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Corporations: Minority Shareholder Defeats Creation of Subsidiary

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Case Comments

Corporations: Minority Shareholder Defeats Creation of Subsidiary

Plaintiff, owner of over one-third of the stock in a closely held corporation, blocked an attempted charter amendment which would have authorized an increase in the corporation's capital stock. In order to circumvent plaintiff's opposition to obtaining additional financing,[1] the corporate management created a subsidiary corporation and transferred money and property of the parent in return for 4,000 of the subsidiary's 50,000 authorized but unissued shares.[2] The trial court set aside the transfer and enjoined the corporation from making any subsequent transfers of this nature. The Minnesota Supreme Court affirmed, *holding* that corporate transfers which are technically permissible will not be allowed to circumscribe the legal rights of a minority stockholder. *Aiple v. Twin City Barge & Towing Co.*, 274 Minn. 38, 143 N.W.2d 374 (1966).

Traditionally, in reliance on the principles of business judgment or majority control,[3] courts have been reluctant to interfere in the internal affairs of corporations. Although intracorporate activity may be formally proper, courts have been willing to exercise equity jurisdiction when necessary to protect the rights of stockholders.[4] Whether through the acts of management or majority stockholders, equitable relief has been granted when conduct is characterized as fraudulent,[5] abusive of discretion,[6] arbitrary,[7] or in bad faith.[8]

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1. Plaintiff's opposition to the increase in capital stock was apparently the result of his interest in a competing corporation. See 274 Minn. at 40, 143 N.W.2d at 375. However, plaintiff contended that more stock was not needed to finance the corporation, and that any expansion should be financed by earnings. Brief for Respondent, p. 15.

2. The transfer represented \$52,569.16/\$496,000.00 of the total fixed assets of the parent corporation. The shipyard division which was transferred from parent to subsidiary represented about \$400,000/\$1,400,000 of the parent's estimated gross income for 1963 and \$57,000/\$900,000 of its total assets. 274 Minn. at 42, 143 N.W.2d at 377.

3. O'Neal & Derwin, Expulsion or Oppression of Business Associates §§ 3.03, 8.02 (1961).

4. *E.g.*, Green v. National Advertising & Amusement Co., 137 Minn. 65, 162 N.W. 1056 (1917).

5. See Mobile Towing & Wrecking Co. v. Hartwell, 208 Ala. 420, 95 So. 191 (1922).

6. See Jones v. Motor Sales Co., 322 Pa. 492, 185 Atl. 809 (1936).

7. Channon v. Channon Co., 218 Ill. App. 397 (1920).

8. Tefft v. Schaefer, 136 Wash. 302, 239 Pac. 837 (1925).

Problems concerning closely-held corporations have helped to create an increasing awareness of the need to expand the scope of equitable relief beyond its traditional bounds. The distinctive qualities of close corporations frequently give rise to internal disputes unique to that form of organization.[9] Despite this uniqueness, most states still regulate close corporations under general private corporation laws,[10] and the courts of those states limit their inquiry to that context.[11] The present trend, however, is to analyze the problem within the context of the close corporation and to grant relief when a stockholder is wrongfully deprived of his legal rights.[12]

Under Minnesota Statutes section 301.37(3)(2), the *Aiple* plaintiff could effectively block any amendment to the corporate charter.[13] Finding that the transaction of the defendant corporation placed the plaintiff in substantially the same situation as he would have been had the vetoed amendment been effective, the court, in granting relief, focused upon this legally protected veto right.

On the premise that an increase in authorized capital stock is a fundamental change which must be ratified by the stockholders through a charter amendment,[14] the court rejected the corporate management's argument that establishing the subsidiary was within its corporate powers.[15] The transaction was

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9. See O'Neal & Derwin, *op. cit. supra* note 3, §§ 1.04, 2.01-.19.
10. See Henn, Corporations § 259 (1961).
11. See O'Neal & Derwin, *op. cit. supra* note 3, § 8.02.
12. *Ibid.*
13. Minn. Stat. § 301.37(3)(2) (1965) provides:

(2) Except as hereinafter in this section provided, an amendment may be adopted only if it receives either:

(a) The affirmative vote of the holders of two-thirds of the voting power of all shareholders entitled under the articles to vote, or such larger or smaller vote, not less than a majority, as the articles may require; or

(b) If not otherwise provided by the articles, the affirmative vote of the holders of a majority of the voting power of all shareholders entitled under the articles to vote and does not receive the negative vote of the holders of more than one-fourth of the voting power of all shareholders entitled to vote.

14. Railway Co. v. Allerton, 85 U.S. (18 Wall.) 233 (1873); see Ballantine, Corporations § 273 (1946); 11 Fletcher, Cyclopedia of Corporations §§ 5129, 5133 (rev. vol. 1958).

15. The Minnesota Business Corporations Act grants corporations the power to hold stock in other corporations, Minn. Stat. § 301.10 (1965), and to dispose of property and assets. Minn. Stat. § 301.09(4) (1965). The defendant's articles of incorporation similarly provided that the corporation could transfer property and acquire stock in any corporation. 274 Minn. at 43, 143 N.W.2d at 378. However, a two-thirds vote of the stockholders is required to authorize a transfer of "all, or sub-

viewed instead as equivalent to an increase in the parent's capital; as such, it was a reconstruction of the corporate body[16] rather than an ordinary business transaction. Plaintiff's rights which were derived from section 301.37(3) were also used to deny defendant's claim that the transfer of the assets to the subsidiary was permissible because not a transfer of "all or substantially all" of the corporate assets.[17]

Conceding that the increase in capital stock may have been beneficial to the stockholders and the corporation, the court argued that allowing such transfers in circumvention of section 301.37(3) could lead to the fragmentation of the parent into any number of subsidiaries. The consequences of such transfers would be to diminish the interests of the minority stockholder, or to force him to buy into the new corporation to protect his interests.[18] Though the court recognized that its decision would allow a minority stockholder to deny his corporation the benefits derived from sound business judgment, it concluded that any change in legal rights should come from the legislature.

The court's position that the subsidiary was established to circumvent the plaintiff's statutory right to veto any recapitali-

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stantially all," of a corporation's assets. MINN. STAT. § 301.36 (1965). The right of a corporation to transfer assets in exchange for stock in another corporation is well established. Dworsky v. The Buzza Co., 215 Minn. 282, 9 N.W.2d 767 (1943); Hill v. Page & Hill Co., 198 Minn. 30, 268 N.W. 705 (1936). See generally BALLANTINE, CORPORATIONS §§ 84, 88 (1946); 6A FLETCHER, CYCLOPEDIA OF CORPORATIONS §§ 2825, 2925 (rev. vol. 1950); HENN, CORPORATIONS § 185 (1961).

16. The Minnesota Business Corporation Act does not explicitly require that a vote of the stockholders be taken when a transfer is not in the ordinary course of business. Other states have incorporated this phrase into their shareholder consent statutes. *E.g.*, ILL. REV. STAT. ch. 32, § 157.72 (1965); N.Y. STOCK CORP. LAW § 20. Since the phrase is usually used in conjunction with the "substantial" amount of assets requirement, however, it is unnecessary to determine whether a transfer is in the ordinary course of business unless it involves a sale of all, or substantially all of the corporate assets.

A number of cases prior to modern corporate statutes discussed the requirement that a sale be in the ordinary course of business, regardless of the fact that less than all, or substantially all of the assets were sold. E.g., Matter of Miglietta, 287 N.Y. 246, 254, 39 N.E.2d 224, 228 (1942); Matter of Timmis, 200 N.Y. 177, 93 N.E. 522 (1910); see, Hanrahan v. Andersen, 108 Mont. 218, 231, 90 P.2d 494, 499 (1939). These cases suggest that the transfer in *Aiple* was not one which required a vote of the stockholders. See generally Note, 28 N.Y.U.L. REV. 1014 (1953); Note, 9 SYRACUSE L. REV. 269 (1958).

17. The opinion, as originally issued, stated that the statute does not authorize such a transaction when "the transfer is not in the ordinary course of business . . . ." Aiple v. Twin City Barge & Towing Co., No. 176, Sup. Ct. Minn., April 22, 1966, p. 8.

18. 274 Minn. at 45, 143 N.W.2d at 379.

zation can follow only if the transaction has the effect of recapitalization. Because a transfer of assets for stock only amounts to an exchange of assets the transaction cannot have the concluded consequences, and thus the court's rationale begs the question. If the shares received in the exchange had a value at least equal to that of the transferred assets, the monetary interest of the stockholder was not affected. His proportionate share of the value of the parent corporation remained stable, and he would share ratably in any increase in that value. Thus, the stockholder would have the same voting power in the parent as he had previously, and the immediate book value of his stock should not be changed.

The only effect the *Aiple* transaction would have upon stockholders would be to diminish any direct control over the utilization of the transferred assets. In most circumstances this would be a negligible right because stockholders are allowed a direct vote only on certain extraordinary matters.[19] However, in *Aiple* this right had somewhat greater dimensions. Plaintiff had enough votes to elect two of the parent's five directors, and consequently, he could exercise more control over the business and assets than the ordinary stockholder.[20] Stockholders do not have property rights in any specific assets of a corporation,[21] however, and the success of their voting power is not guaranteed. By itself, therefore, this control factor does not justify the conclusion that this was an increase in the parent corporation's capital stock.

Contrary to the court's assertion that plaintiff's rights were circumvented, it seems clear that they were respected. There had been no change in the capital of the parent corporation; the only change was in the nature of some of its assets. The facts that plaintiff vetoed the amendment because he felt new finances were not required, and that additional financing was

19. See generally HENN, CORPORATIONS §§ 340-51 (1961).

20. The fact that plaintiff could elect two of five directors gave him possible control of the board if he could persuade one of the other directors to join him in voting. The possibility of persuasion would not necessarily be lost over the transferred division's operations if plaintiff could persuade another director to join him when the subsidiary's shares of stock were voted. However, some control would be lost if the subsidiary issued some of its authorized shares to the parent corporation's control group. Under the *Aiple* facts, because of the unity of the majority stockholders, it can be said that the plaintiff would no longer have any voice in the operations of the transferred division.

21. See 4 DUNNELL DIGEST § 2071 (3d ed. 1952); 1 FLETCHER, *op. cit. supra* note 14, § 31 (rev. vol. 1963).

achieved by creation of the subsidiary, are irrelevant to a consideration of capital structure changes.[22]

If the court's opinion is accepted at face value, its scope could create a great deal of uncertainty in corporate law. Although creation of a subsidiary corporation generally has been dealt with as being a matter of ordinary business judgment,[23] under the *Aiple* rationale creation of a subsidiary may be a reconstruction of the parent's capital structure and, if not authorized, beyond the power of the board of directors. Furthermore, the rationale may extend to the transfer of assets in return for controlling interest in an already existing and separate corporation, or possibly to any exchange of assets for stock. Such results would certainly be contrary to statutory provisions granting corporations general powers, and would extend section 301.37 to untenable dimensions.

On the other hand, the *Aiple* decision can be narrowly construed on the basis of its facts. The court recognized that this was a closely held corporation which had been suffering internal dissension for many years. Several factors indicated that a squeeze-out of the plaintiff minority stockholder was in progress, and that creation of the subsidiary was simply another step. The dangers to plaintiff were great: although he was a stockholder and director of the parent, his voice in the detached division would be almost nonexistent; and he could no longer block extraordinary matters if they were effected within the subsidiary. Furthermore, if the majority stockholders of the parent purchased stock of the subsidiary and denied this opportunity to plaintiff,[24] there is a chance that any injury would be compounded. Especially in the context of the close corporation, creation of a subsidiary should benefit the parent corporation and the parent's stockholders. On this basis the recapitalization position which the court accepted takes on an appearance of validity.

22. Obtaining additional financing would normally be an ordinary business matter over which stockholders have no direct control.

23. *E.g.*, Kardo Co. v. Adams, 231 Fed. 950, 964 (6th Cir. 1916); Durham v. Firestone Tire & Rubber Co. of California, 47 Ariz. 280, 55 P.2d 648 (1936); Rubino v. Pressed Steel Car Co., 53 Atl. 1050 (N.J. Ch. 1903); 6A FLETCHER, *op. cit. supra* note 14, § 2823. The dissent is based partially upon the idea that the acts of the corporation involved the business judgment of the directors and should be regarded as an ordinary manner of doing business. 274 Minn. at 49, 143 N.W.2d at 380.

24. It appeared from the record that plaintiff would not have been able to buy stock in the new corporation. The chairman of the board of both corporations testified that while he wished to raise additional equity capital, he did not want any of it furnished by plaintiff. Brief for Respondent, p. 28.

However, it would have been much easier and more desirable for the court to use an equitable standard of fiduciary duty, rather than to try to support its position that there had been a capital reconstruction.

In the context of close corporations, utilization of fiduciary standards[25] can be more meaningfully applied than can attempts to fit the unique problems of the close corporation into general corporation statutes. Although creation of a subsidiary changes the complexion of the parent corporation and opens many avenues of abuse, as with all normal business decisions, there should be a presumption of its validity. When there is a minority dissent, such action by a close corporation should be subject to close judicial scrutiny. If there are alternatives to a proposed plan which would not infringe upon the rights of a minority stockholder, or if the benefit to the corporation and other stockholders outweighs his interests, equity courts should consider these factors in determining the proper balance of fairness.[26] If such a standard is applied, close corporation stockholders would have greater protection against squeeze-outs and lock-ins, and in many cases courts could grant relief before the damage becomes irreparable.

Aiple represents an unsuccessful attempt to solve a close corporation problem by applying a general corporation statute. Not only is its application of Minnesota Statutes section 301.37

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25. Those in control of a corporation are under a fiduciary duty to exercise corporate powers only for the ratable benefit of all the shareholders. See Berle, *Corporate Powers as Powers in Trust*, 44 HARV. L. REV. 1049 (1931); HENN, CORPORATIONS §§ 268, 276 (1961). See, *e.g.*, Zahn v. Transamerica Corp., 162 F.2d 36 (3d Cir. 1947); Note, 58 COLUM. L. REV. 256 (1958). Such a duty is breached if control is exercised unfairly or in bad faith, or if those who control the corporation benefit more than, or at the expense of, the other stockholders. *Id.* at 257. For a discussion of who are the beneficiaries under the trust concept, *compare* Dodd, *For Whom Are Corporate Managers Trustees?*, 45 HARV. L. REV. 1145 (1932), *with* Berle, *For Whom Corporate Managers Are Trustees: A Note*, 45 HARV. L. REV. 1365 (1932). See also Brudney, *Fiduciary Ideology in Transactions Affecting Corporate Control*, 65 MICH. L. REV. 259 (1966); Comment, 7 ST. LOUIS U.L.J. 143 (1962).

26. Compare Comment, 1959 DUKE L.J. 436, 458. The author suggests a statutory standard of fairness to be applied in minority challenges to majority action. The criteria the author suggests for such a standard include: (1) no legitimate business reason for the action instigated by the majority; (2) the same legitimate business objective could be attained by an alternate plan under which the minority would be unduly prejudiced; or (3) the asserted business objective is clearly secondary in importance to the majority's purpose of improving its position at the minority's expense. If a stockholder can show substantial detriment, any one of the criteria would establish unfairness.

(3) questionable, but the *Aiple* rationale could lead to confusion in the field of corporate law. On the other hand, by applying a fiduciary duty concept in cases such as *Aiple*, courts could establish a flexible test which would be applicable to the limitless fact situations which are possible; and it would put close corporate fiduciaries on notice that transactions, even if beneficial to the corporation, may be subject to judicial intervention.

Inheritance Tax: Transfer by Contractual Will Not Taxable

Prior to separating, testator and his spouse entered into a property settlement under which the wife was to receive less than half their community property. In consideration for the agreement testator was to assume responsibility for maintenance and support of their mentally arrested daughter and to establish in his will a trust to pay her future expenses. Accordingly, testator left the residue of his estate in trust for the benefit of his daughter. The probate court allowed imposition of an inheritance tax upon the amount necessary for the daughter's maintenance. The California Supreme Court reversed, *holding* that a bequest made pursuant to a property settlement is not subject to an inheritance tax, provided the testator had received full consideration in money or money's worth. *In re Estate of Vai*, 52 Cal. Rptr. 705, 417 P.2d 161 (1966).

Contracts to devise or bequeath property frequently serve as an alternative to an outright conveyance or a conveyance in trust because they permit retention and control of the property until death.[1] Since inheritance tax statutes often proclaim to tax *all* transfers by testamentary disposition, it is necessary to determine whether such predeath transactions are subject to an inheritance tax.

It has been held that all changes of ownership effected by will are taxable under inheritance tax statutes.[2] Indeed, the unequivocal terminology of most inheritance tax statutes seems

1. SPARKS, CONTRACTS TO MAKE WILLS (1956).
2. See, *e.g.*, Annot., 157 A.L.R. 964 (1945); Annot., 7 A.L.R. 1046 (1920). This rule was stated absolutely by *In re* Grogan's Estate, 63 Cal. App. 536, 219 Pac. 87 (1923). The inheritance tax statute did not explicitly exempt from taxation those transfers by will made pursuant to a contract, and therefore the statute was construed to include all transfers utilizing a will as a "vehicle" of conveyance. This was held to be true regardless of the motive for the transfer or the existence of consideration. This reasoning was expressly disapproved by the instant case.

to require this result.[3] However, the absoluteness of this rule has been undermined by cases which place emphasis upon the substance of a transfer rather than its form. In *In re Rath's Estate*,[4] property held in trust was transferred to the beneficiaries by the terms of the trustee's will. The will was deemed a mere "conduit" rather than the "vehicle" of transfer. Extending this reasoning, the California court, in *In re Belknap's Estate*,[5] implied an irrevocable trust from the terms of a property settlement which gave the beneficiary a stipulated monthly payment during the testator's life, and which required the testator to provide in his will for the purchase of a fixed sum annuity payable to the beneficiary. Since the will was considered a "conduit" through which previously vested interests were fulfilled,[6] no tax was imposed.

The court in *Estate of Vai* held a bequest made pursuant to a property settlement to be exempt from inheritance taxation to the extent of the consideration received by the testator. Diverging from precedent, it did not conclude that either an express or implied trust was created by the contractual agreement; it instead focused upon the fact that the property settlement granted the beneficiary an immediate right to receive future benefits, which was subsequently enforceable against the estate. The court impliedly equated the beneficiary with a creditor, reasoning that if a decedent provided in his will to pay a creditor in full, that bequest would not be subject to an inheritance tax. The court ultimately based its decision upon the fact that the transfer was deemed to have occurred at the time the agreement was entered, the will being merely the conduit through which

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3. *E.g.*, ILL. REV. STAT., ch. 120, § 375 (1965); MINN. STAT. § 291.01 (1965).

4. 10 Cal. 2d 399, 75 P.2d 509 (1938). Testator's wife agreed to devise certain property to testator, and he in turn was to devise the remainder of that property to her surviving nephews. The extrinsic agreement and wife's will considered together created a life estate in the testator with a power to consume, and a remainder interest in the nephews. The interest of the nephews therefore vested at the death of testator's wife. Because the nephews took the property from one to whom they were related, as opposed to testator who was a blood stranger, a lower inheritance tax rate was applicable. *Accord*, People v. Tombaugh, 303 Ill. 591, 136 N.E. 453 (1922).

5. 66 Cal. App. 2d 644, 152 P.2d 657 (1944).

6. In distinguishing cases such as *In re* Grogan's Estate, 63 Cal. App. 536, 219 Pac. 87 (1923), the *Belknap* court stated: "Said decisions *had reference to a situation where the testator* [by will] *is disposing of his own property*, not of property held by him in trust for others, as to which his will is a mere conduit of title." 66 Cal. App. 2d 644, 654, 152 P.2d 657, 662 (1944).

the obligation of the testator was fulfilled.

Although prior decisions premised application of the conduit doctrine upon the existence of a trust and a vested interest in the trust property,[7] neither an express nor an implied trust could have existed prior to the testator's death in the instant case.[8] Essential elements in the creation of a trust, such as manifestation of a present intention to create a trust[9] and definitely ascertainable subject matter,[10] were not present at the time of the property settlement agreement.[11] Thus, in holding that the will was merely an instrumentality of transfer, the court applied the conduit doctrine even though the premise upon which this concept was originally based did not factually exist.

The conduit analysis may be appropriate when the terms of a prior trust utilize a will as the means of continuing trust benefits. When there is an enforceable agreement to devise or bequeath property in a will, however, it is fallacious to argue that the ultimate transfer is not by will. Moreover, without the existence of a trust, which may be objectively determined, the effect of the doctrine is to eliminate a crucial element of certainty and predictability.

In analogizing the interests of the contractual beneficiary to those of a creditor, the court stated that because no tax would be imposed if the claim were enforced as a debt of the estate, no tax should be paid when the debt is satisfied through the will.

7. See *In re* Rath's Estate, 10 Cal. 2d 399, 75 P.2d 509 (1938); *In re* Belknap's Estate, 66 Cal. App. 2d 644, 152 P.2d 657 (1944).

8. It is also doubtful whether the court in *Estate of Vai* found an interest to be vested in the beneficiary. The lower court adopted the vesting rationale, *In re* Vai's Estate, 47 Cal. Rptr. 227 (1965), but the supreme court vacated the decision without explicitly noting the existence of a vested interest.

It has been held that the concept of vesting or vested interests is an irrelevant criterion in the field of taxation. Bishop Trust Co. v. Burns, 46 Hawaii 375, 381 P.2d 687 (1963). Further, because the term is variable and uncertain, its use may be deceptive and confusing. The term has often been used in an attempt to explain a decision, without actually explaining it; that is, if an interest must be vested in order to reach a predetermined conclusion, then it is so vested. See CORBIN, CONTRACTS § 626 (1960).

9. 1 SCOTT, TRUSTS § 23 (2d ed. 1956); RESTATEMENT (SECOND), TRUSTS § 23 (1959).

10. RESTATEMENT (SECOND), TRUSTS § 76 (1959); see Matter of Howell, 255 N.Y. 211, 174 N.E. 457 (1931).

11. The trust was not to be funded until the testator's death, and its use was only for the beneficiary's care and maintenance subsequent to that time. Also, since the trust was to be funded with an amount that could only be determined at the time of the testator's death, the subject matter was neither definite nor definitely ascertainable.

While it is true that a creditor provided for in a will who enforces his claim against the estate does not pay an inheritance tax,[12] the existence of an enforceable right alone does not eliminate the tax. Clearly an inheritance tax would be imposed if a creditor simply accepted a bequest in satisfaction of his claim.[13] To avoid the tax, a creditor must renounce the legacy and exert his legal claim.[14] Because the beneficiary in *Estate of Vai* did not renounce the legacy and enforce her legal claim, the creditor analogy does not justify the court's decision.

Furthermore, it is necessary to distinguish between a contract creating an enforceable claim against an estate and a contract to make a will containing a specific legacy. Arguably, the property settlement agreement in *Estate of Vai* constituted a contract to leave a certain legacy to the testator's daughter. In the case of a contract to make a will, an inheritance tax would be imposed even if the beneficiary brings an action against the estate to enforce his rights.[15] Certainly, if the beneficiary accepts the legacy under the contractual will, rather than bringing an action to enforce his rights, logic dictates the imposition of an inheritance tax.

The requirement of a consideration in money or money's worth, however, seems justified.[16] Exempting from taxation

12. See Koeffler's Will, 218 Wis. 560, 260 N.W. 638 (1935).

13. See, *e.g.*, Matter of Cohen, 270 N.Y. 383, 1 N.E.2d 474 (1936); Matter of Gould, 156 N.Y. 423, 51 N.E. 287 (1898); Matter of Sharff, 143 Misc. 447, 256 N.Y. Supp. 739 (Surr. Ct. 1932). Compare Jacob A. Jacobs, 9 B.T.A. 636 (1927) (federal estate tax).

14. Sheppard v. Desmond, 169 S.W.2d 788 (Tex. Civ. App. 1943).

15. See, *e.g.*, Daum v. Inheritance Tax Comm'n, 135 Kan. 210, 9 P.2d 992 (1932); Matter of Howell, 255 N.Y. 211, 174 N.E. 457 (1931); Matter of Kidd, 188 N.Y. 274, 80 N.E. 924 (1907); Matter of Dutcher, 158 Misc. 533, 287 N.Y. Supp. 497 (Surr. Ct. 1936).

16. This requirement arguably creates an incongruity between the *Belknap* rationale which was adopted by the instant court and the court's application of that rationale. If, as in *Belknap*, no tax is to be imposed because the transfer is effected by the contractual agreement, the validity of that agreement should be determinative of the taxability issue. Consideration sufficient to support a property settlement agreement is dictated by ordinary contract principles, and generally the courts have found little difficulty in discovering a consideration in these agreements. See, *e.g.*, Jayhawk Equip. Co. v. Mentzer, 193 Kan. 505, 394 P.2d 37 (1964); Church v. Hancock, 261 N.C. 764, 136 S.E.2d 81 (1964); Farley v. Farley, 149 W. Va. 352, 141 S.E.2d 63 (1965). Therefore, the agreement could be valid and the transfer exempt from taxation, despite a relative inequality of benefits received. See RESTATEMENT, CONTRACTS § 81 (1932). Yet, under the rule of *Vai* an inheritance tax may be imposed if the consideration is not in money or money's worth. Thus, the agreement itself may be valid and enforceable, but to the extent it lacks consideration in money or money's worth, the *Vai* court would impose a tax.

all transfers by will pursuant to an enforceable agreement, regardless of the amount or adequacy of consideration, would permit inheritance tax evasion because the value received by a testator might not sufficiently replenish his taxable estate. However, if the money's worth requirement is satisfied, since the taxable estate is not decreased, there is no tax evasion.

In circumventing the unequivocal terms of the inheritance tax statute[17] in order to reach the desired result, the *Vai* court applied a legal fiction based on vague and indefinite concepts. Moreover, the existence or nonexistence of an enforceable right should not determine tax liability. The concepts of "conduit" and "vehicle" of transfer should be disregarded, and reliance should not be placed upon the existence of some prior equitable property right which may be subjective and not necessarily in conformity with the ascertainable elements of a trust.

Rather, when considering a contract to devise or bequeath, a court should recognize that the transfer is by will, but should exempt it from inheritance taxation if the *nature* and *effect* of the transfer justify such an exemption.[18] Since the purpose of an inheritance tax is to tax beneficial succession,[19] received by gift or without purchase,[20] the fact that a transfer of property is made by a will is irrelevant, as taxability does not depend upon form or motive.[21] If a transfer bestows a bounty or benefaction, it should be taxable; but if a contract to bequeath or devise is supported by consideration, the transfer does not constitute beneficial succession, and it should not be taxable. Under this approach, whether or not the decedent's promise is per-

17. The statute provided that:

> A transfer by will or the laws of succession of this State from a person who dies seized or possessed of the property transferred . . . is a transfer subject to this part.

CAL. REV. & TAX. CODE § 13601.

18. "That which is material and all-important is whether the thing which has been done, amounts in substance to the thing which the Legislature has made taxable . . . ." *In re* Kellogg, 123 N.J. Eq. 322, 324, 197 Atl. 263, 264 (Ch. 1938). "The measure determining the liability or freedom from liability to the tax is the nature, the essence, the effect of the transfer." Matter of Orvis, 223 N.Y. 1, 8, 119 N.E. 88, 89 (1918).

19. See, *e.g.*, Kirkwood v. Bank of America, 43 Cal. 2d 333, 273 P.2d 532 (1954); Estate of Craycroft, 191 Cal. App. 2d 436, 12 Cal. Rptr. 552 (1961); People v. Varel, 351 Ill. 96, 184 N.E. 209 (1932). See generally 2 NOSSAMAN, TRUST ADMINISTRATION AND TAXATION § 755 (rev. ed. 1952).

20. Higby v. Martin, 167 Okla. 10, 28 P.2d 1097 (1933); *cf. In re* Krueger's Estate, 11 Wash. 2d 329, 119 P.2d 312 (1941).

21. See Matter of Orvis, 223 N.Y. 1, 119 N.E. 88 (1918).

formed,[22] the promised property, less the monetary value of consideration received, would be subject to inheritance taxation.[23]

Generally, inheritance tax statutes which impose a tax on inter vivos transfers intended to take effect upon the transferor's death only tax transfers of beneficial succession. Either by the terms of the statute[24] or by judicial decision[25] such transfers have been excluded if made for consideration in money or money's worth. A common justification for this exclusion is that since the consideration received exactly offsets the amount of the transfer, the estate is not depleted.[26] Arguably, an additional basis for the exclusion is to prevent a double tax upon the value of the property transferred.[27]

Similarly, when a contract to devise or bequeath property is supported by consideration in money or money's worth, the value of the estate remaining available for distribution to beneficiaries other than the contractual promisee is not depleted. Furthermore, if a tax is imposed upon the property devised pursuant to the contract, as well as upon the consideration when later distributed to the other beneficiaries, the ultimate effect would be double taxation to the extent of this consideration. Thus, the justifications for permitting tax exemption for certain inter vivos transfers appear equally applicable to transfers by will pursuant to a contract based on a money's worth consideration.

Under this approach a creditor provided for in a will would not be placed in the dilemma of having to choose between his

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22. If the promisor breaches by failing to make a conforming will, a constructive trust could be imposed in favor of the promisee and against those who take under the will or by intestacy. See cases cited note 15 *supra*. If the promisor breaches by failing to make a will, and if the entire estate is distributed to his heirs, they will receive in total an amount equal to their intestate shares plus the consideration. A constructive trust could be imposed upon that property received by the heirs in excess of their statutory shares.

23. *Cf.* Commissioner v. Porter, 92 F.2d 426 (2d Cir. 1937). Compare INT. REV. CODE OF 1954, § 2043.

24. For example, the California statute in force at the time of *Estate of Vai* provided:

> Any transfer specified in this article made during lifetime by a resident . . . by deed, grant, bargain, sale, assignment, or gift, without a valuable and adequate consideration, is a transfer subject to this part.

CAL. REV. & TAX. CODE § 13641.

25. See, *e.g.*, Schroeder v. Zink, 4 N.J. 1, 71 A.2d 321 (1950); Matter of Orvis, 223 N.Y. 1, 119 N.E. 88 (1918); Matter of Thomas, 143 Misc. 643, 258 N.Y. Supp. 113 (Surr. Ct. 1932).

26. Schroeder v. Zink, 4 N.J. 1, 71 A.2d 321 (1950); *accord*, *In re* Kraft, 103 N.J. Eq. 543, 143 Atl. 764 (Ch. 1928).

27. See Darr v. Kervick, 31 N.J. 476, 158 A.2d 42 (1960).

legacy and a suit on the debt. To the extent that the value of his claim is ascertainable, no inheritance tax would be imposed upon that amount, even if payment is by will. Moreover, this approach would not be impracticable because of considerations of administrative convenience, since present federal estate tax law requires probate courts to make similar deductions in determining taxable estates.[28]

The unequivocal terms of most statutes taxing transfers by will do not provide an exclusion for such contractual wills. However, some courts have refused to impose an inheritance tax on certain transfers which, although within the classification of the statute, are not within its intent.[29] Accordingly, in the absence of legislative action, judicial legislation may be essential to future application of this suggested approach. Nevertheless, because this approach implements the purposes of inheritance taxation more simply, logically, and therefore effectively, it is preferable to the "conduit" theory as applied by *In re Estate of Vai* and its predecessors.

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28. INT. REV. CODE OF 1954, § 2043, provides that when certain specified transfers have been made, the value of the gross estate shall include the fair market value of the property so transferred less the value of the consideration received therefor.

29. See Schroeder v. Zink, 4 N.J. 1, 71 A.2d 321 (1950):

> It will be noted that the language used is broad enough to include such transfers made in exchange for a consideration of equal value received by the transferor. . . . [I]t is obvious that it was not intended to tax transfers of that kind . . . . So by necessary implication such transfers have been excluded from the operation of the statute . . . .

Id. at 9, 71 A.2d at 325. See cases cited note 25 *supra*. See generally Annot., 157 A.L.R. 964, 979, 984 (1945).