
SHERRARD
GERMAN & KELLY, P.C.
ATTORNEYS AT LAW

28th Floor, Two PNC Plaza, Pittsburgh, PA 15222
Phone: 412-355-0200 • Fax: 412-261-6221 • www.sgkpc.com

REPORT FROM COUNSEL

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PLANNING FOR THE "THREE D'S" IN BUSINESS ORGANIZATIONS: DEATH, DISABILITY AND DISSATISFACTION

By Anthony R. Sosso, Jr., Esquire

In the excitement of beginning a new business venture, whether it is a partnership, corporation, or a limited liability company ("LLC"), many entrepreneurs overlook a very important exercise. They fail to plan for the "Three D's" every organization may face: the death, disability or dissatisfaction of one of its owners. This article will discuss the dangers of failing to effectively plan for these occurrences, and will provide some points for consideration for anyone operating, or thinking of starting, a business with others. Provisions for the "Three D's" can be contained in a Partnership Agreement, Stock Transfer Restriction Agreement, or LLC Operating Agreement among the owners, and may be funded through the procurement of appropriate insurance products. The good news is, if you are alive, still able to work in your business, and not already dissatisfied with your business partners, it is not too late to plan!

No one likes to consider the possibility that one of the owners of a business will die or become unable to continue to work due to a permanent disability or illness. Yet these are very real possibilities. The impact on the business organization, as well as the family of the affected owner, could be devastating. Some individuals protect their families and

estates by purchasing life and disability insurance to replace their lost incomes. However, these policies may not address important needs of the business organization resulting from the absence of an owner. For example, in many smaller businesses, an owner may have unique skills or customer relationships that are important to the profitability of the company and would be lost in his or her absence. A business can purchase "key-man" life and disability insurance on its owners, with benefits payable to the entity, to cover these types of losses.

Death

In a general partnership, absent an agreement to the contrary, the partnership would automatically dissolve upon the death of a partner, and the surviving partners would owe the deceased partner's estate the value of that partner's interest if they chose not to liquidate the partnership. In a business corporation or limited liability company, no automatic dissolution occurs in the event of the death of a shareholder or member. However, without a prior agreement, the deceased owner's shares or interest will pass to the heirs of his or her estate. For the surviving shareholders or members to retain full ownership of the business from that point on, the interest would have to be purchased from the heirs by the entity, surviving shareholders or members. Without a prior agreement, the heirs would be under no obligation to sell back the interest, and the redemption or purchase price would have to be negotiated.

In most situations, surviving owners have an interest in maintaining ownership and control of the organization in the event of the death of another owner. Many would not want to be accountable to the heirs of a deceased owner in the operation of the business. Likewise, many owners would not want their heirs to be burdened with the responsibility of participating in the operation of a business in which they had no previous experience. In addition, owners want to ensure their estates will receive a fair price for their ownership interest in the event of their death. In order to accommodate all of these interests, it is imperative that the owners of a business organization set forth their intentions, in writing, including a method for the determination of the price to be paid to a deceased owner's estate.

Disability

Similar considerations regarding control and valuation arise in the event of the permanent disability or illness of an owner. If the disabled owner is incapable of handling his or her affairs, a third-party guardian will be appointed who will then be responsible for asserting ownership rights in the business. As in the case of death, owners would have an interest in receiving fair value for their ownership interest in the event of permanent disability or illness, a time when the need for funds could be the most extreme.

Dissatisfaction

The third "D" is the dissatisfaction of one of the owners in retaining his or her interest in the business. This could be caused by negative factors, such as disagreements among the

owners, the failure of other owners to contribute necessary investments to keep the business operating, or inappropriate or detrimental practices of other owners. However, it could also be due to factors that would not be perceived as negative, such as the desire by an owner to retire or relocate. All business owners should consider the possibility that a co-owner may want to leave the organization at some point, or that circumstances could arise in which the behavior of a co-owner dictates his or her removal. Mechanisms for redeeming or selling an ownership interest in these instances should be set forth in an agreement.

The terms for consideration in the event of death, disability or dissatisfaction of an owner are: 1) whether the company and remaining owners shall be obligated to redeem or purchase the interest, or whether they will simply receive an option to do so; 2) whether the disabled or withdrawing owner, or the heirs of a deceased owner, shall be obligated to sell their ownership interest to the company or remaining owners, or whether they will reserve the right to retain the interest; 3) the methods to determine the value of the interests in each circumstance; and 4) the mechanisms for payment.

The value of an owner's share can be determined by a number of methods. The owners could set a value at the beginning of the organization's existence, and then periodically review the financial performance of the company and adjust the valuation, perhaps annually. This could be done with or without the aid of accounting or financial consultants. Another valuation method is by the use of a formula, such as by applying an owner's percentage interest to the fair market or book value of the company's assets at the time of the triggering event, or by applying a multiple to the average gross revenues or net profits of the company over a predetermined period of time. Consistent, periodic determinations of valuation are also helpful in establishing the value of a deceased owner's interest for inheritance and estate tax purposes.

It is also possible to set forth alternative valuations based on the action triggering the redemption or sale. For example, the owners may determine that in the event of the death or disability of an owner, the full value of their ownership interest would be paid, but that a penalty would apply in the event of an owner's voluntary or involuntary surrender of their interest.

As stated, in the cases of death and disability, an organization may purchase insurance to protect against economic loss and fund a redemption of the deceased or disabled owner's interest. However, insurance may not be a viable option if one or more of the owners is uninsurable or the insurance is too costly. Further, insurance products would not provide funds for a redemption or sale resulting from the voluntary or involuntary withdrawal of an owner. Therefore, the applicable agreement should set forth payment terms that reflect the organization's or remaining owners' ability to pay.

Effective planning for the "Three D's" should not be overlooked, even by small, closely-held entities. Experienced legal counsel can help develop a plan, and financial and insurance consultants can supply products to carry it out.

About the Author

Anthony R. Sosso, Jr., is an associate attorney with the firm. He practices in the areas of corporate, employment, real estate and family law. Mr. Sosso received his undergraduate degree with distinction from George Washington University, and his law degree cum laude from Duquesne University. He has co-authored two publications on legal guardianship programs for abused and neglected children, "Subsidized Legal Guardianship, A toll to Obtain Permanency for Children Placed in Kinship Care," and "Subsidized Legal Guardianship Update."

EQUITABLE DIVISION OF PROPERTY RECEIVED BY GIFT OR INHERITANCE

By Laine Alee O'Mara, Esquire

Pennsylvania law provides for the equitable division of marital property upon divorce or annulment whereby all "marital property" is divided between the parties in a proportion, not necessarily 50-50, as deemed equitable by the court. Marital property generally includes all property acquired by either party during the marriage and the appreciation on property acquired prior to marriage. A presumption exists that all property acquired by either party during the marriage is marital property. On the other hand, property acquired by gift, bequest, devise or descent is generally considered nonmarital property and is exempt from equitable distribution upon divorce or annulment. However, this is not an absolute rule, and in certain circumstances nonmarital property acquired by gift or inheritance will become marital property and will be subject to equitable distribution.

For example, in *Gruver v. Gruver*, 539 A.2d 395 (1988) the husband deposited \$4,904 which he had inherited from his grandfather together with \$96 of joint funds which he owned with his wife, into a certificate of deposit account in their joint names. The Pennsylvania Superior Court held that the entire \$5,000 certificate of deposit was marital property and was subject to equitable distribution, rather than just the portion of the certificate of deposit that was purchased with joint funds.

In reaching its decision in *Gruver*, the court relied on the prior case of *Madden v. Madden*, 486 A.2d 401 (1985). In that case the husband cashed certain saving bonds that he had received as a gift from his mother and bought new savings bonds and titled them in joint names with his wife. After problems arose between the couple, the husband cashed the jointly owned bonds and placed them into a certificate of deposit in his name alone. The court held that the certificate of deposit in his sole name was marital property because the money had lost its status as an excludable gift when it was placed in joint names.

Similarly, in *Bold v. Bold*, 516 A.2d 741 (1986), the Superior Court held that the wife had changed the status of inherited property when she placed it into a joint account with her husband. Following the *Gruver* decision, the Superior Court in *Verholek v. Verholek*, 741 A.2d 792 (1999), held that a husband's inheritance was marital property, both because the inherited funds were co-mingled with marital funds and because the husband, through his actions, apparently did not consider the inherited funds to be separate, non-marital property.

Thus, despite the general rule that property received by gift or inheritance is nonmarital property and is not subject to equitable division on divorce, such property may become "marital property" subject to equitable division upon divorce if the parties co-mingle such property with marital property or otherwise are found to have treated the property as other than separate, non-marital property.

About the Author

Laine Alee O'Mara is an associate attorney with the firm. Ms. O'Mara is a 1992 graduate of Babson College, where she earned her bachelor's degree in Finance and Quantitative Methods. She received her law degree from the University of Pittsburgh in 1998 and is currently practicing in the areas of litigation and corporate law.

WHAT IS INTELLECTUAL PROPERTY?

Until recently, it seemed that only authors, inventors, and corporations and their lawyers had any occasion to encounter intellectual property laws. With computer technology and the Internet available to practically everyone, these laws and their protections have become much more relevant, making it worthwhile to have some knowledge of the subject. "Intellectual property" involves three major areas: patents, trademarks, and copyrights.

Patents

A patent is the grant of a property right by the federal government to an inventor. A patent lasts 20 years from the date on which the application for it was filed. A patent gives "negative" rights to its owner. Instead of the right to make, use, sell, or import an invention, a patent is the right to exclude others from these activities.

A person who "invents or discovers any new and useful process, machine, manufacture, or composition of matter, or any new and useful improvement thereof, may obtain a patent." Collectively, the items that can be patented encompass most man-made products and the processes for making them. "Usefulness" means having a useful purpose and, in the case of a machine, being operable for the intended purpose. The subject of a patent must be nonobvious. "Nonobvious" means that the invention is different enough from

existing technology and knowledge that it would not be obvious to a person with skill in the field.

Our courts have set the limits on what can be patented, excluding laws of nature, physical phenomena, and abstract ideas. A patent can be granted for a new machine, for example, but not on the idea or suggestion of the new machine. A complete description of the subject matter for which a patent is sought is a required part of the patenting process.

Trademarks

A trademark is a word, phrase, symbol, or design, or a combination thereof, that identifies and distinguishes the source or origin of goods or services. A service mark is like a trademark except that it refers to a service instead of a product. Trademark rights can be used to prevent others from using a confusingly similar mark but not to prevent the making of the same goods or selling such goods under a nonconfusing mark.

The filing of a registration application with the federal Patent and Trademark Office is one way to establish rights in a mark, but rights also can arise simply from the actual use of a mark. There are greater benefits from registration, however, such as a presumption that the owner of the registered mark is, in fact, its owner and is entitled to use it across the country. Unlike patents and copyrights, trademark rights can last as long as the trademark is used to identify goods or services, although the registration must be renewed every 10 years and certain information must be filed with the government to keep the registration alive.

Copyrights

A copyright protects the writings of an author of "original works of authorship" from unauthorized copying. Published and unpublished works of a literary, dramatic, musical, or artistic nature are protected by copyright law. Copyrights are registered in the Copyright Office in the Library of Congress, but a copyright is secured automatically when the work is fixed in a copy or phonorecord for the first time.

Federal law gives the owner of a copyright the exclusive right to do, or to authorize others to do, the following things: reproduce the work in copies or phonorecords, prepare derivative works, distribute copies or photorecords to the public, perform the work publicly, display the work publicly, and, for sound recordings, perform the work publicly by means of a digital audio transmission. Generally, any work created after January 1, 1978 is protected for the author's life, plus 50 years.

A LUCKY MULLIGAN

An advertisement for a golf tournament offered a \$10,000 prize for making a hole-in-one on the first hole. To raise money above and beyond the entrance fee, the tournament also

sold mulligans, which are extra shots usually taken after a particularly bad shot. One participant bought a mulligan and used it on the first hole when his first shot did not end up in the cup. For this golfer, practice made perfect, as the second attempt was a hole-in-one.

When the prize winner went to collect, the tournament refused to pay and the dispute ended up in court. The tournament organizers argued that the prize was only available for a regular shot, not a mulligan. The court was not persuaded because the golfer was never informed that he could not use the mulligan he bought to go for the big prize. When the tournament made an offer to each golfer to pay the \$10,000 prize, the only term to be met was that a golfer hit a hole-in-one on the first hole. When a participant satisfied that term, whether or not with a mulligan, the tournament became contractually obligated to pay the prize.