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Estate Planning for the Close Corporation

Planning for an estate which contains the controlling interest in a close corporation often presents a difficult problem. Since a sale of the corporation, or the testator's interest in it, may not realize the full value of the business, and since a liquidation of the assets sacrifices the going concern value of the operation, the usual objective is to devise a plan for the continuation of the business after the testator's death. A further complicating factor is the common desire of the testator that the control and remainder interest in the business be given to one heir while the return on the controlling interest be used to provide suitable support for another.

With these goals in mind, the most obvious dispositive plan is to create a trust funded by the controlling interest, naming one heir trustee and the other beneficiary. However, the utility of such a plan—often termed an estate corporation—has been frustrated by the application of traditional fiduciary obligations to the trustee, particularly the duty of undivided loyalty with no further inquiry. This Note will explore the problems inherent in an estate corporation, examine alternative plans for the disposition of a business interest, and suggest a trust instrument to avoid or mitigate these problems.

I. DUTIES OF A TRUSTEE-DIRECTOR

As used in this Note, an “estate corporation” is a close corporation in which the controlling interest is held by executors or testamentary trustees. When an estate contains a corporation,
the executor or trustee may become an officer or director of the corporation. The resulting dual role is necessitated by the nature of a trust, the res of which is the controlling interest in a business as distinguished from an investment trust, the res of which is noncontrolling interests, such as stocks and bonds of public companies. An investment trust presents relatively simple management decisions—buy, sell or retain. On the other hand, the management of a controlling interest in a corporation entails complex and recurring decisions inherent in the operation of a business. The ease with which management decisions are made in an investment trust leads to a correspondingly simple causal connection between a particular decision by the trustee and an alleged breach of trust, while the complexity of decisions in an estate corporation renders this relationship unclear. Further, in terms of the interests relevant to the decision making process, the trustee of an investment trust should consider solely the interest of the beneficiary. However, the trustee-director of an estate corporation must consider the additional interests of the corporation's future, the minority shareholders, the creditors, and the employees. The courts, unfortunately, have been


Except for the act of incorporation, the problems of the two types of estate corporations do not differ significantly. Compare Pyle v. Pyle, 137 App. Div. 568, 123 N.Y. Supp. 256 (1910) (post mortem), with *In re Hirsch's Estate*, 116 App. Div. 367, 101 N.Y. Supp. 893 (1906). However, the act of incorporating a post mortem corporation may present some problems. *In re Halperin's Will*, 201 Misc. 763, 106 N.Y.S.2d 96 (Sur. Ct. 1951), held that the surviving spouse's right of election against the will could not be destroyed by testamentary instructions to incorporate.


5. Illustrative of the judicial confusion created by the estate corporation is the issue whether a beneficiary may seek his remedy in a court of original jurisdiction or whether he is required to proceed in the court to which the trustee must account. Most older cases held that the latter court retained exclusive jurisdiction by virtue of admission to probate. See, e.g., *In re Kahn's Estate*, 43 Misc. 2d 208, 250 N.Y.S.2d 781 (Sur. Ct. 1964); *In re Barrett's Estate*, 168 Misc. 937, 6 N.Y.S.2d 689 (Sur. Ct. 1938). Consequently, the traditional trust remedies of removal, surcharge, and accounting are available, and the higher standard of loyalty imposed on a testamentary trustee is applicable. Recently, however, it was held that a suit by the beneficiary in surrogate court to require an estate corporation to pay a dividend had been properly dismissed without prejudice to bring a derivative suit. Cashman v. Petrie, 14 N.Y.2d 426, 201 N.E.2d 24 (1964).


7. See Rosencrans v. Fry, 21 N.J. Super. 289, 91 A.2d 162 (Super. Ct. Ch. 1952), aff'd, 12 N.J. 88, 95 A.2d 905 (1953); Latorraca v. Lator-
slow to recognize these fundamental differences, and in most instances have rigidly applied the principles developed in the context of the investment trust to the estate corporation.

The application of the trustee's duty of undivided loyalty with no further inquiry to the trustee-director of an estate corporation is the crucial problem. The classic statement of this traditional duty was made by Judge Cardozo:


However, at least one court has refused to conceptualize the problem in this way. The court in In re Schnur's Estate, 39 Misc. 2d 880, 886, 242 N.Y.S.2d 126, 132 (Surr. Ct. 1963), declared: "It is not so much a matter of disregarding the corporate form, but rather of giving paramount consideration to the testamentary plan and scheme, and effectuating it in the manner prescribed by the testator."


A small number of well reasoned opinions reject the mechanical application of either body of law, recognizing that the problems lie somewhere between the two. See In re Schnur's Estate, 39 Misc. 2d 880, 242 N.Y.S.2d 126 (Surr. Ct. 1963); In re Nickelsburg's Estate, 34 Misc. 2d 82, 224 N.Y.S.2d 90 (Surr. Ct. 1961).

10. See In re Horowitz's Will, 297 N.Y. 252, 78 N.E.2d 598 (1948): "An executor who, to carry out his trust, becomes a director of a corporation in which the estate's moneys are invested, remains an executor and is held to the full duty of an executor." Id. at 258, 78 N.E.2d at 601.


sensitive, is then the standard of behavior. As to this there
has developed a tradition that is unbending and inveterate.
Uncompromising rigidity has been the attitude of the courts
of equity when petitioned to undermine the rule of undivided
loyalty by the "disintegrating erosion" of particular excep-
tions.11

A trustee may not consider third party interest no matter how
intuitively relevant, and is forbidden from acting in his own
interest. 12 Traditionally, once a conflict of interests is found,
no further inquiry is necessary to hold the trustee liable.13 The
trustee can be removed from office,14 surcharged for losses to
the trust,15 or forced to account for gains to others than the
beneficiary,16 good faith and fairness of action notwithstanding.

Within the context of a trust containing liquid stocks or
bonds, a strict application of the duty of undivided loyalty with
no further inquiry may effectively deter an unscrupulous trustee
from taking advantage of his position through clandestine ac-
tivities.17 However, as the trust res and its management deci-

generally, RESTATEMENT (SECOND), TRUSTS § 170(1) (1959); Bogert,
Trusts & Trustees § 543 (2d ed. 1960); 2 Scott, Trusts § 170 (2d ed.
1956); Hoover, Basic Principles Underlying Duty of Loyalty, 5 CLEV.-
MAR. L. REV. 7 (1956).

12. Hoover, Basic Principles Underlying Duty of Loyalty, 5 CLEV.
MAR. L. REV. 7, 9 (1956). See also RESTATEMENT (SECOND), TRUSTS §
170(1) (1957): "The trustee is under a duty to the beneficiary to
administer the trust solely in the interest of the beneficiary." It has
been pointed out that self-dealing is only one branch of the duty of
loyalty. Thus, if the conflict of interests involves a third party, the
standard of liability to be applied would differ from that when the
trustee's own interest was involved. See Scott, The Trustee's Duty of
Loyalty, 49 HARV. L. REV. 521 (1936).

13. See City Bank Farmers Trust Co. v. Cannon, 291 N.Y. 125, 51
N.E.2d 674 (1945); Meinhard v. Salmon, 249 N.Y. 458, 164 N.E. 545
(1928); Haggerty, Conflicting Interests of Estate Fiduciaries in New
York and the "No Further Inquiry" Rule, 18 FORDHAM L. REV. 1 (1949);
Hoover, supra note 12.

14. See Taylor v. Errion, 137 N.J. Eq. 221, 44 A.2d 356 (Ch. 1945),
367, 101 N.Y. Supp. 893 (1906); Bogert, Trusts & Trustees § 861 (2d ed.
1960).

15. See In re Horowitz's Will, 297 N.Y. 252, 78 N.E.2d 598 (1948);
Bogert, Trusts & Trustees § 862 (2d ed. 1960); 14 MINN. L. REV. 308
(1930). Some courts have stated that a greater breach of duty is re-
quired to remove a trustee than to surcharge him. See In re Berri, 130
Misc. 527, 224 N.Y. Supp. 466 (Surr. Ct. 1927); In re Hartt's Estate, 295
P.2d 985 (Wyo. 1956).


17. It is often stated that this deterrent effect is the major pur-
pose and justification for the no further inquiry rule. See, e.g., Matter
sions become more complex, strict application of the duty becomes unrealistic. In restricting and inhibiting the trustee from using the skill, experience, and "connections" for which he was selected, a strict application of this rule to a complex trust ignores modern economic realities. Furthermore, the disintegrating erosion of which Cardozo spoke has in fact occurred, thus eliminating a major justification for a rigid application of the rule. Consequently, in an estate corporation the traditional duty of undivided loyalty without further inquiry should be modified. Since a trustee is under the duty to take charge of the trust res, he presumably will be required to become a director or officer of a close corporation of which the trust contains a controlling interest. Yet this very act of becoming a director-officer imposes duties on the trustee toward the corporation, its shareholders and creditors, which place him in a position of divided loyalty. Assuming that the trustee is selected because of his skill in running the corporation, he should not be forced to withdraw from his position as director, depriving the corporation of its best possible management; nor should he be forced to resign as trustee, thereby relinquishing control of the corporation. With either alternative the corporation would suffer and, insofar as the trust is dependent


21. Some courts would require the trustee to become a director of the corporation. See Latorraca v. Latorraca, 132 N.J. Eq. 40, 26 A.2d 522 (Ch. 1942), aff'd mem., 133 N.J. Eq. 286, 31 A.2d 819 (1943); In re Teasdale's Estate, 281 Wis. 243, 52 N.W.2d 366 (1952); In re Peabody's Estate, 218 Wis. 541, 260 N.W. 444 (1935); In re Hartt's Estate, 295 P.2d 985 (Wyo. 1956). But see In re Hubbell's Will, 302 N.Y. 246, 97 N.E.2d 888 (1951).


upon the corporation, the trust beneficiaries would suffer.\textsuperscript{24}

Few courts have faced squarely the issue of applying the duty of undivided loyalty to the trustee-director of an estate corporation. Moreover, the solutions evolved have not been adequate. The majority of the cases have applied the duty rigidly, surcharging or removing the trustee for acting with conflicting interests.\textsuperscript{25} A strong minority of cases refuse to impose liability, but on grounds which are analytically unsatisfactory.

One line of the minority assumes the ostrich-like position of denying any conflict of interest. In \textit{Matter of Tannenbaum},\textsuperscript{26} the executrix held half the shares of a corporation in trust and half in her individual capacity. She liquidated the corporation and sold the assets to herself without payment for good will. The legatees sought an accounting for the value of the good will. The surrogate surcharged her for acting with conflicting interests. The appellate division reversed on this issue, two judges dissenting, stating that there was no conflict of interests.\textsuperscript{27} Because the corporation would have been destroyed unless the liquidation was effected, the correct result was reached. However, since the defendant had at least three interests affected by the liquidation—executrix, director of the corporation, share-
holder—the reasoning of the court that no conflict of interests existed is questionable analysis for the planner to rely upon.

A second line of cases which refuses to apply the strict requirement of undivided loyalty reasons that the testator created the conflict and impliedly waived a rigid application of trust rules. Further, these courts presume that by naming an individual as trustee, the testator manifested his faith in that individual's ability to act, notwithstanding any potential conflict of interests. While this reasoning will yield results consistent with the testator's intent, the approach is not entirely in harmony with prior trust law. Also, by focusing on the act of naming an individual as trustee rather than on the nature of the estate corporation, the problem is avoided but not solved. It is submitted that the distinguishing factor between the estate corporation and the simple trust should not be the act of selecting an individual as trustee, which is generic to the creation of any trust, but rather the specific characteristics of the estate corporation itself. However, from a planning standpoint, if the courts will give effect to an implied intent it would seem advisable to manifest an express intent on as many problems as is possible.

The strict application of the duty of loyalty to the estate corporation raises several specific problems. It is particularly troublesome with regard to the establishment of capital reserves from the income of the corporation. Unless otherwise speci-


29. Courts have been slow to create exceptions to trust law in order to relieve a trustee from liability. This is illustrated by the traditionally narrow construction of exculpatory clauses. See note 64 infra and accompanying text. It would seem that a principle as firmly entrenched as the duty of undivided loyalty should not be uprooted by the patently ambiguous act of naming an individual trustee.

30. What if the individual named as trustee is unwilling or unable to serve? Presumably, the result should not differ by virtue of the named trustee's inability to serve.

fied, trust rules dictate that all current income produced by the trust res be paid to the life beneficiary. The establishment of a reserve fund from income not only withholds current income but also tends to favor the remaindermen. However, reserves for future expenses and depreciation are vital to the corporation and its creditors. While the older cases indicated that a retention of income for future expenses would be a breach of trust, more recent cases seem to allow reserves to be established, at least when they are reasonable, necessary, and authorized by the testator.

A further problem is the compensation of a trustee-director. Trust rules limit a trustee’s compensation, generally to a small percentage of the value of the trust res. The older cases limited a trustee-director to this “legal” compensation because of his capacity as a trustee. However, the “legal” compensation will generally be far below that normally paid to a director-officer of a corporation. Recognizing this fact, some more recent
decisions have refused to limit a trustee-director's compensation,40 reasoning that without this liberalization, no individual would assume the responsibilities of a director in return for the compensation of a trustee.41 In addition, to the extent the corporation would be required to pay management fees to someone, and the trustee-director is the most qualified to manage, rigid fee schedules could be relaxed.

Although the ideal solution would be for the courts to abandon the no further inquiry rule as applied to the estate corporation42 and impose liability only on particular facts,43 it is doubt-


41. The emerging standard appears to be whether the fees paid to the trustee-director were reasonable. Relevant factors to determine whether the salary received was reasonable include: (1) what similar employees have been and are being paid; (2) whether the trustee served the corporation before his appointment and at what salary; (3) whether the position can be filled by another; (4) the time and labor actually expended; (5) testator's intent; and (6) the risks and responsibilities incurred by the trustee. See Stone v. Baldwin, 348 Ill. App. 225, 109 N.E.2d 244 (1952); In re Block's Will, 186 Misc. 945, 60 N.Y.S.2d 639 (Surr. Ct. 1946); In re Peabody's Estate, 218 Wis. 541, 260 N.W. 444 (1935).

42. The abolition of the no further inquiry rule has been urged in other contexts. See Haggerty, Conflicting Interests of Estate Fiduciaries in New York and the “No Further Inquiry” Rule, 18 FORDHAM L. REV. 1 (1949); Niles & Schwarz, Breach of Trust—Recent Developments, 20 N.Y.U.L. REV. 185, 180-80 (1944). Within the context of the estate corporation at least two courts have intimated the abolition of the no further inquiry rule. In Rosencrans v. Fry, 21 N.J. Super. 289, 91 A.2d 162 (Super. Ct. Ch. 1952), it was said:

[The trustee] cannot be criticized upon the naked basis of potentially conflicting interests, nor can the existence of that potentiality per se constitute a culpable circumstance to be charged against [the trustee] in determining whether he violated his duty as trustee.

Id., at 289, 91 A.2d at 162. Dicium in In re Kellogg's Trust, 35 Misc. 2d 541, 546, 230 N.Y.S.2d 836, 840 (Sup. Ct. 1962), stated that a trustee should not be held liable “upon the basis of a conflict of interests so long as such a conflict remained merely passive. . . .”

43. A possible standard for judicial imposition of liability upon a trustee-director of an estate corporation would include the following factors: (1) Has the trustee-director acted in good faith? (2) Was the action in question based on sound business judgment in light of the circumstances at the time the decision was made? (3) Was the loss incurred of a permanent character or was it a temporary withholding required by the long term picture, such as the establishment of a
ful they will do so. Since the duty of undivided loyalty with no further inquiry is too firmly entrenched to be easily uprooted, an estate plan resting on the assumption that the courts will alter their past decisions as a friendly gesture is precarious. It is in this context that it becomes incumbent upon the planner to either avoid the problem or draft an instrument within which both the courts and the trustee-director can operate.

II. PLANNING

For purposes of the remaining discussion, the following hypothetical facts will be assumed. The testator wishes to provide for his wife after his death. His son is both capable of, and has in fact participated in, the management of the close corporation, which is the dominant asset of the estate and of value principally as a going concern. The corporation has one class of fully participating common stock. The testator holds sixty percent of the stock; the remaining forty percent is split evenly between the testator's son and an unrelated third party. The third party also has participated in the corporation's management.

Two caveats should be noted. First, any estate plan must be tailored to the individual situation and desires of the particular testator. The purpose of this Note is only to suggest some of the possible solutions. Second, while tax factors may be significant and should be considered, the following discussion is limited solely to non-tax factors.

A. METHODS OF ELIMINATING TESTATOR'S CONTROLLING INTEREST

Should the testator fail to eliminate the close corporation from his estate and the stock pass to a trust with the son as trustee, the precarious position of the son, the trust, and the corporation are apparent from the foregoing discussion. To avoid these problems by eliminating the testator's controlling interest in the corporation from his estate, a buy out or recapitalization may be used.

While the testator is alive, the shareholders or the corporation reserve for depreciation? (4) Is the gain received by a third party detrimental and adverse to the trust beneficiary or is it merely incidental and without prejudice to the beneficiary's rights? (5) Was the relative harm incurred by the beneficiary greater or less than the harm which would have befallen the corporation, its creditors, minority shareholders, and employees, had the action not been taken?

44. A discussion of the tax aspects of the proposed alternatives will appear in a later issue of this Review.
45. While the decedent's interest may be sold after his death with-
poration could execute an agreement to purchase his interest upon his death. The agreement could be funded by life insurance, and the proceeds of such a sale placed in a trust to be administered in the traditional manner. Through the use of the buy out device, the close corporation would be continued without danger of judicial interference, and the wife would be provided with a steady, dependable means of support. However, to the extent that the corporation has potential for rapid growth, and the testator desires that his wife and other heirs participate in this growth, a premature liquidation of his interest would be undesirable.

An alternative means of removing the testator's voting control from his estate while retaining an equity interest in the corporation for the beneficiary would be to recapitalize the corporation and provide for additional classes of stock. The testator could convert a portion of his common stock into nonvoting cumulative participating preferred, retaining the remainder of the common and bequeathing it to the son outright. The participating preferred would be given outright or in trust to the wife by will naming a corporate trustee. Control would pass smoothly to the son unburdened by trust; the wife would receive not only a relatively secure income producing source but also, to the extent of her participation, an opportunity to share in the potential growth of the company.

However, a recapitalization does create certain problems. Such a plan would require the consent of the other shareholders since their interests would be affected. Further, any recapitalization should be effected during the testator's life since his executor may have difficulties with the shareholders and creditors in initiating such a plan. Moreover, although the

out the formalities of a buy out executed during his lifetime, such a sale may be difficult. If either the corporation or the shareholders are to purchase the testator's shares, not only the problem of share valuation but also the possible need to fund such an agreement dictate careful planning prior to death. See note 1 supra.


47. See generally Wolfberg, Uses of Preferred Stock in Tax Planning for Closely Held Corporations, 44 Taxes 52 (1966).

48. See, e.g., Minn. Stat. § 301.37 (1965), which states the required vote to change the rights of various classes of stock. Generally, more than a majority is required.

preferred stock is participating, it may not reflect corporate growth through an appreciation in dividends equivalent to that received by common. On the other hand, should the corporation's earnings decrease, but remain large enough to pay some dividends, the cumulative rights given to the wife might encourage her son as director to declare dividends, thereby decreasing the working capital at a time when it is most needed.

The elimination of the testator's controlling interest in the corporation from his estate would benefit the son by allowing him greater freedom in the corporation's management. Further, by eliminating this restraint upon management the corporation itself would have a greater chance for prosperity. Yet to the extent that the testator desires his heirs to participate in the future growth and prosperity of the corporation, he most likely will desire that the controlling interest remain an asset of his estate.

B. Retention of the Controlling Asset Within the Estate

If the testator rejects both the buy out and recapitalization in favor of retaining the controlling interest in his estate, careful planning must be done to mitigate the problems inherent in the application of the duty of undivided loyalty. If retained as an asset of the estate, presumably the controlling interest will be held in trust. Even if a trust is not created, the executor's powers to run the business should be expressed in the will since the period of probate may be lengthy.

1. The Role of the Corporate Fiduciary

An estate planner must advise his client as to who should be the trustee or executor. A corporate fiduciary would provide

50. A rapid increase in profits might normally lead to stock splits and first options on later issues. One advantage of a recapitalization or buy out is the elimination of the trustee-director's difficult position with respect to the duty of undivided loyalty. It has been suggested that to the extent that the trustee-director exercises such rights he is affirming and consolidating the conflicting interests. See Pierson, Stock of a Closely Held Corporation as an Original Trust Res or a Subsequent Investment, 11 Okla. L. Rev. 33, 51-52 (1958); cf. In re Grace's Estate, 42 Misc. 2d 214, 247 N.Y.S.2d 695 (Surr. Ct. 1964). Yet a refusal to exercise such an option may also be a breach of trust since the trust may lose its controlling interest in the corporation.

51. For reasons why a testator may not desire his interest to be liquidated upon his death, see Adelman, The Power to Carry on the Business of a Decedent, 36 Mich. L. Rev. 185-86 (1937); Polasky, Planning for the Disposition of a Substantial Interest in a Closely Held Business, 44 Iowa L. Rev. 83, 106-37 (1958).
experience and expertise in the tax and management problems of estates. Assuming it would accept the trust, the corporate trustee may choose to play either an active or passive role in the management of the corporation. To the extent that the corporate fiduciary plays an active role in the business, its management policy may differ from that of the incumbent manager. In addition, because of the corporate fiduciary's traditional committee approach to the solution of management problems, it may tend toward conservatism and stifle the growth prospects of the corporation.

The testator may appoint the corporate fiduciary as either co-trustee with his son or as sole trustee. If the corporate fiduciary becomes co-trustee it may be more likely to play a passive role in the management of the corporation. Also, at least one court has indicated that the consent of the corporate fiduciary co-trustee will protect the individual trustee from liability based on divided loyalty.

The availability of a corporate fiduciary may encourage the use of a "directory trust." With a directory trust the testator would appoint the corporate fiduciary merely to hold the stock as if it were a normal trust asset. The will would provide for the election of the son as a director of the corporation or as

52. Although the attitude may be changing, there is some indication that corporate fiduciaries will not accept trusts containing businesses. See Cowdery, To Handle or Not to Handle, 94 Trusts & Estates 485 (1955); Smith, How to Operate a Business, 98 Trusts & Estates 1141 (1959); Symposium, Handling Businesses in Trust, 93 Trusts & Estates 105 (1954). At least one corporate fiduciary has stated that it accepts trusts containing business interests only with a view toward liquidation of those interests and reinvestment of the proceeds in more traditional trust holdings. Pfleiderer, When the Fiduciary Takes Over, 93 Trusts & Estates 107 (1954).

53. The corporate fiduciary may have a duty to play an active role. See note 21 supra and accompanying text.


55. If the son acts as co-trustee, the corporate fiduciary may rely on his mother's reluctance to sue. If a suit is nevertheless brought, the corporate fiduciary would probably be entitled to contribution from the son. See Bogert, Trusts & Trustees §§ 584-91 (2d ed. 1960).


58. If the will required the shares to be voted in a particular manner it might be construed as a voting trust and be subject to attack for
The corporate fiduciary then would be exculpated from liability for business activities, and the son's judgment in the management of the business would be judged by corporate principles.

2. Drafting for the Retention

In general

In drafting the administrative provisions, special care should be taken to state the duties and liabilities of the trustee. Because the administrative provisions will be in derogation of the common law duty of loyalty with no further inquiry, the testator's awareness of the problem and his solution to it must be expressed. From the drafting viewpoint, there are three possible attitudes: imposition of mandatory duties, exculpation from traditional liability, or grant of discretionary powers.

Imposition of mandatory duties (for example, requiring the trustee to accept and manage the corporation) may be the safest technique to facilitate the adaptation of trust principles to the estate corporation. When the instrument imposes duties upon the trustee, he can then argue that unless he acts in accordance with these prescribed duties he will be in breach of trust. In addition, insofar as a court desires to give effect to the testator's intent, a trustee would be relatively safe in following the testator's orders. Yet the needs of the estate corporation may change enough to make the duties imposed inappropriate. Corporate fiduciaries have stated that they will not accept a trust expressly requiring the trustee to perform given acts with respect to the corporation, preferring one empowering them to act in manners which they deem proper.

Failing to meet the statutory requirements. Cf. Abercrombie v. Davies, 123 A.2d 893 (Del. 1956).


60. See note 57 supra and accompanying text.

61. However, because the son no longer stands in the fiduciary position of trustee for his mother, her interests may not be as well protected.


63. See Foulke, The Family Business, 100 TRUSTS & ESTATES 606 (1961); Trachtman, Closely Held Businesses, 90 TRUSTS & ESTATES 668 (1951). But see Adelman, The Power to Carry on the Business of a Decedent, 26 MICH. L. REV. 185, 187 (1937), which seems to suggest that without a requirement in the will that the executor must carry on the business, he would be acting without authority should he assume control.

The imposition of a duty to run the business may be disadvantageous with regard to the trustee's right to a salary as a corporate officer. In In re Froelich's Estate, 122 App. Div. 440, 107 N.Y. Supp. 173 (1907),
Although a broad exculpatory provision will be narrowly construed and thus be ineffective, a properly drafted clause will probably restrict liability if a standard is included by which the trustee’s conduct can be judged. However, such a clause must state with particularity each act for which immunity is desired. Thus the inability to foresee all sources of liability prevents complete protection.

The affirmative grant of discretionary powers may be the best approach. Whether the grant of powers approach will be successful depends solely upon a court’s willingness to effectuate the testator’s intent, and thus the latter will not be as reliable as the imposition of duties. Still a grant of powers will allow the trustee greater freedom to both accept and work within the trust.

The charter and bylaws of the corporation should be considered when planning for an estate corporation. At a minimum these documents should be consistent with those of the trust lest the trustee be forced to choose between them. The bylaws could also set out the powers and duties with respect to such matters as salary and details of dividend distribution; the will

aff’d mem., 192 N.Y. 590, 85 N.E. 1110 (1908), the trustee–director of an estate corporation was surcharged for his salary even though the will apparently authorized its payment. The appellate division reasoned that since the will required the trustee to run the business, his management activities were transformed into trust duties, making him liable for any compensation received in excess of his statutory fee.

64. See In re Anneke’s Trust, 229 Minn. 60, 72, 38 N.W.2d 177, 183 (1949); 2 Scott, Trusts § 222.2 (2d ed. 1956); Fletcher, Divided Loyalty and Self-Dealing, 94 Trusts & Estates 234 (1955); Note, 20 Minn. L. Rv. 210 (1935).

65. See In re Dow’s Will, 32 Misc. 2d 415, 156 N.Y.S.2d 804 (Sur. Ct. 1955), aff’d, 3 App. Div. 2d 968, 162 N.Y.S.2d 196 (1957); Annot., 158 A.L.R. 276 (1945); Annot., 83 A.L.R. 616 (1933). The most common use of exculpatory clauses—limiting liability for negligence or inadvertence—may present analytical difficulty when utilized in an instrument creating an estate corporation. The trustee–director of an estate corporation presumably has been selected for his unique skill and experience with the corporation, and to exculpate him from negligence or inadvertence while simultaneously affirming his competence would seem to be inconsistent. Appropriate precatory statements should be included to explain this anomaly.

66. For a possible alternative standard in the case of an estate corporation, see note 43 supra and accompanying text.

67. See note 64 supra and accompanying text.

68. The grant of powers would be in the nature of precatory words. Courts have generally stated that precatory words will not be given binding effect. See, e.g., Barrenscheen v. Grosch, 306 Ill. App. 200, 28 N.E.2d 181 (1940); In re Oliver’s Will, 42 N.Y.S.2d 865 (Sur. Ct. 1943). Compare note 62 supra and accompanying text.
should incorporate the bylaws by reference. An advantage of using the corporate documents would be to encourage the application of corporate principles to a trustee-director’s acts. Moreover, to the extent that the charter and bylaws are considered a contract among the shareholders, the shareholders will be bound by their provisions. However, the probate court may disregard the bylaws in the exercise of its jurisdiction over the trust.  

A sample clause

For many years I have been engaged in the manufacturing business owned and operated by XYZ Inc., a domestic corporation of state A. Since I am the principal and majority stockholder, and since in all probability the chief asset of my estate will consist of shares of stock of said corporation, it is my wish and desire and I do hereby authorize (but do not require) my executors and trustees, if my estate does in fact own a stock interest and so long as it does, to assume control and continue operation of the business of said corporation for such period as they deem advisable and as is authorized under the terms of this will. It is my belief that through the continued operation of XYZ Inc., or its successor corporation, as a going business the interests of both my wife Jane and my son John will be best served. In the event that the corporation does not continue to serve either of these interests, my executors and trustees are authorized to sell or retain the business as they deem advisable.

This trust is created to provide for my beloved wife, Jane, during her life should she survive me. Although it is my intention that the executors and trustees under this instrument should protect and represent my wife Jane’s interest, I do desire, and hereby express my intention that, insofar as possible, my executors and trustees shall manage this trust and the corporation contained therein so as to maximize the interests of not only my wife but also the corporation. (For purposes of determining the interests of the corporation, the needs of the corporation in order to continue in the industry as a growing and prosperous business, and the responsibilities of the corporation to its shareholders and creditors shall be considered). It is my intention, and I do believe, that through

69. See note 9 supra.
70. See note 63 supra and accompanying text.
71. Absent express authority in the will to carry on the business an executor would be subject to liability should he do so. An executor is under a duty to liquidate the assets of an estate, and a trustee must invest the proceeds in “legal” assets. A close corporation is not a legal asset. See Adelman, The Power to Carry on the Business of a Decedent, 36 Mich. L. Rev. 185 (1958).
careful management the interests of my wife and the corporation can be simultaneously served. If and only if it should appear that this end can not be achieved and that the interests of my wife and the corporation should become incompatible, it is my intention that my executors and trustees should act in the interest of my wife.72

Throughout the existence of the corporation my son, John Doe, has played an important and integral part in its growth and success. I am fully aware that my son John is a director and officer of XYZ Corporation. It is my belief, and I do affirm, that because of my son John’s experience and expertise, he is the person best qualified to manage and control the corporation; I desire that he be allowed to continue in this position.

Because of my trust and belief in my son John’s integrity and skill in management of the assets of my estate and the trust created of it, I appoint him co-executor and co-trustee.73 I am fully aware that my son John holds, individually and free of trust, capital stock in XYZ Inc., but I do not desire, nor do I make it a condition of his appointment as co-executor or co-trustee that he divest himself of such stock. I am aware that if my son retains his position as director and assumes the positions of co-executor and co-trustee, I have placed him in a position in which a court may find him to be acting with conflicting interests and that as a result he may be held liable without further inquiry for acting in such a situation regardless of any fault or wrongful conduct on his part. I do hereby express my intent that such principles of law as would impose strict liability upon my son John as trustee solely on the basis of such potentially conflicting interests should not be applied and that my executors and trustees should be exculpated from any and all strict liability as a result thereof.

I direct and it is my intention that my executors and trustees be held to the following standard with respect to their activities in management of the corporation.74 My executors and trustees shall at all times act with and be held to a standard of good faith reasonable business judgment75 considering the interests of my wife and the corporation. For purposes of determining their good faith and reasonable business judgment, my executors and trustees

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72. Unfortunately, at some point the testator must decide whether the wife or corporation should be preferred in the event of irreconcilable conflict.
73. See notes 55-56 supra and accompanying text.
74. See note 43 supra and accompanying text.
75. For a discussion of judicial treatment of the application of the business judgment rule to the issue of establishment of capital reserves, see note 35 supra and accompanying text.
shall have the burden to prove good faith.\textsuperscript{76} The rights and interests of both the trust and the corporation shall at all times be considered.\textsuperscript{77} My executors and trustees shall not be liable for gains to the corporation which do not accrue to the beneficiary.\textsuperscript{78}

If my son John as executor and/or trustee participates actively in the management of XYZ Inc., whether directly as an officer of the corporation or otherwise, he shall be entitled, and shall agree by accepting the position, to receive reasonable compensation\textsuperscript{79} which the corporation would be required to pay to any individual in order to secure equivalent management functions. Such compensation shall be paid solely by the corporation. For purposes of determining what is reasonable compensation, the following factors shall be relevant but not determinative: (1) the fair market value of his services as determined by compensations paid to individuals in similar positions in similar firms; (2) the compensation paid to that individual who holds the same position at the time of my death as my son shall hold as director,\textsuperscript{80} increased or decreased in relation to the change in net income of the corporation. In any event such compensation shall be not less than one percent nor more than fifteen percent of the annual gross income of the corporation.\textsuperscript{81}

In the event that such compensation in the nature of a

\textsuperscript{76} One policy underlying the duty of undivided loyalty is that because the beneficiary would neither have access to nor an understanding of trust transactions, the trustee should be absolutely liable in a situation where he may not act in the interest of the beneficiary. See Hoover, \textit{Basic Principles Underlying Duty of Loyalty}, 5 CLEV.-MAR. L. Rev. 7, 11 (1956). It would seem that the proper way to effectuate such policies would be to require the trustee to establish his good faith rather than to refuse to inquire into it. See Haggerty, \textit{Conflicting Interests of Estate Fiduciaries in New York and the "No Further Inquiry" Rule}, 18 Fordham L. Rev. 1 (1949); Niles & Schwartz, \textit{Breach of Trust—Recent Developments}, 20 N.Y.U. L. Rev. 165 (1944).

\textsuperscript{77} Trust law states that the sole relevant consideration for a trustee shall be the interest of the beneficiary. See note 6 \textit{supra} and accompanying text.

\textsuperscript{78} Trust law holds that a trustee acting with conflicting interests may be accountable for all gains to parties other than the beneficiary. See note 16 \textit{supra} and accompanying text.

\textsuperscript{79} See notes 38-41 \textit{supra} and accompanying text.

\textsuperscript{80} See \textit{In re Hatt's Estate}, 295 P.2d 985 (Wyo. 1956), where the court approved a trustee-director's salary equal to that received by the testator during his life.

\textsuperscript{81} Cf. \textit{In re Froelich's Estate}, 122 App. Div. 440, 107 N.Y. Supp. 175 (1907), aff'd mem., 192 N.Y. 590, 85 N.E. 1110 (1908), where a percentage format was apparently approved although the trustee was denied compensation on other grounds. If a percentage clause is used, the range should be broad enough to accommodate any possible change in the corporation's earnings. The percentage should be of the corporation's gross income to insure a corporation deduction for the salary.
management fee shall be paid to my son John, and so long as it is, it shall be his sole compensation for management of the trust created under this will and he shall not receive additional trustee's fees.\(^8\)

If my son John shall cease, or be required to cease, active participation in the management of the corporation, or if the corporation ceases to be an asset of my estate or the trust herein created, and my son John continues to serve as co-executor or co-trustee, he shall be entitled to trustee fees as required by law.

The foregoing is illustrative of the type of language which should be included in any instrument creating an estate corporation in order to ameliorate the application of the duty of undivided loyalty. It is believed that the opening precatory paragraphs are both helpful and necessary in interpreting the testator's intent as to the duties and liabilities of the trustee-director. The compensation provision is specifically included because of the substantial litigation on the question.\(^8\) Similarly, an equally explicit clause as to the duties and liabilities concerning the declaration of dividends should be included.\(^8\) An illustrative clause on dividend declaration has not been included because it is thought that this question is so intimately connected with the needs of each individual corporation and its likelihood for future earnings that such a clause must be specifically tailored to meet the needs of the corporation in question. The corporation's bylaws should be amended specifically to include the substance, if not the actual language of the compensation and dividend clauses in order to eliminate any conflict.

The draftsman should also include provisions addressed to problems which may arise in the course of running the business. Since such provisions would be in the nature of boiler plate and are beyond the scope of this Note, sample provisions have not

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8. To the extent that a court may be influenced by statutory trustees' fees, see note 38 supra and accompanying text. The specific negation of those standards may authorize the receipt of a more reasonable sum.

8. See note 37 supra and accompanying text.


To the extent that the testator does not indicate his desires, a court may rely on the past history of dividend payment when called upon to evaluate a trustee-director's acts. See Rosencrans v. Fry, 21 N. J. Super. 289, 91 A.2d 162 (Super. Ct. Ch. 1952), aff'd, 12 N.J. 88, 95 A.2d 905 (1953).
been provided. At a minimum such provisions should include discretion to carry on the corporation, to alter or expand the business nature of the corporation should it be necessary, and to establish capital reserves.

3. Discouraging a Challenge of the Fiduciary's Conduct

Although careful drafting to protect the trustee-director, corporation, and estate beneficiary is essential, it may not be effective. To further protect the trustee-director, devices such as consent provisions, insurance plans, indemnity provisions, and recovery clauses should be considered.

If the beneficiaries are sui generis, they may consent to the unusual form of administration required by the estate corporation, and such consent will probably be given effect to bar a subsequent challenge. In addition, the trustee-director may seek court approval which, if given, will insulate him from subsequent liability. The trustee-director may take out insurance to indemnify himself from liability resulting from acting with conflicting interests. If the will or trust permits, the premiums on such policies probably can be paid by the corporation.

Similarly, the will can state that the trust or corporation should indemnify the trustee out of income for liability incurred solely because of his dual position as trustee-director. Should such a provision be given effect, the life beneficiary would be discouraged from suit because there would be no net benefit. Of course such a provision would not discourage suit by the remainderman since his recovery would be at the expense of the

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85. Sample boiler plate clauses may be found in FINGAR & BOOKSTAYER, NEW YORK WILLS §§ 125, 167 (1949); STEPHENSON, DRAFTING WILLS AND TRUST AGREEMENTS 129-56 (1955). F-H WILLS-TRUSTS—ESTATE PLANNING FORMS, ¶¶ 63,001-02, 62,300-08.
86. See note 71 supra.
87. Absent such authority the trustee-director may not be able to change the nature of the business. See In re Doelger's Estate, 254 App. Div. 178, 4 N.Y.S.2d 334 (1938).
88. See note 31 supra and accompanying text.
89. See BOGERT, TRUSTS & TRUSTEES § 941 (2d ed. 1962).
91. See 2 SCOTT, TRUSTS § 264, at p. 1488 (1st ed. 1939).
Finally, the will can provide that any damages recovered because of the trustee-director's position of divided loyalty would accrue to the corporation rather than to the trust. Because the life beneficiary could not directly recover, he would lack a motive for suit in a case where no actual harm was done.

CONCLUSION

The application of traditional trust principles to the estate corporation has hindered the emergence of this device as a truly effective estate planning tool. Although some courts have recognized the inherent differences between the investment trust and the estate corporation, there is little hope of an immediate and widespread modification of the duty of undivided loyalty with no further inquiry. In this context it is incumbent upon the estate planner to recognize the problems involved, to avoid them, or to alter their application.

93. The provision could be modified to state that the trustee shall be indemnified out of corpus should the remainderman sue. The value of such a provision is questionable, however, since if the trust is indemnifier, this would entail a sale of the stock which would risk a loss of control, or if the corporation is the indemnifier, a sale of assets which could be harmful to the corporation.