holdings in the company, and then left with the trustee as collateral security for the payment of the notes.

A typical paragraph reads as follows:

> In the event the net proceeds of the insurance policies are not sufficient to pay for all of the stock, then each party hereto shall have the right to execute a collateral note for the remainder of the purchase price of the stock to which he shall be entitled hereunder, and said note shall be payable in ten equal semi-annual installments and shall be made payable to the order of the executor or administrator of deceased stockholder's estate and shall bear interest at the rate of 6% per annum. Upon the execution of said notes and the delivery thereof to the trustee, said trustee shall cause said stock to be transferred and to be pledged as collateral security for the payment of said notes and deliver the same to the executor or administrator of the deceased party's estate.

If one of the parties cannot be insured, provision is made for a separate stock retirement fund into which annual payments are made by the other stockholders and which is held by the trustee and invested, so that at the death of the uninsurable stockholder or partner there will be a fund with which to purchase at least part of his stock. The amount of the annual payments into the fund will be governed by the value of the stock and provision should be made for notes to be signed by the surviving stockholders for the balance of the value of the decedent's interest, the notes to be secured by the stock in question.

Most agreements provide that the estate of the deceased partner or stockholder shall be reimbursed for insurance premiums paid on the lives of the survivors. In other words, the estate of the partner who has paid the premiums on the lives of the surviving partners but who received no benefit therefrom due to his prior death should be reimbursed for the premiums paid in this connection, as well as for payments made into a stock retirement fund.

FOURTH:—DISPOSITION OF STOCK CERTIFICATES OR PARTNERSHIP BILLS OF SALE AFTER EXECUTION OF AGREEMENT.

In corporation business insurance trusts the stock certificates may be handled in three ways.

(1) The stockholder may retain possession and control of his own certificate by binding the representatives of his estate to deliver the same to the trustee at the agreed price.

(2) The stockholder may deposit the stock, endorsed in blank or with a signed stock power attached, with the trustee at the time the trust agreement is entered into, but the stock remains in the name of the depositing stockholder on the books of the company, so that he receives all dividends thereon and exercises full voting control during the life of the agreement.

(3) Each stockholder may transfer the title to his shares to the trustee at the time the agreement is executed.

The second plan whereby the stock certificate is delivered to the trustee endorsed in blank or with the stock power attached, without in any way interfering with the rights of ownership in the certificate is the most desirable of the three methods. Also, the deposit of the stock gives the parties greater assurance that the contract will be carried out.

A sample paragraph reads as follows:

> Each of the stockholders has executed an assignment in blank of the stock of the John Doe Corporation standing in his name and has deposited the certificate (or certificates) with the Trustee as set forth in the Schedule attached hereto and made a part hereof. Such assignment and deposit, however, shall in no way affect the right of a stockholder to vote such stock and to collect dividends thereon as heretofore until such time as the purchase price has been received by the stockholder or his executor or administrator under the terms of this agreement.

Across the face of each stock certificate and upon the stub of the stock book should be written a statement to the effect that the same is subject to the terms of the business insurance trust agreement and no stockholder in a close corporation should have the right to sell his stock during the life of the trust agreement. A stockholder should not be allowed to withdraw stock for the purpose of pledging the same as collateral, although this is done sometimes with the understanding that in the event of that stockholder's death the loan first will be paid out of the proceeds and the remainder of the value will be paid to the trustee for the estate of the decedent.

FIFTH:—DISPOSITION OF INSURANCE POLICIES.

The insurance policies should be deposited with the trustee and the trustee should be named therein as beneficiary or the policies should be assigned to it. Some insurance companies believe an assignment to be preferable on account of certain policy provisions which give the insured certain rights to benefits during his lifetime unless the policy is assigned.

SIXTH:—FIRST RIGHT TO PURCHASE STOCK OF ANY PARTY WHO MAY DESIRE TO WITHDRAW FROM BUSINESS.

Most agreements of this sort contain a provision granting to the parties the first right to purchase stock of any party thereto who desires to retire from the business prior to the termination of the agreement. Various methods are used to determine the value at which the interest may be purchased, but the best method is the method established by the parties for the determination of value in the event of death, and this is fair to all parties to the agreement. A typical paragraph in this connection is as follows:

> If any stockholder elects to sell any of his stock during his lifetime, he shall give the trustee and remaining stockholders written notice of his intention to sell, and the said stockholders shall have the right to purchase such stock at any time within thirty days from the date of such notice, provided the purchase price is then established, and if not, within thirty days from the date when such purchase price shall have been established. Each stockholder shall have the right to purchase a proportion of such stock equal to the ratio which the shares standing in his name bear to the total shares standing in the names of all the stockholders who are parties to this agreement. (Then follow provisions relating to the method of determining the value of stock, which usually is identical with the method for determining the value in the event of death.)

In conclusion, some of the advantages of the business insurance trust, in the case of a corporation, may be summarized as follows:

"(a) Control of the business by the existing management is perpetuated.

"(b) The survivors are not placed in the position of earning dividends for an estate holding a substantial part of the stock but in no way contributing to the operation of the company.

"(c) The possibility that a decedent's executor might sell his stock to outside interests is eliminated.

"(d) The financial welfare of a decedent's dependents is not contingent upon the successful continuation of a business in which he has been engaged.

"(e) A fair value is placed on the stock by the parties to the agreement."

Some of the advantages of a business insurance trust agreement in the case of a partnership may be summarized as follows:

"(a) The necessity of a complete liquidation and winding up of the partnership after its dissolution by the death of a partner is averted, the business continuing under the control of the surviving partners.

"(b) The survivors are not placed in the position of dividing profits with the deceased partner's family who probably in no way contribute to the operation of the company.

"(c) The financial welfare of a decedent's dependents is not contingent upon the successful continuation of a business in which he has been engaged.

"(d) A fair value is placed on the partnership interests by the parties to the agreement.

"(e) Where the insurance is payable to the trustee the partners have interposed the services of a disinterested party to assume control of the appraisal of the interest of the deceased, the collection of the insurance proceeds, the payment thereof to the designated beneficiaries, and the disposition of the policies on the life of the surviving partners."

Now no doubt many of you are thinking that the foregoing constitutes a set of fairly accurate statements, but you are wondering whether Business Insurance Trust Agreements are not rather rare in this community and therefore of little importance to the average lawyer. That point of view is justified to some extent at this time, but business insurance trust agreements are more or less common in the East and more of them are in force in this community than most of us realize. This is a comparatively new field in insurance and today presents to the life insurance salesman his greatest opportunity for service with consequent financial gain to himself. Insurance companies here are schooling their men in the sale of such policies, and we, as lawyers, shall have more and more to do in the preparation of such instruments in the future. There are so many advantages to be derived from such agreements it is safe to say the day is not far distant when most substantial business organizations will have a business insurance trust agreement or some modified form thereof in force among some or all of its partners or controlling stockholders.

So long as the price to be paid includes all the proper elements of value, the advantages of the plan far outweigh any disadvantages, and if the parties are unable, out of their income from the business, to carry sufficient insurance to provide the entire purchase price, the plan for partial insurance and the balance by notes should be seriously considered.

The time is near at hand when almost every lawyer will explain to a client interested in corporate organization work the principles of the business insurance trust agreement and the possible modifications of the same as applied to that client's problem; and, in most instances, this will result in a more satisfied client, a larger fee in return for better services rendered, and, in any event, a feeling upon the part of the client that his lawyer is keeping abreast of the times,—in short, that he is efficient.

Bibliography: The Seefurth Service, Chicago; American Bankers Association Publications; Saving Taxes in Drafting Wills and Trusts, by Robinson.

BARRISTERS AND BROADCASTING

THE BAR COUNCIL'S RULING

(From the Manchester Guardian, of January 30, 1931.)

The General Council of the Bar announces, in its annual statement, a relaxation of the ruling of 1928 which forbade practising barristers to broadcast on law. They may now do so, but it must be done anonymously—"a proviso which, from the B. B. C. point of view," the official weekly journal "The Listener" points out, "practically cancels the value of the concession."

The Council is presumably anxious that its members shall speak only as the mouthpiece of the law they serve, and that their pronouncements shall be free from personal bias or self-advertisement. This impersonality, however, is fatal to a successful broadcast. Such subjects as the layman might like to hear discussed are not expounded best by a nameless personification of the law. The listener wants to be talked to by a man whom he recognizes to be an expert in his subject.