

# THE FORM OF ORGANIZATION FOR SMALL BUSINESS

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Story has it that, as they sat in the smoking compartment of a California-bound Pullman, someone inquired of the late P. D. Armour, then at the height of his financial success, whether a certain Mr. X was a very rich man and the following exchange took place. Armour: "No, I wouldn't say that. I believe he's in comfortable circumstances." Inquirer, persisting: "But, I understood he had made a great deal of money recently and had become very wealthy. How much would you say he was worth?" Armour: "I don't know; I suppose two or three millions." We can better grasp this point of view by carrying the probable ratio from these gentlemen down into smaller figures. To the storekeeper with twenty-five or fifty thousand in his emporium, the drayman with two or three thousand in a couple of trucks is not an impressive business figure; nor to the salesman out on a moonlight excursion with twenty-five to fifty dollars in his pocket, is the college instructor with two or three in his. If someone could define small business in some non-arbitrary fashion, one not just for the purpose of determining the catch of some statistical net, it might be helpful. But, of course, no one can do any such thing. Probably Armour and Company, even with only its 45,000 stockholders compared with Pennsylvania's 200,000 and A. T. & T.'s 650,000, would by any present test not be small business.

Professor Ketchum has complained that most of the classifications used are too rigid and lack recognition of the size differences in different industries. Under such classifications, says he, there will be no such thing as small aluminum plants or large barber shops.<sup>1</sup> The oft-mentioned Department of Commerce definition<sup>2</sup> (manufacturers with one hundred or less employees, wholesalers with an annual volume of \$200,000 or less, and retailers with \$50,000 or less—thought by some to

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<sup>1</sup> Ketchum, *The Financial Problems of Small Business* (1944) 17 JOUR. OF BUS. 67.

<sup>2</sup> Quoted in statement of Mr. Geo. Seedman, Pres. Am. Bus. Cong., in *Hearings before the Special Committee to Study and Survey Problems of Small Business Enterprises* (Senate) 77th Cong., 2nd Sess. (1942) part 9, p. 849. (Hereafter cited *Sen. Hrgs. Sm. Bus. 77-2*.) See also TEMPORARY NAT. ECON. COMM. MONOGRAPH 17, PROBLEMS OF SMALL BUSINESS, 76th Cong., 3rd Sess. (1941) 247, 283-285 (hereafter cited as T. N. E. C. MON. 17); *The Anatomy of British Industry* (1945) CXLVIII ECONOMIST (London) 251, summarizing paper by Leak and Maizels. "They draw the line between small and large business units arbitrarily but with some justification at 500 employees, e.g. units employing between 11 and 499 persons are small ones and units employing 500 persons or more are large ones."

be too conservative)<sup>3</sup> falls in the range of this criticism.<sup>4</sup> So far as the present paper is concerned, though not at all limited to the smallest of small business, the analysis herein is likely to be best applicable to concerns down towards the "Mom and Pop" size<sup>5</sup>—to the starting businesses of returning soldiers<sup>6</sup>—than to those in the upper ranges of small business as above defined.

Summer 1945 seems no time to perpetrate unnecessary questionnaires or surveys, yet it appears worthwhile to know something of what small businessmen themselves think when the question of form of organization is before them for decision, so a few small town lawyers and retailers were turned to.

First in the weight of stimuli to incorporate, said they without exception, is the matter of personal liability.<sup>7</sup> Tax advantages in partnership? Yes, but that is of little consequence in the early stages and in small concerns; and it can be taken care of in salaries to incorporator-officers. The factor of survivorship gets only occasional serious thought from small business people thinking of incorporating. We shall here consider these matters in the order just indicated.

### I. PERSONAL LIABILITY

The normal rule is of course complete personal liability for partners, and members of joint stock associations;<sup>8</sup> entire non-liability for shareholders in corporations.<sup>9</sup> To this there are important but, to most enterprisers standing at the fork of decision, probably not controlling, exceptions. Double or pro-rata liability has sometimes been the statutory accompaniment of shareholding, not just in banks but in all corporations.<sup>10</sup> This special hazard has gone, however, with revised and modernized general corporation laws and appears to be on the way out even as to banks.<sup>11</sup> Another liability, however, of a related but narrower character is defi-

<sup>3</sup> Testimony of Mr. Wm. B. Basile, Gen. Counsel Conference of American Small Business Organizations, Inc., *Sen. Hrgs. Sm. Bus. 77-2*, *supra* note 2, at part 9, p. 863: "We do not believe a manufacturer who employs 500 employees is large" . . . if it is "a business which does not have a national tie-up."

<sup>4</sup> See also, Mr. Paul A. Polson, Vice-Pres., The Polson Rubber Co., *Sen. Hrgs. Sm. Bus. 77-2*, *supra* note 2, at pt. 2, p. 438, that a manufacturer doing over a million and a half of business annually is "very small" as compared with his four huge competitors; Mr. Stanley J. Cummings, Exec. Secy. Natl. Assn. of Uniform Mfrs., *id.* part 10, at 1099, 1104 that the number of employees per concern in his industry runs from 2 to 250, averaging 75 and that one with 250 "is considered a giant."

<sup>5</sup> The expression of Prof. Theo. N. Beckman, *Post War Problem Number One for Small Business: Urgent Need for Loans and Risk Capital*, SMALL BUSINESS: ACCESS TO CAPITAL, Sen. Comm. Print No. 15, 78th Cong., 1st Sess. (1943) 29.

<sup>6</sup> Seven percent of them according to Army Statistics. See *supra*, this symposium, Myers, *Small Business for Veterans*, p. 344.

<sup>7</sup> Thereby simply repeating and confirming what has commonly been asserted heretofore. See *e.g.* I COOK, CORPORATIONS (8th ed., 1923) 44, quoting speech of Pres. Eliot of Harvard.

<sup>8</sup> CRANE, PARTNERSHIP (1938) 2, 118. Cf., however, W. VA. CONST. Art. II, sec. 2 as to joint stock companies.

<sup>9</sup> I FLETCHER, CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS (perm. ed.) §14.

<sup>10</sup> *Id.*, at §§6276-6279.

<sup>11</sup> BALLANTINE AND STERLING, CALIF. CORP. LAWS (1938) §113. As to banks, see *e.g.* Mich. Pub. Acts (1937) No. 341, §59; MISS. CODE ANN. (1942) §5266; 7 P. S. (PA.) §§819-614; TENN. CODE (Wms. 1941) §5927; WIS. STAT. (1943) §221.42(2); WYO. REV. STAT. (SUPP., 1940) §§10-508A to 508C. The bank liability is rooted in the constitutions of Illinois, Nebraska, Ohio, South Carolina, South Dakota, Texas, Utah, Washington and West Virginia, however. As to national banks see 12 U. S. C. A. §§51(b), 63. See also (1935) 13 N. C. L. REV. 357.

nately not on the way out. It is the statutory liability of shareholders for wage claims which is found in varying severity in a number of states.<sup>12</sup> Considering the constant recurrence and proportionately heavy weight of wage claims in most businesses, this item is perhaps the nearest thing to a risk equalizer in the set-up of corporations as compared with partnerships in these states.

Another far less specific risk of personal liability for business charges notwithstanding incorporation crops up in the rules about disregarding the corporate entity. Where this is done by statute as in the wage claim laws just mentioned it amounts to an indirect modification of the corporation law and the rights conferred by it. And this is probably true in a realistic sense even if the disregarding statute is one of a different government as *e.g.* a Federal statute ignoring, in furtherance of some federal policy, the separate corporate existence of a state-created corporation.<sup>13</sup> When there is no such statute the same thing may come about from judicial decision when the corporate form is being used for some fraudulent or evasive purpose.

Many of the cases where the corporate organization is thus disregarded and the controlling stockholders dealt with as the real party in interest (to borrow a phrase from another legal area) are concerned with monopoly, rate regulation, taxation, jurisdiction of local courts and other situations and problems equally remote from that before us,<sup>14</sup> which is whether the corporate organization effectually and universally insulates the controlling stockholders from liability to the corporate creditors. For the most part it can be said that the corporate organization does so insulate. That is as might be expected in view of the general idea that freedom from personal liability is the very essence of incorporation statutes. Some cases go a long way toward preserving that insulation even where the controlling stockholder has sought to risk little by the device of small capital and large debt and even where the enterpriser has given himself a preferred position to other creditors by taking security for a large part of his investment.<sup>15</sup> But there has been growing dissatisfaction with so extended an application of the doctrine to shield schemers<sup>16</sup> especially if the claimants are tort or wage claimants.<sup>17</sup> Where the controlling stock-

<sup>12</sup> 5 MASS. ANN. L. (1933) c. 156, §35; MICH. CONST. Art. XII, §4, 20 MICH. STAT. ANN. §27.1363; N. Y. CONSOL. L. MCKINNEY, Bk. 58, §71; 13 P. S. (PA.) §351; WIS. STAT. (1943) §182.23; 13 FLETCHER, *op. cit. supra*, note 9, at §6282.

<sup>13</sup> See Public Utility Holding Company Act of 1935, 15 U. S. C. A. §79 *et seq.* There is no necessity for thinking of this as disregarding the corporate entity but it is the habit to do so.

<sup>14</sup> United States v. Milwaukee Refrigerator Transit Co., 142 Fed. 247 (E. D. Wis., 1905); Palmolive Co. v. Conway, 43 F. (2d) 226 (W. D. Wis., 1930); Industrial Research Corp. v. General Motors Corp., 29 F. (2d) 623 (N. D. Ohio, 1928). See generally, LATTY, SUBSIDIARIES AND AFFILIATED CORPORATIONS (1936) ch. III, p. 41 *et seq.*

<sup>15</sup> Salomon v. A. Salomon & Co. [1897] App. Cas. 22; Finn v. Geo. T. Mickle Lumber Co., 47 F. (2d) 676 (C. C. A. 9th, 1930); Hanson v. Bradley, 298 Mass. 371, 10 N. E. (2d) 259 (1937). See also Mannon v. R. A. Young & Sons Coal Co., — Ark. —, 179 S. W. (2d) 457 (1944), where the case went off on the statute of limitations but the court pays respectful attention to the separate entity. Counsel had urged that the subsidiary was deliberately undercapitalized and kept in "a near insolvent condition" to evade payment for injuries to employees.

<sup>16</sup> See *e.g.* LATTY, *op. cit. supra* note 14, at 120. Cf. similar attack on the device of irresponsible independent contractors, note 41, *infra*.

<sup>17</sup> *Id.* at 204.

holder is another corporation the assault has pierced the defenses in a number of cases. The claims of the dominating parent for loans, etc., have been subordinated to those of general creditors<sup>18</sup> and in some instances the parent has been held liable directly for the obligations of its subsidiary on grounds, really, of unfairness,<sup>19</sup> *i.e.*, trying to stretch corporate insulation too far. While most of these holdings have been cases of dominant corporate stockholders and not those of individuals having similar control, the criticism of undercapitalization and milking has not been limited to situations of intercorporate financing and it would probably be wiser to say to the new venturer: "So long as you play fair in your capital set-up and don't seek to get the speculative gains of ownership and at the same time the security and priority which outside lenders might be expected to ask, you are safe under the shield of corporate entity; on the other hand, if you incorporate with a minimum of capital stock,<sup>20</sup> and then supply the remaining necessary capital yourself by lease or sale with mortgage back or day to day loans, you shouldn't be surprised if these guarded investments were likewise treated as risk capital within the reach of creditors, especially tort and wage claimants." Which is not at all to say that the little man who puts in his mite of risk capital and then succeeds in getting big loans from outside will be held personally liable for the obligations of the corporation which he has in good faith organized.

Subject to the limitations above indicated, individual stockholder liability *via* the disregard route seems not very much of a probability or an equilibrizing factor in weighing the corporate and partnership advantages. Corporate insulation is for the most part, in the situations that concern us, an effective reality.

Before the incorporator of small business closes his calculations he should be cognizant of one practical business factor which tends to saddle individual liability on the incorporators of small business. As one small banker put it, "If the corporate statement is good enough we will loan to it without indorsement but if not we'll have to have the individuals on the note." In this state of circumstances the shareholder's insulation from liability for ordinary business expenses in a corpora-

<sup>18</sup> And even to preferred stockholders under the special facts disclosed in the now famous "Deep Rock Case." *Taylor v. Standard Gas Co.*, 306 U. S. 307 (1939), noted (1939) 24 CORN. L. Q. 587; (1941) 54 HARV. L. REV. 1045; (1939) 34 ILL. L. REV. 94; (1939) 38 MICH. L. REV. 88. Cf. *Franklin Process Co. v. Western Franklin Process Co.*, 308 Ill. App. 302, 31 N. E. (2d) 364 (1st Dist. 1941) (leave to appeal denied) where the court said creditors must have suffered "some special injury" by reason of the acts of the parent. Approved as constituting a welcome, if uncertain, improvement on the instrumentality test. Note (1941) 36 ILL. L. REV. 229, following Latty's approach.

<sup>19</sup> *Chesapeake Stone Co. v. Holbrook*, 168 Ky. 128, 18 S. W. 953 (1916); *Louisville & Nash. R. R. v. Carter*, 226 Ky. 561, 10 S. W. (2d) 1064 (1927), bankrupt subsidiary called a sham. See also *Christian & Craft Grocery Co. v. Fruitdale Lumber Co.*, 121 Ala. 340, 25 So. 566 (1899); *Home News v. Goodman*, — Md. —, 35 A. (2d) 442 (1944); *Gordon v. Hartford Sterling Co.*, 350 Pa. 277, 38 A. (2d) 229 (1944). Cf. *Mannon v. R. A. Young & Sons Coal Co.*, *supra* note 15.

<sup>20</sup> There is generally no fixed minimum. Some states require a specified capital as a condition to commencing business. See, e.g., 15 MICH. STAT. ANN. §21.4 (\$1,000). Considering that the legislatures usually fix rather substantial capital requirements for banks, it can be argued that no such policy exists as to private corporations generally. On the other hand, the difficulty of setting a figure for corporations generally is impressive.

tion with small capital will for the most part extend only to those incurred on open account.<sup>21</sup>

Businessmen's freedom from liability when they choose incorporation therefore seems legally to be about what they suppose it to be but practically somewhat less because of the frequent demands of banks and others for supplemental personal guaranties.

When it comes to the corresponding question as to partnerships, there are various devices for limiting liability which may or may not be satisfactory. Thus, it is possible for the capitalist "partner," within limits, to avoid liability for the firm's obligation, even though he stipulates for a share of the profits as his return rather than for a fixed interest charge on the money (or other property) "loaned." In case of organizers, one or some of whom have no desire to be active in the business but want a speculative interest in the earnings, this set-up might fill the bill well enough, though more often perhaps all the organizers want like insulation and would veto this arrangement which only provides it for the willingly inactive investor. Uncertainties creep in anyway when the so-called lender begins to take a hand in the running of the business either to protect his loan or to improve the earnings so as to augment his return,<sup>22</sup> and the Uniform Partnership Act now adopted in twenty-four states,<sup>23</sup> while recognizing a class of liability-free lenders of capital for a share of profits, does little<sup>24</sup> toward determining when one ceases to be such a lender and becomes a personally liable participant in the partnership. After recognizing co-ownership of the business as an essential feature and declaring that the receipt of a share of the profits is *prima facie* evidence that one is a partner, that *prima facie* case is dispelled when the profits are received as fluctuating interest on a loan.<sup>25</sup> The difficulties of prediction under this set of rules are numerous and obvious<sup>26</sup> but the old common law hazard of partnership liability from merely receiving a share of the profits, and that alone, is destroyed and there is case authority that a veto right as distinguished from reserved power of affirmative direction will not enmesh the lender in the partnership and its personal liability.<sup>27</sup> Much the same doctrines apply to a limited partner as to a lender for a share of the profits. Under the Uniform Limited Partnership Act, now in force in twenty-seven states,<sup>28</sup> unintended technical slips or misrepresentations in connection with filing the required notices, etc., no longer submit him to individual liability except in favor of

<sup>21</sup> Thus perhaps most often sticking other small businesses rather than banks and the big fellows who call for statements and procure credit reports.

<sup>22</sup> *San Joaquin Light & Power Corporation v. Costaloupes*, 96 Cal. App. 322, 274 Pac. 84 (1929); *Southern Can Co. v. Saylor*, 152 Md. 303, 136 Atl. 624 (1927).

<sup>23</sup> 7 UNIFORM LAW ANN. (SUPP. 1944) 6.

<sup>24</sup> And perhaps for flexibility, should do little, although Prof. (now Mr. Justice) Douglas sought to introduce a degree of certainty by the tests in his article, *Vicarious Liability and Administration of Risk* II (1929) 38 YALE L. J. 720.

<sup>25</sup> UNIFORM PARTNERSHIP ACT §7; 7 U. L. A. 13.

<sup>26</sup> Note (1941) 19 N. C. L. REV. 499.

<sup>27</sup> *Martin v. Peyton*, 246 N. Y. 213, 158 N. E. 77 (1927).

<sup>28</sup> 8 U. L. A. (SUPP. 1944) 6.

those actually misled to their detriment.<sup>29</sup> And the more or less specific rights of inspection, etc., which are conferred upon him,<sup>30</sup> and the right of control which is expressly denied to him,<sup>31</sup> are the rough equals of like rights and disabilities of the share-taking lender under the general partnership act. So nearly do these approximate each other as far as may be determined, that one prominent authority was moved to write an article questioning the need for limited partnerships at all.<sup>32</sup> The significance of the differences which exist and which might be of interest to those considering the partnership form of organization and so are of interest to this comment seem to be these:

In states where the Uniform Partnership Act has not been adopted and there remain vestiges of the old take-the-benefits-take-the-responsibilities doctrine<sup>33</sup> one may justifiably feel safer in going through slightly bothersome statutory formalities and having a specifically recognizable legislative cloak than playing with the seemingly greater uncertainties of only a "modern-trend" common law protection. That points to a choice of the limited partnership. On the other hand, there is the argument that since the Uniform Limited Partnership Act not only denies the right to participate in control (a vague concept) but lists certain rights of him who would be a limited partner,<sup>34</sup> it may well be held that the listed rights are the measure of his safe activities and are less than those already recognized for a lender to a general partnership.<sup>35</sup> It is to be doubted whether such a rule ought to or will prevail but to people teetering toward a decision, an uncertainty may sometimes take on the force of an unfavorable certainty.

Something not strikingly different from the protection afforded by the inactive arrangements just reviewed is to be found in the so-called subpartnership. One writer in 1930 concluded that in a majority of American jurisdictions an outsider could remain an outsider and yet participate in partnership X Y Z's profits by forming a subordinate partnership with X under which he would participate in X's share of profits (and losses).<sup>36</sup>

There were logical difficulties, and perhaps objections of policy, to these cases which would suggest caution in adopting the subpartnership as a shield to liability. And while more recent cases cast no further doubts, they have involved other questions than liability<sup>37</sup> and give no further assurance on that matter.

So much as to the devices for erecting a protecting cover over one or more individuals who participate at arms' length in financing a partnership but which do not provide limited liability for the active members. There are other means for ex-

<sup>29</sup> UNIFORM LIMITED PARTNERSHIP ACT §6.

<sup>30</sup> *Id.* §10.

<sup>31</sup> *Id.* §7.

<sup>32</sup> Crane, *Are Limited Partnerships Necessary?* (1933) 17 MINN. L. REV. 351.

<sup>33</sup> *Waugh v. Carver*, 2 H. Bl. 235, 126 Eng. Reprint 525 (1793).

<sup>34</sup> U. L. P. A. §10.

<sup>35</sup> Note (1936) 45 YALE L. J. 895.

<sup>36</sup> Rowley, *Risk Evasion through Subpartnership* (1930) 30 COL. L. REV. 674.

<sup>37</sup> *E.g.* *Silberfeld v. Swiss Bank Corp.*, 41 N. Y. Supp. (2d) 470, 266 App. Div. 756 (2d Dept. 1943), subpartner's right to accounting.

tending that shelter over all the participants, even the active managers. Some of the more obvious which have no special significance for partnerships will not be dwelt upon. There is, of course, insurance, a protection against liability springing from automobile and plant operation, workmen's compensation risks, responsibility in case of forgery, risk of loss from embezzlement, etc. So far as can be learned there is no such thing as coverage generally against the risk of the failure of the business and the liability for the obligations saddled upon it by the poor management of the partners. If such coverage were to be had, the premium cost could hardly be anything but prohibitive considering the mortality rate of small business.<sup>38</sup> Instead of buying insurance one can entrust some of the more hazardous operations of the business to independent contractors<sup>39</sup> but that of course narrows the scope of the undertaking and whittles down the profit opportunities. And as to the protection itself, while the cases generally grant it even when an irresponsible contractor is employed<sup>40</sup> (and he is likely to be cheapest) there is not wanting evidence that a change to liability in such situations is in the making.<sup>41</sup>

Risk avoidance thus far considered has been of a sort expected to give partners part at least of the immunity enjoyed by members of business corporations. There remains a few situations where the shoe is on the other foot and the partnership can serve as a means of avoiding risks of costs which would be incurred by a corporation. Workmen's compensation coverage is generally not required of businesses with less than five employees. A business with five active working partners and four employees does not have five employees within the meaning of these statutes.<sup>42</sup> Nor would it have eight employees within the inclusion provision of some social security and unemployment insurance tax acts.<sup>43</sup> It is evident that the same number of workers for a corporation in which any or all of them were stockholders would put the business inside the respective acts mentioned.

In states having modest, and usually quite obsolete property exemptions, the specter of loss of home and family possessions is one of the strongest persuasions to incorporation. This dire hazard can be met in various ways. First, simplest and perhaps most effective is to vest title to the essentials of family life—home, furniture, etc.—in the partner's wife, or in the partner and his wife by the entirety so that the property is subject to seizure for the debts of neither.<sup>44</sup> This latter arrange-

<sup>38</sup> T. N. E. C. MON. 17, *supra* note 2, at Chs. 2-4.

<sup>39</sup> See e.g., *Brinks, Movers of Money* (June 25, 1945) LIFE 45.

<sup>40</sup> *Beach v. McLean*, 219 N. C. 521, 14 S. E. (2d) 515 (1941) contractor insolvent—workmen's compensation case.

<sup>41</sup> Steffen, *Independent Contractor and the Good Life* (1935) 2 U. CHI. L. REV. 501.

<sup>42</sup> *Dube v. Robinson*, 92 N. H. 312, 30 A. (2d) 482 (1943). Otherwise by statute in some states. 3 SCHNEIDER, WORKMEN'S COMPENSATION (perm. ed. 1943) §812. Cf. where partnership is organized to avoid compensation liability. Notes (1937) 12 WIS. L. REV. 219; (1939) 14 ST. JOHNS L. REV. 134.

<sup>43</sup> *Auten v. Michigan Unemployment Compensation Comm.*, 310 Mich. 453, 17 N. W. (2d) 249 (1945); 1 C. C. H. UNEMPLOYMENT INS. SVC. (Treatise) ¶¶153, 1250, 1344. On using separate business units in an effort to avoid this tax see Note, 142 A. L. R. 918. Cf. *Maryland Unemployment Compensation Bd. v. Albrecht*, — Md. —, 36 A. (2d) 666 (1944).

<sup>44</sup> This is the general rule but subject to modification in a few states. See TIFFANY, REAL PROPERTY (3rd ed., 1939) §434.

ment, however, exposes the partner to the risk of having title suddenly vested in him by the wife's death.<sup>45</sup> Furthermore, many states do not recognize estates by entirety in personalty<sup>46</sup> and an attempt to create such an estate will result in a tenancy in common,<sup>47</sup> making the husband's interest liable for his and partnership debts.

Since the capital of a partnership need not be property owned jointly by the partners nor partnership assets but may consist in the mere use,<sup>48</sup> or a lease,<sup>49</sup> of property owned by the partners individually, the husband can put into the partnership as his capital contribution (or a part thereof) the use of property held by him and his wife as tenants by the entirety, giving a lease to the partnership with favorable cancellation privileges. In some states this arrangement would not even require the cooperation of the wife as a husband is not only entitled to the rents and profits during coverture but can convey the possession during his life.<sup>50</sup> In other states, however, this exclusive right has been taken away by the married women's property acts.<sup>51</sup> In any event, if title to land used in partnership business and held by partner and his wife as tenants by the entirety is leased to the partnership, or the use contributed by the husband, the land itself would not be a partnership asset and would escape the grasp of partnership creditors even when they proceeded against the partner-husband's personal assets. This immunity, of course, would be destroyed if the wife joined in making notes for the partnership debts, as she might be required to do by a lending bank, for an estate by the entirety is liable for joint debts of husband and wife.<sup>52</sup>

Since partners may by agreement make any disposition of the firm assets that an individual can make of his property, subject to the principle that the transfer is not made to defraud creditors,<sup>53</sup> there would seem to be no reason why there might not be a bona fide division of the assets of a going concern between the individual partners with a transfer of title to realty to the partners and their wives as tenants by the entireties. If the new owners then leased the property to the partnership and the real estate were entered on the firm books under a lease account<sup>54</sup> it would no longer be partnership property and consequently the derivative equities of subsequent creditors would be at an end.<sup>55</sup>

<sup>45</sup> *Id.*, at §430.

<sup>46</sup> For various rules, see Note (1938) 117 A. L. R. 915.

<sup>47</sup> *Winchester-Simmons Co. v. Cutler*, 194 N. C. 698, 151 S. E. 622 (1927).

<sup>48</sup> *Champion v. Bostwick*, 18 Wend. 175, 31 Am. D. 376 (N. Y. 1837).

<sup>49</sup> *Bernheimer v. Schmid*, 36 Misc. 456, 73 N. Y. Supp. 767 (1901).

<sup>50</sup> *TIFFANY, REAL PROPERTY* (3rd ed., 1939) §435.

<sup>51</sup> *Ibid.*

<sup>52</sup> *Moore v. Greenville Banking & Trust Co.*, 178 N. C. 118, 100 S. E. 269 (1919). If, by signing a note the wife were held to be husband's surety and not a principal, this result would not follow in states which do not allow wife to contract as a surety for husband. *ARANT, SURETYSHIP* (1931) 33. Except that the land could not be sold for individual debts of either, where husband and wife are partners there would seem to be no advantage in holding property by the entireties.

<sup>53</sup> *In re Brewer*, 289 Fed. 79 (E. D. N. C., 1923). A husband and wife cannot, by investing his or her money in land, title to which is taken in himself and his wife as tenants by the entireties prevent the transaction from being attacked like any other conveyance as in fraud of creditors. 13 R. C. L. 1128; Note (1935) 96 A. L. R. 459.

<sup>54</sup> *Bernheimer v. Schmid*, 36 Misc. 456, 73 N. Y. Supp. 767 (1901).

<sup>55</sup> *In re Brewer*, 289 Fed. 79 (E. D. N. C., 1923).



One weak spot is always present in the transfer of title from one engaged in business to his wife or other near relative. Such a transfer would invite attack under the doctrine of fraud on creditors, either present or subsequent. This would be true even though some lesser interest in the property so transferred were put back into the partnership; indeed, suspicion might be heightened by this device.

At common law a voluntary conveyance to a wife or near relative in advance of embarking on some business enterprise involving risk in order to secure the property from the hazards of the business is good as to subsequent creditors unless made *with the intent* to incur debts and a design to avoid payment by such conveyance.<sup>56</sup> But such a transfer may itself be held to be some evidence of a fraudulent intent and each case must stand upon its own footing.<sup>57</sup> The impossibility of determining what finding a jury will make on the question of intent gives to this protective device a shadow of uncertainty that would have to be appraised as best it could be and weighed in the total calculations as a minor unfavorable factor in what the partnership style of organization has to offer the embarking enterpriser. In the seventeen states which have adopted the Uniform Fraudulent Conveyance Act, the matter is made to depend on whether or not sufficient capital is retained in the business.<sup>58</sup> "Unreasonably small" capital is the phrase. Slippery words, these, "unreasonably" and "small," but the statute beclouds the prospects even more than the Common Law for the enterpriser who hopes for protection from business hazard by the device of stripping himself in advance.

## II. TAX ADVANTAGES

Taxwise a corporation is not only treated as a separate personality but in the all-important income tax field it is not allowed to deduct from its taxable earnings sums paid out to stockholders as dividends as it may payments to bondholders for interest.<sup>59</sup> Herein lies probably the most striking difference in the tax situation

<sup>56</sup> *Neuberger v. Keim*, 134 N. Y. 35, 31 N. E. 268 (1892); *Stratton v. Edwards*, 174 Mass. 374, 54 N. E. 886 (1899); *Gately v. Kappler*, 209 Mass. 426, 95 N. E. 859 (1911); *Citizens' Trust Co. v. Eaves*, 5 Fed. (2d) 921 (C. C. A. 8th, 1925); *Cram v. Cram*, 262 Mass. 509, 160 N. E. 337 (1928).

<sup>57</sup> *Hagerman v. Buchanan*, 45 N. J. Eq. 292, 17 Atl. 946 (1889); *Vail v. Diamond*, 95 N. J. Eq. 97, 122 Atl. 623 (1923); *Westmoreland Guarantee Building & Loan Assn. v. Thomas*, 207 Pa. 513, 56 Atl. 1072 (1904); *Hildebrand v. Willig*, 64 N. J. Eq. 249, 53 Atl. 1035 (1903). See also discussions in 27 C. J. 521, 522, §§199, 200; 37 C. J. S. 962, §§134, 135; (1937) 43 W. VA. L. REV. 225; (1924) 37 HARV. L. REV. 489; (1928) 22 ILL. L. REV. 673.

<sup>58</sup> UNIFORM FRAUDULENT CONVEYANCE ACT, §5; 9 U. L. A. 357; 39 P. S. (PA.) §355; WIS. STAT. (1943) §242.05. An interesting comparison is §8 of the Uniform Act wherein, as to conveyance of partnership property, the key is insolvency.

<sup>59</sup> This matter is often thought of in a slightly different fashion, *i.e.* that the double taxation comes from taxing the corporate income to the corporation and the dividends to the shareholder. It is so considered later herein. An obvious effect of the rule is to discourage the use of equity capital. To meet the corporate tax saving maneuver of issuing a large proportion of bonds and a small amount of stock to its shareholders, some tax laws have restricted the deductions for interest paid. See N. C. GEN. STAT. (1943) §§105-143, where the indebtedness is to a parent or affiliate corporation. Cf. *Winstead, Can Corporations Deduct from Gross Income Dividends on Preferred Stock?* (1944) 23 TEX. L. REV. 39, arguing for an affirmative answer when the dividends are payable with or without earnings.

If the small-corporation organizers get the happy thought to put their investment in the corporation not as "equity capital" but as loans, so as to create a deductible expense from corporate income, they may be destroying insulation from personal liability. See Part I of this article.

between businesses conducted in the corporate and the partnership form.<sup>60</sup> Numerous studies have shown with striking unanimity that of recent years, and when both federal and state levies are considered, proprietors of business enterprises pay a substantial and increasing toll for the privileges and conveniences of the corporate form.<sup>61</sup> Several of these studies have taken one or more hypothetical situations and worked them through but the number of variables and frequent changes in rates make the specific figures useful only to a limited extent.

It is proposed here to point out the significant factors which operate to make greater or less the tax burden as it is felt ultimately at the pocketbook of the human beings who own the small business on which our interest centers. First there are the taxes imposed on corporations alone as a distinct class of taxpayer. Besides the original corporate obstetrical charges<sup>62</sup> which occur once only, there may be annually recurring franchise and capital stock taxes.<sup>63</sup> And there is the present federal excess profits tax with its extreme complications.<sup>64</sup> All such taxes add to the cost of doing business as a corporation because they are additional taxes. If the franchise tax is a substitute for an income tax, however, it properly belongs in the next group.

This other group is the taxes imposed both on corporations and on individuals, partners being only individuals.<sup>65</sup> Taxes of this sort are property, income, and business license taxes. In a legalistic sense these taxes are not only equitable but equal and uniform. They hit business enterprisers using the corporate form more heavily only because in a nonlegalistic sense the property and income taxes fall twice

<sup>60</sup> The corporation, of course, gets no personal exemption.

<sup>61</sup> Note (1939) 23 MINN. L. REV. 506, 511 reprinted with some additional comment in MATTHEWS, CASES AND MATERIALS ON AGENCY AND PARTNERSHIP (1940) 756-770, using an assumed store in Minnesota with \$50,000 of net income; Metzendorf, *A "Partner" or Incorporation* (1940) 37 COMMERCE 16 (Illinois situation); Best, *The Corporate Advantages of Corporate and Other Forms of Business Organization* (1940) PROC. WIS. BAR ASSN. 122; Klein, *Corporate v. Partnership Form of Doing Business* (1942) 20 TAXES 214 (New York examples); *Corporation versus Partnership*, 452 C. C. H. Standard Fed. Tax Rep. (hereafter cited C. C. H.) §1169.016 (several assumed cases—Federal taxes only); RESEARCH INSTITUTE OF AMERICA, PARTNERSHIP OR CORPORATION? (pamphlet, 1944) 4-11 (New York calculation). This last pictures the corporate form as the more economical in the assumed situations but this conclusion is upon the assumption that no dividends are paid and that there is no excess profits tax. More generally see Rabkin and Johnson, *The Partnership Under Federal Tax Laws* (1942) 55 HARV. L. REV. 909 (examines the tax situation on death of a partner and payments of income to his estate); Hansel, *Limited versus General Partnership for Close Corporations* (1938) 16 TAX MAG. 524; Note, *Taxability of Unincorporated Corporate Equivalents* (1944) 92 U. PA. L. REV. 296 (examines tax situation as to business trusts).

A monograph, "Form of Business Organization and the Tax Laws," by Chas. D. Hamel, has been announced for early publication by the American Bar Assn. Section on Taxation and the Practicing Law Institute.

<sup>62</sup> See, e.g., N. C. GEN. STAT. (1943) §§55-158, 55-159.

<sup>63</sup> See, e.g., N. C. GEN. STAT. (1943) §55-122. Federal and state stock transfer taxes have usually been noted also in the comparisons but they seem of small significance.

<sup>64</sup> 1 COORDINATORS' CYC. TAX SERVICE (1945 ser.) ch. 119. The old excess profits tax was not limited to corporations as is the present act. A \$10,000 exemption is now in effect and a new bill would increase this to \$25,000. See note 71, *infra*. The complete but simple Lasser Tables, showing corporate tax payments including excess profits taxes on various assumed average and current earnings figures, are published in (March, 1945) ADVERTISING AND SELLING 108, 110.

<sup>65</sup> Not universally. The delegated management partnerships with various corporate features under the law of certain states, e.g., Pennsylvania, are taxable as corporations. 453 C. C. H. §1846.

on the same economic interest. Thus, under property taxes, the corporation as a taxpayer is taxed on the property it owns—its assets—and the shareholder is likewise taxed on the property he owns including shares in the corporation though they derive their value from the same assets and only those assets. Often legislative concessions are made to the claim that this is economic double taxation and some credit is allowed the individual for property taxes paid by the corporation.<sup>66</sup> It is obvious that until that credit completely avoids the duplication, a partnership has a tax advantage, a matter which would have to be determined at a given date for each state. A corresponding and similar duplication exists in some modified form as respects income taxes with again a strong probability that the partnership will be found to have the advantage.<sup>67</sup>

There are some countervailing circumstances here, real or apparent, that need to be noted. First of all, ignoring the excess profits tax, corporate income taxes are graduated, if at all, much less steeply than are those on individuals. In a small but active and growing corporation which could, on that account, show adequate reason for retaining a large part of its profits in the business,<sup>68</sup> a principal stockholder who, because of large outside income was in high tax brackets, would avoid receipt of income taxable at a very high rate and the only income tax then payable would be that by the corporation at a much more moderate rate. Had the business been a partnership the individual would have been taxable on his share whether or not he received it. This advantage is not likely to be relevant to the situation of most of the smaller small businessmen. But even where it applies it is a somewhat illusory advantage because the accumulated gains in the corporate treasury will come to book at a later day and, unless then offsetable against losses, may yield their full toll.<sup>69</sup>

It has been remarked that among the organizers of really small business (the returning soldiers and their five-thousand dollar garage, for example) there is a general notion that taxes on corporation income can largely be avoided by paying the earnings out as salaries to the principal stockholders. There seem to be two possible grounds for that belief. First, though the law will recognize salary deduc-

<sup>66</sup> See, e.g., N. C. GEN. STAT. (1943) §105.203. On the constitutional question presented see *Person v. Board of State Tax Comrs.*, 184 N. C. 499, 115 S. E. 336 (1922).

<sup>67</sup> As to states having no individual income tax the partnership advantage is obvious but the matter is more properly in the first group above.

<sup>68</sup> And so avoid the tax on undistributed profits. 452 C. C. H. ¶677.023. The uncertainty as to when profits may be so retained tax free has been described by Heninger, *Federal Taxation of Corporate Surpluses* (1943) 28 I.A. L. REV. 639, as follows: "It is absolutely impossible for a corporate executive to determine in advance or even after the close of the taxable year whether the company is subject to the tax." See also 1 COORDINATORS' CYC. TAX SVC. (1945 ser.) 7; Vickrey, *Proposals for a Reasonable Undistributed Profits Tax* (1945) 23 TAXES 122.

<sup>69</sup> This statement hedges because under certain circumstances they will not yield their full toll. The stored up earnings may come to him later as a capital gain either through later sale of his stock at an advanced figure or through liquidation of the corporation and distribution to him of corporate assets. In either case he would be taxable at a lower rate than he would have been on current dividends. Death of the stockholder would produce still more striking tax consequences because of the rule that the heirs take as their basis not the value to the original stockholder but the value at the date of his death or one year thereafter. INT. REV. CODE §113(a)(5); 452 C. C. H. ¶773.

tions from corporate income as business expense only if the salaries are reasonable,<sup>70</sup> it is possible that the earnings paid out are not high when compared with what the stockholder-officer would earn working for another in a somewhat similar capacity, especially when he is a working officer in a business whose earning power springs more from services than from investment. He may even be paying for his independence by definitely lower earnings. Second, it is more than likely that many very small corporations are "getting away with" payments which would not pass a scrutiny such as is applied to their larger corporate neighbors. Every one of the thousands of returns cannot have the same exact inspection. If this suspicion is a fact, we are having already a non-uniform, and perhaps a partially intentional, administrative concession to small business comparable to some of the concessions we seem on the way to getting through proposed legislation.<sup>71</sup>

The tests of reasonableness applied when an issue is actually made of the matter have been given as these:<sup>72</sup> (1) is the payment in fact salary or other compensation; (2) have personal services been actually rendered; and (3) is the payment reasonable when measured by the amount and quality of the services performed with relation to the business of the particular taxpayer?

There is a considerable degree of unpredictability here as to actual results<sup>73</sup> but instances can be found of rather sharp cutting of salary deductions even in what would be regarded as the moderate range—reductions, for example, of from \$8,000 to \$900, and from \$5,200 to \$2,400 (commissioner allowed only \$1,200), and in another instance from \$10,000 to \$5,000.<sup>74</sup> That such a ruling, if applied to a small corporation, might produce a rather disconcerting increase of tax can be demonstrated by figures for our hypothetical garage corporation with \$5,000 of capital in-

<sup>70</sup> INT. REV. CODE §23(a)(1); 451 C. C. H. ¶161.

<sup>71</sup> Report No. 1 of the Joint Committee on Internal Revenue Taxation, May 11, 1945, proposing a specific exemption of \$25,000 for excess profits tax instead of the present \$10,000. It was said that this would relieve 12,000 small corporations entirely from the burden of the tax. (May 16, 1945) 32 C. C. H. Std. Fed. Tax Rep. III, 3. The early repeal of this tax has been widely urged but that would help big corporations as well as little ones, as would the repeal of "double taxation" of income also currently demanded. Mr. Altman calls for the removal of the "Siamese Twins," capital stock tax and declared value excess profits tax which he condemns as being especially trying to small business. *Post War Tax Revision* (Jan., 1945) 23 TAXES 22, 26. See similar recommendations of the Small Business Advisory Committee appended to King, *Relation of Federal Taxation to the Financing of Small Business*, *supra*, this symposium, 371 at 380.

<sup>72</sup> Bruce H. Johnson at Indiana Bar Assn. Round Table Meeting (1944) 20 IND. L. J. 83, adding practical advice. Cf. five factors listed in Miller, *What the Tax Court Wants to Know in a Reasonable Compensation Case* (May, 1945) 79 J. OF ACCOUNTANCY 366. There is a strong presumption in favor of the commissioner's decision. See also Simon, (1944) 22 TAXES 200; Griswold, (1943) 66 N. J. L. J. 289.

<sup>73</sup> "The amount to be deducted cannot be determined from a definite test; it is but a matter of personal opinion and taste," 1 COORDINATORS' CYC. TAX SVC. (1945 ser.) 289.

<sup>74</sup> 1 COORDINATORS' CYC. TAX SVC. (1945 ser.), §§106.05, 106.07. See also 451 C. C. H. ¶161 and annotations, especially ¶161.269 as to greater strictness in dealing with wartime increases. On the other hand, if increases are approved by the appropriate authority under salary and wage stabilization, that would be persuasive, though inconclusive, evidence of the reasonableness of the deduction. Johnson, *op. cit. supra*, note 72, at 84.

vested by two returned veterans and a net of \$8,500 before paying \$4,000 to each of the two proprietor stockholders.<sup>75</sup>

(The figures in Column 1 are on the assumption that the full \$8,000 paid as salaries to two stockholders is allowed as a deduction. Those in Column 2 on the assumption that, though the full amount is paid, only \$5,000 is allowed and that unexpected increases in the taxes result.)

	Col. 1	Col. 2
Investment (capital stock) .....	\$5,000	\$5,000
Net before salaries and income taxes .....	8,500	8,500
Payments made as salaries: 2 @ \$4,000 .....	8,000	8,000
Allowed as salary deduction .....	8,000	5,000
Net available for dividends (none pd. as such) .....	500	500
Treated as dividend payments <sup>76</sup> .....		3,000
Capital stock tax \$1.25 x 5,000 .....	6.25	6.25
Declared value excess profits tax <sup>77</sup> .....	0	379.50
Normal income tax .....	75.00	468.08
Surtax .....	50.00	312.05
Total .....	\$131.25	\$1,165.88

The same supposed case may be used to compare the tax situation for both corporate and partnership forms of organization. Assume each of the principals has a wife and one child. The figures follow (Columns 1 and 2 are continuations of the above):

#### BUSINESS IN CORPORATE FORM

##### *Federal corporate taxes:*

Total federal taxes from above .....	\$131.25	\$1,165.88
Add Old Age Benefits tax (2 x 1 x 3,000 or 2,500) ...	60.00	50.00
Unemployment Insurance tax (2 x 3 x 3,000 or 2,500) .....	180.00	150.00
	371.25	1,365.88

##### *State corporation taxes (North Carolina):*

Income tax at 6% .....	30.00	210.00
Franchise tax—minimum .....	10.00	10.00
Total State and Federal Taxes on Corporation .....	411.25	1,585.88 <sup>78</sup>

<sup>76</sup> In most states a third incorporator would be required but he would likely be a one-share, qualification-only, party. If the wives had taken a substantial interest, however, new calculations would have to be made.

<sup>77</sup> INCOME TAX REGS. 111, §29-23(a)-7; 451 C. C. H. ¶162.013. Of course, had the shareholders known in advance that \$3,000 would be disallowed as salaries and treated as dividend payments, and had they been willing to do without that personal income, they could have plowed it back into the business and paid no personal income tax on it, subject to the possibility, not very likely here, that it would come in for added taxation as improperly accumulated income under INT. REV. CODE §102; 452 C. C. H. ¶671; 1 COORDINATORS' CYC. TAX SVC. (1945 ser.), ch. 115, 555-568.

<sup>77</sup> Again, if the shareholders had known that \$3,000 would be disallowed as assumed in Col. 2, they could have reduced the declared value excess profits tax to nothing by following the suggestion in the services [see, e.g., COORDINATORS' CYC. TAX SVC. (1945 ser.) §137.20] to declare capital at ten times net earnings. This, done here, would increase the capital stock tax to \$43.25 for a net saving of around \$335 on the two taxes. That reduction would, however, be reflected in a slight increase in the income tax.

<sup>78</sup> The tax figure found here would force a dip into capital to pay it but that is the result of the unexpectedness of the salary ruling assumed.

Each stockholder, one-half .....	205.63	792.94
<i>Individual taxes:</i>		
Federal income (from table) .....	521.00	521.00
Old Age Benefits withheld .....	30.00	25.00
State income .....	43.50	0.00
Grand total Federal and State Taxes borne by each individual .....	\$800.13	\$1,338.94

## BUSINESS CONDUCTED AS PARTNERSHIP

Each partner 1/2 of \$8,500 .....	\$4,250.00
Federal Income Tax (from table) .....	577.00
State Income Tax .....	51.00
Total tax each partner .....	\$ 628.00

Other tax consequences flow from the difference between partnerships and corporations but they are of less moment in the calculations of small enterprisers. For example, a sole stockholder has been held not entitled to set off against his individual income from other sources the losses of the corporation whose business is in so many aspects his business.<sup>79</sup> Nor can the corporation avoid corporate taxes by the claim that its separate existence should be ignored under special circumstances.<sup>80</sup>

Family partnerships when found to be bona fide, especially those including husbands and wives,<sup>81</sup> offer opportunities for dividing business gains and dropping the total intake into lower tax brackets. There is a flood of recent literature on this subject as it comes into greater prominence as a tax saving device.<sup>82</sup> But other comparable arrangements can be found to divide the income from close corporations into smaller rivulets and, while therefore the family partnership may have something to offer in a given situation it is not a first rate consideration in the choice of legal form to be adopted.

As a last observation on the comparative tax situation it should be noted that hopes are entertained in some quarters and numerous plans are on foot to lessen the tax burdens of small business by such means as raising the excess profits tax exemption and by graduating corporation income taxes and granting a substantial exemption before the bottom rates begin.<sup>83</sup> The trend of such measures would obviously be to

<sup>79</sup> *Menihan v. Commissioner of Internal Revenue*, 79 F. (2d) 304 (C. C. A. 2d, 1935). The increasingly liberal carry forward and carry back provisions reduce the unfavorable consequences of this doctrine.

<sup>80</sup> *Moline Properties, Inc. v. Commissioner*, 319 U. S. 436 (1943).

<sup>81</sup> The present reference is to cases where it is sought to make the wife an active partner. Cf. situation where the wife by investing capital becomes a limited partner or a lender to the partnership as would any outsider, *supra*, text at notes 22-31. In some states the wife cannot become a business partner of her husband. See, e.g., R. I. Acts (1944) c. 1397 removing this disability.

<sup>82</sup> Murdock, P. J., recognizes the difficulties of family partnership cases: *What Has the Tax Court of the U. S. Been Doing?* (1945) 31 A. B. A. J. 297, 316. See also, Hellerstein, *Tax Status of Family Partnerships* (1945) 17 ROCKY MOUNTAIN L. REV. 197; Paul, *Partnerships in Tax Avoidance* (1945) 13 GEO. WASH. L. REV. 121; Elrod, *Husband and Wife or Family Partnerships* (1944) 20 IND. L. JOUR. 65.

<sup>83</sup> In addition to the citations in note 71, *supra*, see press release February 20, 1945, describing plan of the House Small Business Committee, Wright Patman, Chairman. Reports of hearings by this committee are not yet available. See also proposals of the Investment Bankers Association of America, *CAPITAL FOR SMALL BUSINESS* (pamphlet, 1945) 15-16. These include an exemption of \$2,000 and lower rates in the lower brackets, with a six-year carry forward for losses.

reduce in some degree the tax disadvantage of corporations, particularly small corporations as compared with partnerships. Prospective enterprisers will have to be kept current on these developments to form a sound judgment.

### III. CONTINUITY

As has been mentioned, organizers of small business seem seldom to give much thought to the question of continuity and seldom attach much weight to it when their advisers point it out. It can hardly be that this general indifference is due to the high mortality of small business and the organizers' awareness that their chances of lasting very long are in the low percentages.<sup>84</sup> It is notorious that human optimism persists in the face of what should be alarming statistics. But it may be due to another optimism than that the business will survive, *i.e.*, "We *personally* expect to live. We can take care of such matters later. We want what serves us best right now." Nevertheless there are those embarking even in little business who, knowing that the corporate form automatically gives freedom of transfer of interests and uninterrupted *legal* continuity, will want to look over the partnership possibilities in those respects and weigh them in with the more important liability and tax factors. If a corporation were to be organized even for a period this side of perpetuity, no doubt it would as a matter of routine provide for a duration of twenty or more years. Seldom would the organizers of a small partnership business consider any such life span as this. One, two or five years with provision for renewal, would be more likely. The problem of continuity, therefore, would automatically present itself at a relatively early date even if the business prospered and the partners continued both robust and compatible. It would then probably be only a matter of renewal, however, with possible slight modifications of the terms. It is when one dissatisfied or disabled partner wants to, or must pull out, or where one partner dies, that the problem becomes more or less acute and the need for advance provision is evident. Then the preliminary question is whether what the law permits by way of such advance provision is satisfactory and workable.

A partnership is dissolved by the withdrawal—rightful or wrongful—of one of the partners.<sup>85</sup> A partner can get out of a partnership by his own volition; it is not the business equivalent of marriage. An end can be put to the mutual agency and related contractual relations between the partners by the unilateral act of one of the contracting parties. If he breaks the contract it calls for damages. But the contract may provide for just this thing and then it will be no breach of contract. Thus, one of the organizers may become a partner for three years with the understanding that during the term he may sell or give his share to his younger brother who is to replace him as partner. In business contemplation this provides for a continuance of the partnership. In a legal sense it does not, but provides instead for dissolution and the creation of a new partnership. Whatever theoretical or

<sup>84</sup> T. N. E. C. MON. 17, *supra* note 2, chs. 2-4, showing heavy mortality of small business in whatever field and whatever form conducted.

<sup>85</sup> CRANE, PARTNERSHIP (1938) 324, 328. Dissolution differs from termination. U. P. A., §30; 7 U. L. A. 43.

legalistic changes are wrought by these provisions and acts of the parties, the real point is that, if the other partner lives up to his agreement and accepts the new associate, this arrangement does produce in one narrow and definitely foreseen situation the transferability which the corporate form of organization would have given in introducing a new person into the business.<sup>86</sup> It would be less likely that the transferability could be broadened to reach substantially the freedom of corporate transfers by a provision that partner A could transfer to anyone he chose and partner B would then go on with this dark horse. As a practical matter partner B would be likely to decline such an advance commitment and, even if he made it, might very likely refuse to go on with the newcomer when he put in an appearance (even though that decision exposed him to suit).

Death, however, is the contingency most often provided against. Absent some arrangement to meet this emergency, the death of one partner dissolves the partnership and places the business in the hands of the surviving partner for liquidation,<sup>87</sup> a procedure often synonymous with disadvantageous sales of property and heavy loss of investment. Had the business been a corporation or a joint stock association, or even a business trust with transferable shares, no such crisis would be presented as far as any rules of law are concerned.<sup>88</sup> The shares would pass to the personal representative and thence to the beneficiaries or kin without a legal ripple in the corporation's existence. *Legal* ripple, I say, because in a small corporation dominated largely by one or two essential people, a death in that quarter may create problems of selling out under pressure unrelated to legal technicalities but fully as real.

But to meet the difficulties, both legal and practical, which are bound up in a partner's death several sorts of continuing or reviving arrangements are feasible. They fall into two general classes based on whether the partner (1) wishes only his capital to remain in the business till the expiration of the agreed term or (2) wishes to insert a new partner in the firm in his stead (legally, that is, create a new partnership between his survivors and his nominee).<sup>89</sup>

Ways to keep the capital in and no more would appear to be these: Simply provide for leaving it in—the surviving partner (or partners) being in full charge of the continuing business in the capacity of quasi-trustee (some sort of fiduciary) as to the decedent's share;<sup>90</sup> appraise the interest of the deceased and treat it as paid to his estate and returned in the form of a loan thenceforth for a share of the profits; appraise the share and treat it as the contribution of decedent's executor or ben-

<sup>86</sup> In one way it does more since the new partner has managerial powers while the new stockholder merely as stockholder does not.

<sup>87</sup> U. P. A., §§31(4), 37.

<sup>88</sup> 16 FLETCHER, CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS (perm. ed.) §8283.

<sup>89</sup> *Baker v. Wides' Ex'r*, 299 Ky. 414, 185 S. W. (2d) 699 (1945) (Surviving partner continued business with acquiescence of executor and heirs of dec'd partner. *Held*, subsequent operations are those of a new partnership); *Benedict v. Price*, 38 F. (2d) 309 (E. D. N. Y., 1929); *Thompson v. Flynn*, 95 Mont. 484, 27 P. (2d) 505 (1933); see *People v. Zangain*, 301 Ill. 299, 133 N. E. 783 (1921).

<sup>90</sup> For one such arrangement see *Benedict v. Price*, 38 F. (2d) 309 (E. D. N. Y., 1929).



eficiary to a new limited partnership then to be formed with the survivors as general partners and the executor or beneficiary as limited partner; appraise the share and treat it as a contribution of that amount by the executor or next of kin to the capital stock of a corporation then to be formed.<sup>91</sup>

In 1940 Professor Warner Fuller published a thorough study of partnership continuation agreements<sup>92</sup> which indicates that arrangements for leaving the decedent's capital in the business under the exclusive control of the survivor for a specified length of time have been tested in the past and have yielded the desired immunity, *i.e.*, have imposed no general liability on the estate, the executor or the kin for future partnership debts.<sup>93</sup> Other cases bear this out.<sup>94</sup> No instance of the other suggested devices—the organization of either a limited partnership or a corporation—has been found, but no reason appears why they should not be successful.

Any of these things could be done by the will<sup>95</sup> of the deceased partner as well as by the terms in the original partnership agreement<sup>96</sup> except that if the survivor refused to carry out the testamentary direction he would be breaking no contract as he would if the articles of partnership made like provisions.<sup>97</sup> Considering that an original agreement to continue could not be specifically enforced but only would ground a suit for very uncertain amounts of damage<sup>98</sup> it may be that the testamentary provision, subject entirely to the concurrence of the survivor, would not involve much more uncertainty than would the advance contract.

The other arrangement, like that assumed above for substitution on a partner's retirement, is not only to keep the capital in but for the advance designation of an individual who, it is agreed, will replace the deceased partner.<sup>99</sup> Greater uncertainties exist here, for either the survivor or the nominee may balk and the continuance

<sup>91</sup> This arrangement might result in the partnership being treated as an association (because of delegated management) and its being taxed in consequence as a corporation. This ought not to be and the treatment of limited partnerships might seem to guarantee against such fate. Otherwise the chief gain which had been sought would have been lost.

<sup>92</sup> Fuller, *Partnership Agreements for Continuation of an Enterprise after the Death of a Partner* (1940) 50 *YALE L. J.* 202.

<sup>93</sup> Unless new contracts are authorized by will or by the partnership agreement, *Groves v. Aegerter*, 226 Mo. App. 128, 42 S. W. (2d) 974 (St. L. App. 1931); Fuller, *supra* note 92, at 210-214.

<sup>94</sup> *Schumann-Heink v. Folsom*, 328 Ill. 321, 159 N. E. 250 (1927); *In re Patton's Estate*, 170 Ore. 186, 132 P. (2d) 402 (1942); *Kilhoffer v. Zeis*, 109 Misc. 555, 179 N. Y. Supp. 523 (1919); *Holcombe v. Long*, 245 Mass. 353, 139 N. E. 633 (1923); *Blumer Brewing Corp. v. Mayer*, 223 Wis. 540, 269 N. W. 693 (1936); *Western Shoe Co. v. Neumeister*, 258 Mich. 662, 242 N. W. 802 (1932). See *Williams v. Schee*, 214 Iowa 1181, 243 N. W. 529 (1932); *Tate v. Hoover*, 345 Pa. 19, 26 A. (2d) 665 (1942).

<sup>95</sup> *In re Patton's Estate*, 170 Ore. 186, 132 P. (2d) 402 (1942); *Kilhoffer v. Zeis*, 109 Misc. 555, 179 N. Y. Supp. 523 (1917). See *Williams v. Schee*, 214 Iowa 1181, 243 N. W. 529 (1932).

<sup>96</sup> *Faggelle v. Maremma*, 131 Conn. 277, 38 A. (2d) 791 (1944).

<sup>97</sup> Fuller, *supra* note 92, at 206, 207; *In re Mamaux's Estate*, 274 Pa. 533, 118 Atl. 441 (1922). See *Slater v. Slater*, 208 App. Div. 567, 204 N. Y. S. 112 (1st Dept., 1924); *People v. Zangain*, 301 Ill. 299, 133 N. E. 783 (1921); *Thompson v. Flynn*, 95 Mont. 484, 27 P. (2d) 505 (1933); *Western Shoe Co. v. Neumeister*, 258 Mich. 662, 242 N. W. 802 (1932). And, of course, the heirs of deceased partner have the right to agree with survivor that their share may continue in firm, *Fidelity Union Casualty Co. v. Hammock*, 5 S. W. (2d) 812 (Tex. Civ. App., Galveston, 1928); *Maynard v. McClellan*, 236 Mo. App. 352, 156 S. W. (2d) 770 (K. C. App. 1941); *Gibbone v. Derrick*, 338 Pa. 317, 12 A. (2d) 111 (1940).

<sup>98</sup> Fuller, *supra* note 92, at 206, 207.

<sup>99</sup> *Id.* at 208-210.

be actually frustrated notwithstanding that liability for damages would be incurred by the survivor in the one case or the estate in the other. And contributing in a practical way to the disposition of the nominee to balk is the fact that he will come under full personal liability for future indebtedness, not only if he is an heir but as well if he is decedent's executor or trustee participating in the partnership affairs solely for the benefit of the deceased partner's kin.<sup>100</sup>

Another program which, while not continuing the decedent's interest in the business may meet the evil of forced liquidation, is the rather obvious one of giving the survivor an option or an obligation to purchase the deceased's interest at an appraised price with possible provisions for time payments, notes and security.<sup>101</sup> The insufficiencies of this arrangement are evident enough but so far as they hinge on the financial inability of the surviving partner to pay and take over, conceivably that weakness might be met by a policy of joint life insurance payable to the survivor or by each partner insuring the life of the other<sup>102</sup> for a substantial sum and being thus supplied the ready money for the cash demands of his agreement at the very moment he needed it. Such agreements may provide (1) that the amount of the insurance will be paid to a designated beneficiary or to the deceased partner's estate as full payment of his share of the business; (2) for payment to the surviving partner to discharge the debts of the partnership or to purchase the deceased partner's interest or both; or (3) for an appraisal of deceased partner's interest and that such part of the insurance as will equal his interest be paid to his estate.<sup>103</sup>

It is sufficiently demonstrated by Professor Fuller's study and by other cases that the worst feature of the doctrine of dissolution and winding up upon the death of a partner, *i.e.*, sacrifice sale, can be avoided in some narrowly effective fashions such as those above outlined. But considering the uncertainties disclosed, few people would be so circumstanced as to make these cumbersome possibilities anything like an equivalent of the automatic legal continuity of the corporation notwithstanding human vicissitudes. For one, however, about to take the partnership *cum onere* because of its indisputable tax advantages, some one or more of these devices may present a better-than-nothing solution in his particular case.

One entirely extra-legal thought may be added. One of the aids to small business survival has been the voluntary group or chain, providing the little fellows some of the money-saving and business-getting features of the large corporate chains. Business periodicals have recently reported that one, at least, of these voluntary central organizations, Independent Grocers Alliance, has set up a series of training schools for returning veterans and others to prepare them to start independent busi-

<sup>100</sup> *Id.* at 215. Although he would have a right of exoneration, of course.

<sup>101</sup> For examples of such purchase agreements see *Baker v. Wides' Ex'r.*, 299 Ky. 414, 185 S. W. (2d) 699 (1945); *Holcombe v. Long*, 245 Mass. 353, 139 N. E. 633 (1923); *In re Eddy's Estate*, 175 Misc. 1011, 26 N. Y. S. (2d) 115 (Surr. 1941); *Casey v. Hurley*, 112 Conn. 536, 152 Atl. 892 (1931); *In re Clift's Estate*, 231 App. Div. 634, 248 N. Y. Supp. 473, appeal dismissed, 256 N. Y. 680, 177 N. E. 191 (1931); *O'Brien v. O'Brien*, 294 Ky. 793, 172 S. W. (2d) 595 (1942); *Leonard v. Leonard*, 201 N. Y. Supp. 113 (Sup. Trial Tm. 1922); *Block v. Mylish*, — Pa. —, 41 A. (2d) 731 (1945).

<sup>102</sup> 37 C. J. 397, §66.

<sup>103</sup> 2 APPLEMAN, INSURANCE LAW AND PRACTICE (1941) §871.

nesses of their own in association with the group.<sup>104</sup> If, where an established partnership in their field faced liquidation through the death of a partner, I.G.A. and other similar organizations had ready a pool of promising trainees with a little capital to invest they might introduce a suitable purchaser of the deceased partner's interest. Indeed if the trainee did not have sufficient capital the central organization might supply part of it. Such an added feature might round out the services already offered to small business and reduce the hazards and disadvantages of partnership enterprise as well as those of individual proprietorships and smaller corporations.

#### IV. ACCESS TO CAPITAL

There is a widespread idea that it is much easier to sell stock in a new venture than to get partners or lenders for a partnership.<sup>105</sup> This is probably a half truth and, considering statistics,<sup>106</sup> should be stated in the negative—it is not quite so difficult to sell people stock as it is to get them to join in or loan to a partnership. The public at large, that is. There is probably some notion of continuity and permanence associated with the idea of a corporation in people's minds—some actual continuity of the *business* being perhaps subconsciously inferred from the legal continuity of the *entity*.<sup>107</sup> But vastly more important is the fact that investors generally have no idea of how to share partnership profits without becoming a partner with the resulting personal liability—or indeed do they know whether any such protected opportunity exists. They are scared off by the unknown complexities. This predisposition toward shares rather than a share is a negative factor, however. The statistics already alluded to<sup>108</sup> and the flat assertion of the investment bank-

<sup>104</sup> Among the topics which will be taken up at the "I. G. A. College of Food Retailing" under the second of their subjects, Acquiring and Financing the Store, is Forms of Ownership. The single proprietorship is in their opinion "the ideal form" for one with the necessary capital and ability but the main features of partnerships and corporations will be expounded. Letters from Mr. J. Frank Grimes, President.

<sup>105</sup> "A small corporation usually finds that it can sell preferred stock of small denomination to a large number of investors who would not enter into a partnership and assume the incidental liability. The organizers usually hold all common stock which by charter or bylaws gives them the management and control of the corporation and sell the preferred stock to obtain operating capital." Letter from a lawyer in local county seat. Similar thought has been expressed as to raising new capital: "One of the greatest advantages of the corporate form is the relative ease with which it can enlist new capital. All that is necessary is to find purchasers for additional shares of stock." (That is all, just that! Ed.) RESEARCH INSTITUTE OF AMERICA, PARTNERSHIP OR CORPORATION (pamphlet, 1944) 3. The analysis hastens, however, to add in the form of an observation that "As a practical matter, there isn't much difference between a *small* corporation and a partnership so far as expansion problems are concerned. It is probably no easier to find a person ready, willing and able to invest in a small corporation than it is to find a new partner for a business of the same size."

<sup>106</sup> See note 108 *infra*.

<sup>107</sup> How little permanence there is to most small businesses, including corporations, may be learned from tables of mortality for each form of organization in Poughkeepsie, N. Y., and in Chicago shown in T. N. E. C. MON. 17, *supra* note 2, at 40, 49, 59. Those tables show a somewhat longer life for corporations than for partnerships and individual proprietorships in the first few years but such statistics prove nothing as to the greater probability of corporate survival because of the form of organization. The corporations would obviously include fewer of the smallest and weakest business units. Cf. also amounts of assets in liquidation classified according to form of organization. *Id.* at 100.

<sup>108</sup> See report and tables on costs and percentages of unsold securities of small registered issues. *Id.* at 219, 292-295. Many report no sales.

ers<sup>109</sup> establish that the marketing of issues of less than \$100,000 is quite generally expensive and unsuccessful. And if two returning soldiers have hope of some financial aid from a retired merchant of means<sup>110</sup> who knows them or of them, they may expect him to lend his money to them for a share of their partnership profits as quickly as he would take shares of stock in their unknown new business when it is incorporated.

Different situations, therefore, call for different answers. But high hopes of selling stock should be tamed down as the uncontradicted evidence is that incorporation is no guarantee of outside equity capital.<sup>111</sup>

Other sources and varieties of aid for small business when canvassed fail to indicate that anything hinges on the form of organization adopted. Proposed bills for government action have usually made provision for individuals, firms and corporations.<sup>112</sup> The Smaller War Plants Corporation, which evidently hopes to continue some sort of activities for small business on a more permanent basis,<sup>113</sup> reports no distinction made in the work of its organization.<sup>114</sup> So far as can be learned the central organizations of the voluntary groups or chains whose aid to small business in the merchandizing field can be one of the chief factors in its survival, make no distinction either in the privileges of membership.

Nor do the bankers intend to draw any line between corporations and partnerships as such in the extension of loans through their newly established bank credit groups in many cities.<sup>115</sup>

On the basis of this evidence there appears to be a slight advantage, the extent of which is difficult to estimate, in the corporate form of organization for small business so far as goes the job of getting savings of numbers of individuals into the enterprise. That it adds anything in most cases to the ease of attracting a substantial capital contribution or loan from a single well-informed businessman is doubtful, to say the least. That it is of help toward procuring either the advisory

<sup>109</sup> CAPITAL FOR SMALL BUSINESS (Pamphlet, Small Bus. Comm. Investment Bkrs. Assn. of America, 1945) 9.

<sup>110</sup> This is said to have been and to be the chief source of small business financing. T. N. E. C. MON. 17, *supra* note 2, at 262.

<sup>111</sup> The I. G. A. program, *supra* note 104, tells its prospective grocers only that they may raise money by selling preferred stock to relatives and friends.

<sup>112</sup> Sometimes directly, sometimes by using the phrase "small business concerns." See legislative proposals, T. N. E. C. MON. 17, *supra* note 2, at 364-370; Proposed "War Distress Business Loans Corporation Act" §3(a), Senate Small Business Committee, 77th Cong., 2d Sess. (1943), *Hearings*, part 9, 859; H. R. 52, 79th Cong., 1st Sess. (1945), 91 CONG. REC. March 20, 1945, at A1424.

<sup>113</sup> H. R. 52, 79th Cong., 1st Sess., *supra* note 112, changing name to Federal Small Business Corporation. See critical comment, I. B. A. pamphlet, *supra* note 109, at 9.

<sup>114</sup> Letter from Mr. Joseph W. Kaufman, Asst. to the General Counsel. In response to inquiry whether contracts have been made equally available and have been equally simple when a small concern seeking business has been a partnership, he said: "There is no difference whatever, in obtaining business, so far as our experience indicates, as to whether the concern is a corporation or a partnership." The Act itself speaks of "small business concerns."

<sup>115</sup> Letter from Mr. R. M. Hanes, Chairman, Post War Small Business Credit Commission, American Bankers Assn. Of course, says he, the management and the assets will be looked into in any case. The Investment Bankers' proposals evidently intend to cover all forms of business, though in one place sale of stock of the beneficiary is mentioned. Pamphlet, *supra* note 109, at 5.

or financial aid of governmental agencies, central management organizations or regularly established financial concerns, including their new group set-ups, seems definitely belied by the printed records and the statements of those who have to do with the policies of these bodies.

#### CONCLUSION

To attempt a valid, generally applicable, recommendation to small business on this subject is like trying to select an all-purpose suit for a man, not a certain man but any man. Nevertheless where organizers are troubled about personal liability and their business is not soon likely to show profits above what can be justified as salaries to the officers, there is much to be said for incorporating. After all, a corporation can be dissolved if the profits get to the place where they create tax problems or other experience shows that de-corporation "is indicated." The general impressions on the subject therefore, seem in the end not to be very far off.

No serious attention has been paid herein to the possibility of using a business trust or a joint stock association as the form under which to operate since, considering the tax and management features, neither of these structures is thought to offer any substantial attraction for the large majority of those about to embark on a small business venture.<sup>116</sup>

<sup>116</sup> See, however, Everberg, *Advantages and Disadvantages of Common Law Trust Organizations* (1945) 50 COM. L. J. 4.