Vanderbilt Law Review

Volume 16
Issue 2 *Issue 2 - March 1963*

Article 4

3-1963

Changing a Partnership Into a Corporation

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Changing a Partnership Into a Corporation—Some Considerations Affecting the Time When Incorporation May Benefit the Owners of a Growing Business

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In this article Professor Gifford discusses some of the factors which are relevant to a decision with respect to the stage at which a growing business should be transformed from a partnership to a corporation.

The transformation of the form of business organization from that of a partnership into that of a corporation should be undertaken only after a consideration and a balancing of the relative advantages and disadvantages, to each of the persons constituting the partnership, of doing business under each of the respective forms.[1] To the extent that partnership law and corporate law permit contractual changes in the structure or effects of such business organizations from that which would be their structure or effects in the absence of contract, the owners of a business utilizing either form have a free hand in shaping the business organization to suit their particular purposes; they need not, therefore, make an all-or-nothing choice between two types of organization, each of which differs radically from the other in several characteristics, but, within wide limits, may pick and choose from among all of the characteristics often attributed to either of the two forms of organization for those which best fulfill their needs.

The present essay will deal only with those businesses which possess unlimited growth potential in respect of the amount of assets

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1. The potential advantages of incorporation have been variously described. See, *e.g.*, BAKER & CARY, CASES ON CORPORATIONS 19 n.1 (1959): insulation from liability, federal income tax considerations, continuity of existence, centralization of management, and free transferability of interests; Paul & Kalish, *Transition from a Partnership to a Corporation*, N.Y.U. 18TH INST. ON FED. TAX 639-41 (1960): unlimited life, limited liability of stockholders, "ready" transferability of interests, tax advantages of spreading income, fringe benefits, family income spreading, and conversion of earnings to capital gains by a future sale of stock. Corporate disadvantages are listed by the latter authors as double taxation and unavailability of corporate losses to offset other income of shareholders. See also Kahn, *Organization and Growth of a Partnership*, *id.* at 615, 637-38; Gibson, *Selecting the Form of Entity for Small Business*, 18 BUS. LAW. 100 (1962).

which they can profitably employ in the production of income. If such businesses grow sufficiently, they will probably ultimately reach the stage of publicly held corporations.[2] The reasons for this will vary, although it would seem that once the growth process has picked up momentum, the business may require capital at a rate faster than earnings can be accumulated or funds can be obtained from lenders.[3] At such a time incorporation may be a practical necessity because the sale of ownership interests among many investors may be an essential means of raising needed capital and the relative ease with which corporate ownership interests may be transferred[4] may make that form of organization more compatible with widespread holdings of ownership interests. Furthermore, even prior to the public holding stage, incorporation may be necessary as a device with which to maximize earnings available for reinvestment[5] and as a means of accommodating the differing interests of several classes of investors or among investors of the same class in respect of participation in control[6] over the affairs of the business and limited liability.[7]

The scope of the present essay will be confined to a brief consideration of the factors of transferability of ownership interests, owner liability, control structure, financial structure, and certain tax effects as such factors may bear on the decision of the proper time to incorporate prior to the public holding stage.[8]

2. Baker & Cary, Cases on Corporations 19 (1959).

3. Compare McLain, *Why and How We Went Public*, in 2 Corp. Prac. Commentator no. 2 p. 34, 35 (1960).

4. See p. 356 *infra*.

5. See pp. 364-67 *infra*.

6. See pp. 359-65, 371-72 *infra*.

7. See pp. 358-59, 363, 371-72 *infra*.

8. Since not directly related to the determination of the time at which growth will impel incorporation, the supposed partnership attribute of uncertain continuity of life is not treated herein. Such attribute is often considered as deriving from the provisions of § 31 of the Uniform Partnership Act which provide that dissolution of the partnership will be caused by the death of any partner or by the express will of any partner although in contravention of the partnership agreement. The "dissolution" that occurs on the death of a partner does not compel the liquidation of the partnership business by the remaining partners, and partnership agreements often provide for the continuance of such business after the death of one or more partners. See Uniform Partnership Act § 41(3). Thus the interest of the deceased partner may be purchased by the survivors pursuant to provisions so providing in the partnership agreement, Silverthorne v. Mayo, 238 N.C. 274, 77 S.E.2d 678 (1953), and the funds for such purchase can be supplied from life insurance. See Note, *The Use of Life Insurance To Fund Agreements Providing for Disposition of a Business Interest*, 71 Harv. L. Rev. 687 (1958). The power conferred by § 31 upon each partner to force a "dissolution" in contravention of the partnership agreement merely requires the remaining partners either to pay the partner forcing dissolution the value of his interest in the partnership (less damages for forcing dissolution in breach of the partnership agreement) or to post bond to secure such payment at the end of the partnership term and to indemnify him against partnership liabilities. The latter alternative method of dealing with the interest of the partner forcing dissolution permits the remaining partners to use the former's property in the partnership business until the end of the previously agreed-upon term at the

I. Transferability of Ownership Interests

A. In General

The growth stage of the business will usually substantially influence the extent to which transferability or non-transferability of ownership interests is a desirable factor; the growth stage will also influence the kinds of ownership interests to which transferability would be desirable, if it is determined that less than all of the ownership interests should be transferable. By definition, restrictions on transfer would be incompatible with a business which had reached the stage of public trading of its ownership interests. Restrictions on transfer are often desired, however, by the owners in control of a closely-held business in order to preserve existing harmonious personal relations among themselves or to preserve present power relationships; non-controlling owners may similarly desire some restrictions over transfer as assurance that the present owners in control, whose judgment and discretion are trusted by them, will not be replaced by successor controlling owners whose judgment and discretion may be less worthy of such trust.[9] Restrictions on transfer,

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expense only of a bond to secure the specified payment and indemnity. While the bond expense may be substantial, it would appear to be less than the expense involved in immediate payment for the partnership interest, and since damages resulting from the dissolution in breach of contract are recoverable from the partner forcing such dissolution and may be deducted from the value of his partnership interest, the financial burden imposed upon the business or the remaining partners by such forced dissolution would be reduced still further. If the cost of the bond is an item of damages and is presently recoverable from the partner causing the dissolution in breach of agreement, such financial burden would appear to amount only to the attorneys' fees incurred in collecting such damages. Section 31, therefore, would not directly interfere with business continuity by compelling termination of the business by legal command, and on the above interpretation, would not so interfere indirectly, with the exception hereinafter pointed out, by imposing financial burdens on the business which would jeopardize its continued existence.

In the case in which the business did not have the prospect of a profitable future, § 31 might have the effect of speeding up its nltimate liquidation, however, by making the bond expense non-reimburseable by the partner forcing the liquidation. Such result might occur if, because of the lack of expectation of future business profits, the remaining partners were deemed to be under a duty to mitigate damages by foregoing payment of such bond expense and immediately liquidating the business.

A perhaps somewhat more substantial basis for attributing an uncertain continuity of life to a partnership would lie in the lack of flexibility of that form in respect of combining limited liability, sharing of profits, and participation in control. Such lack of flexibility would impede the transition by the business from a stage in which it was operated entirely by owner-managers to stages in which it was operated, at least in part, by hired, non-owner managers—a transition which time might require it to make if it is to outlast the lives of presently existing general partners. *Cf.* p. 364 *infra.*

9. Reliance by non-controlling owners upon the characters of the controlling owners is reflected, for example, in several provisions of the Uniform Limited Partnership Act which prohibit the admission of a new general partner without the consent of the limited partners, §§ 9(1)(e), 24(2)(d), although the aet contemplates a certificate provision conferring on general partners the power to admit new limited partners, § 9(1)(f), and conferring on cach of the limited partners the power to confer on

accordingly, would seem to be most strongly desired as applied to the transfer of ownership interests which carry with them any appreciable participation in control over the operations of the business.[10] Furthermore, to the extent that an original, cohesive group of controlling owners is diluted by the admission of additional owners with whom control is shared, the desirability of maintaining restrictions on transfer may be diminished. In so far, however, as section 9[11] of the Uniform Partnership Act confers on general partners a power to bind their partnership despite their lack of authority to do so, an additional reason for restricting transfers of general partnership interests would exist. If growth requires the enlargement of the "ownership base" of the business, the original controlling owners may desire to retain control in themselves and accordingly may continue to restrict transfer of their interests; but in order to facilitate the sale of ownership interests not sharing in control, they may choose not to impose restrictions on the transfer of the latter interests.

B. Comparative Adaptability of Corporate and Partnership Forms to Facilitating or Restricting Transfer

The power to restrict absolutely the transfer of that part of ownership interests which share in the "management or administration" of the business and a power to inhibit the transfer of that part of ownership interests which do not share in management or administration are conferred by statute in the case of a partnership. Section 18(g) of the Uniform Partnership Act provides that in the absence of an agree-

their respective assignees the right to become substituted limited partners, §§ 19(4), 25(4).

10. To the extent that control over most business affairs is concentrated in a few hands, the difficulties connected with transfers to outsiders would appear to be lessened. Since transfers to outsiders would seem to create problems to the degree that the interest transferred possessed some but not all of the power of control over the affairs of the business, transfers of interests having little or no such power would theoretically present no great personal relations difficulties for the remaining owners. Except to the extent that the judgment and discretion of the respective individuals owning interests possessing substantial powers of control were trusted and relied upon by the non-controlling owners, sales of such interests would similarly fail to create personal relations difficulties to the degree that the interests sold possessed all of the power of control over all aspects of the business, since, by hypothesis, there would be no remaining members of a controlling group which would be forced to share their power with a stranger if all of such power were transferred.

11. Uniform Partnership Act § 9 provides in part:

"(1) Every partner is an agent of the partnership for the purpose of its business, and the act of every partner, including the execution in the partnership name of any instrument, for apparently carrying on in the usual way the business of the partnership of which he is a member binds the partnership, unless the partner so acting has in fact no authority to act for the partnership in the particular matter, and the person with whom he is dealing has knowledge of the fact that he has no such authority.

". . . .

"(4) No act of a partner in contravention of a restriction on authority shall bind the ment to the contrary: "No person can become a member of a partnership without the consent of all the partners." Although section 27(1)[12] of the act indicates that even though the partnership agreement prohibits an assignment of a partnership interest, an assignment of such an interest in a going partnership business in contravention of such agreement will be effective to vest in the assignee the assignor's right to receive the profits of the business, such section gives effect to section 18(g) and to the desire of owners of a closely held business to restrict transfers of interests sharing in control by providing that unless otherwise agreed by all of the partners, such assignee receives no right to interfere in the "management or administration" of the partnership business or affairs. In addition, section 27(1) inhibits transfers even of the right to share in business profits by denying to assignees of partners, in the absence of an agreement to the contrary, certain remedial rights against the partnership possessed by their assignors, *i.e.*, the rights to require information or accounting of partnership transactions and to inspect partnership books.[13]

Although section 19(1) of the Uniform Limited Partnership Act states that "a limited partner's interest is assignable," the assignee of a limited partner, unless and until he becomes a "substituted limited partner," is entitled only to his assignor's right to share in the profits of the business or return of contribution,[14] but is denied remedial rights against the partnership similar to those that section 27(1), in the absence of an agreement otherwise providing, denies to the assignee of a general partner to whose admission to the partnership the other partners have not consented.[15] Since an assignee of a limited partner

partnership to persons having knowledge of the restriction."

Section 9 would appear to be modified by § 3(1) of that Act which provides: "A person has 'knowledge' of a fact within the meaning of this act not only when he has aetual knowledge thereof, but also when he has knowledge of such other facts as in the circumstances shows bad faith."

12. UNIFORM PARTNERSHIP ACT § 27(1): "A conveyance by a partuer of his interest in the partnership does not of itself dissolve the partnership, nor, as against the other partners in the absence of agreement, entitle the assignee, during the eontinuance of the partnership, to interfere in the management or administration of the partnership business or affairs, or to require any information or account of partnership transactions, or to inspect the partnership books; but it merely entitles the assignee to receive in accordance with his contract the profits to whieh the assigning partuer would otherwise be entitled."

13. See UNIFORM PARTNERSHIP ACT §§ 19-22. Despite the apparent divestiture by § 27(1) of a mere assignee of the rights created by the foregoing sections, the enforcement by such assignee of his right to share in the profits may require an accounting. *Cf.* 2 ROWLEY, PARTNERSHIP § 53.20, at 584 (1960).

14. UNIFORM LIMITED PARTNERSHIP ACT § 19(3): "An assignee, who does not become a substituted limited partner, has no right to require any information or account of the partuership transactions or to inspect the partnership books; he is only entitled to receive the share of the profits or other compensation by way of income, or the return of his contribution, to which his assignor would otherwise be entitled."

15. *Ibid*; UNIFORM PARTNERSHIP ACT § 27(1).

has no right to become a substituted limited partner over the objection of any partner unless the limited partnership certificate so provides,[16] the assignment of the right to share in business profits can be inhibited under the Uniform Limited Partnership Act as well as under the Uniform Partnership Act by the denial of the same remedial rights to assignees.

Corporate stock, on the other hand, is, in the absence of an agreement or a certificate of incorporation or a by-law provision to the contrary, freely transferable;[17] the transferee receives the same right to receive dividends, the same right to share in control of the corporation, and the same remedial rights against the corporation as were possessed by his transferor. Such transferability, however, often can be greatly restricted by contract, by law or certificate of incorporation provision.[18] Because an absolute prohibition on the transfer of stock in a business corporation would, in most cases, be of doubtful validity,[19] restrictions on the transfer of corporate stock often take the form of vesting in the shareholders or in the corporation a right of first refusal with respect to impending transfers of shares by the stockholders.[20] The power which can be conferred upon the owners of a corporation over the identity of assignees of ownership interests succeeding to a right to participate in control, therefore, may be somewhat less efficacious than the power which can be conferred upon the owners of a partnership since the exercise of such right of first refusal in respect of inter vivos transfers depends upon the continuing financial ability and willingness of the corporation or its stockholders to exercise such right of first refusal.[21] Theoretically,

16. UNIFORM LIMITED PARTNERSHIP ACT § 19(4).

17. See, *e.g.*, 12 FLETCHER, PRIVATE CORPORATIONS § 5480 (1957); *cf.* UNIFORM STOCK TRANSFER ACT § 15.

18. See, *e.g.*, 12 FLETCHER, *op. cit. supra* note 17, § 5453; 2 O'NEAL, CLOSE CORPORATIONS § 7.14 (1958).

19. Allen v. Biltmore Tissue Corp., 2 N.Y.2d 534, 542, 141 N.E.2d 812, 816 (1957) (dictum).

20. See, *e.g.*, Doss v. Yingling, 95 Ind. App. 494, 172 N.E. 801 (1930); Hassel v. Pohle, 214 App. Div. 654, 212 N.Y. Supp. 561 (1925); Note, *Control Devices*, 52 Nw. U.L. REV. 375, 382 (1957).

21. In deciding whether to exercise such right of first refusal, the financial impact upon the business or other right-of-first-refusal holders would be balanced against the desire to maintain control over the identity of new owners who would participate in control over business affairs. Operating to reduce such impact would be the fact that the right-of-first-refusal holders would not be called upon to make a determination of whether or not to exercise the right until an owner desiring to be rid of his investment had found a purchaser who was willing to purchase at a price satisfactory to such owner. Finding such a purchaser for a minority interest in a closely held business might in itself present some difficulty, and such difficulty would be increased by the right of first refusal in the business or other owners which would prevent the transferor from consummating the sale with a prospective purchaser until the business or other right-of-first-refusal holders had been informed and had been given an opportunity to make the purchase. Furthermore, the likelihood of finding such a

therefore, the partnership form would seem to possess some degree of advantage with respect to the ability to restrict inter vivos transfers of ownership interests sharing in control; whether that theoretical advantage would be an actual advantage would depend upon a practical appraisal of the financial resources of the business and its owners.

With respect to facilitating the transferability of interests not participating in control, the partnership form would seem to be disadvantageous, and the disadvantages of such form would seem to multiply as the number of partners increased. Transfers of an ownership interest not having a right to participate in control and which was clothed in limited partnership garb in order to avoid the risk of personal liability for business debts being imposed upon its owner,[22] would be governed by the transfer provisions of the Uniform Limited Partnership Act. That act provides that the assignees of limited partners cannot succeed to the statutory remedial rights against the partnership possessed by their assignors unless and until they become substituted limited partners.[23] Even though a limited partnership certificate expressly grants the right to assignees of limited partners to become substituted limited partners,[24] such assignees do not become such until the limited partnership certificate is amended.[25] Since the amendment of a limited partnership certificate requires the signature of all of the members of the partnership,[26] the amendment procedure may be somewhat cumbersome; and when many partnership interests are outstanding, it may be impossible of accomplishment.[27] Although the lack of adaptability of the limited partnership form to ownership among a substantial number of persons does not absolutely preclude the use of such form even after the business begins substantially to expand its ownership base,[28] it will be a factor which when added to tax and control factors may influence the owners toward a decision to incorporate.

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purchaser would diminish in the times when the business was not prospering and consequently when it and the other right-of-first-refusal holders might be least able to exercise the right of first refusal without incurring substantial hardship. Control over the identity of persons succeeding to an ownership interest on the death of its holder could be effected under both the partnership and corporate forms through the life insurance device. See note 8 *supra*.

22. See p. 358 *infra*. But the use of profit-sharing creditor type instruments may provide an alternative means of investment in a partnership, see pp. 362-63 *infra*, which would not be governed by the Uniform Limited Partnership Act.

23. UNIFORM LIMITED PARTNERSHIP ACT § 19(3), quoted note 14 *supra*.

24. The certificate may so provide. UNIFORM LIMITED PARTNERSHIP ACT § 19(4).

25. UNIFORM LIMITED PARTNERSHIP ACT § 19(5).

26. *Id.* § 25(1)(b).

27. *Cf.* 2 ROWLEY, PARTNERSHIP § 53.19 (1960), quoted note 28 *infra*.

28. Thus in the area of real estate syndications where there is no need for raising additional capital by reinvestment of earnings, the absence of double taxation of earnings in the partnership form has often impelled the use of limited partnerships despite the transfer disadvantages. *Compare* Aronsohn, *Changing Nature of Real Estate*

II. Owner Liability for Business Debts

Although the partners of a partnership and the so-called general partners of a limited partnership are personally and jointly liable for the debts of the partnership,[29] an investor in a partnership business may become a "limited" partner—a partner whose liability is confined to his capital contribution and to his share of undistributed earnings[30] —upon compliance by him and by the other partners with certain formalities prescribed in the Uniform Limited Partnership Act.[31] A condition of such limitation of liability of the limited partner, however, is that he may not take "part in the control of the business";[32] the meaning of the quoted phrase will be examined below in connection with the consideration of the relative adaptability of the partnership and corporate forms to varying control structures. Here it will merely be noted that the partnership form precludes the combination of limited liability with taking part in "control" of a business.

The owners of a corporate business, on the other hand, are endowed by law with limited liability for the debts of the business[33] and such limited liability is not conditioned on the non-exercise of control. Although this limited liability may be subject to criticism in the case of a "one-man corporaton,"[34] it would appear increasingly desirable from the viewpoint of the owners and objectively justified as the number of owners increases and control is separated in growing degrees from ownership. Like most other corporate attributes, however, limited liability is subject to contractual modification, and in the case of a small, closely held corporation, one or more of its shareholders often

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Syndicates, N.Y.U. 18th Inst. on Fed. Tax 63, 64-65 (1960):

"[I]t is apparent that a large majority of the real estate syndicates organized over the past two years have been organized either as joint ventures or as limited partnerships. The overwhelming majority of them have been organized as limited partnerships under the Uniform Limited Partnersbip Act, which has been enacted in approximately 38 jurisdictions."

with 2 Rowley, Partnership § 53.19 (1960):

"The provisions of the articles of limited partnership of most present day real estate syndicates taking that form, permitting transfer of their interests by limited partners but, for practical reasons owed to the large number of limited partners, not requiring amendment of the certificate, highlights this problem of the anomalous status of assignees of limited partnership interests who are not limited partners."

29. Uniform Partnership Act § 15; Uniform Limited Partnership Act § 9(1). Such partners are jointly and severally liable for certain tortious conduct. Uniform Partnership Act § 15(a); Uniform Limited Partnership Act § 9(1).

30. Uniform Limited Partnership Act § 7.

31. *Id.* § 2.

32. *Id.* § 7: "A limited partner shall not become liable as a general partner unless, in addition to the exercise of his rights and powers as a limited partner, he takes part in the control of the business."

33. See, *e.g.*, Bottlers' Seal Co. v. Rainey, 243 N.Y. 333, 346, 153 N.E. 437, 442 (1926).

34. See Note, *Judicial Supervision of the One Man Corporation*, 45 Harv. L. Rev. 1084, 1089 (1932).

guarantee the obligations of the corporation.[35] Business necessity would in many cases dictate the making of such guarantees when a small partnership business or a partnership business heavily burdened with debt committments was changed into a corporate business, since credit availability may depend upon the financial strength of one or more of its owners.[36] To the extent of these guarantees, therefore, such owner or owners partake of liabilities similar to those of a general partner; and in such cases and as respects such owner or owners and to the extent of such guarantees, the corporate form would not possess an attractiveness based upon liability limitation. Moreover, to the extent that such guarantees are made by less than all of the owners, the guarantor-owners may partake of liabilities in excess of those of general partners since they would have no right of contribution[37] from the owners who have not given such guarantees. Only when the size of the business and its financial resources have grown to the point that the financial strength of the owners ceases to be a factor in the availability of credit to the business, therefore, is the full benefit of limited liability obtainable for all of its owners through the medium of incorporation.

III. Control Structure

A high degree of flexibility in the government of a business is possible under both the partnership and corporate forms. Although partnership government is sometimes conceived as involving a dispersion of control and a structure in which all of the partners participate in making many decisions[38] and corporate government is often conceived as centering exclusive control over operations of the business in the board of directors,[39] neither form must conform to such conceptions in all circumstances. Thus the government of a partnership can be concentrated in the hands of managing partners[40] or of an executive committee,[41] voting power can be distributed among the partners in the forms of weighted votes and non-voting partners, and separate classes of partners, resembling the separate classes of stock sometimes found in corporations, can be established. The government of a corporation, on the other hand, need not be centralized but may

35. Note, *Corporate Formation*, 52 Nw. U.L. Rev. 352, 354 (1957); *Note, Capitalization*, *id.* at 365.

36. *Cf.* Lewis, *The Uniform Limited Partnership Act*, 65 U. Pa. L. Rev. 715, 717-18 (1917).

37. The right of contribution exists only when the partnership agreement does not otherwise provide. Uniform Partnership Act § 18.

38. Such is the structure of partnership government in the absence of an agreement to the contrary. Uniform Partnership Act § 18(h).

39. *E.g.*, Treas. Reg. § 301.7701-2(c)(1) (1960).

40. See Potter v. Brown, 328 Pa. 554, 195 Atl. 901 (1938).

41. *E.g.*, Treas. Reg. § 301.7701-2(g) (1960), examples (1) and (2).

be diffused by the use of high quorum requirements on the board of directors[42] or for stockholders' meetings[43] and of extra-majority voting requirements,[44] and agreements among stockholders can often obligate such stockholders to vote for specified action.[45] Although control can be diffused or centralized under both the corporate and partnership forms of organization, however, the limited liability which can be conferred upon a limited partner will be destroyed by section 7 of the Uniform Limited Partnership Act whenever such limited partner "takes part in the control of the business."[46] While it would appear that the draftsmen of that act contemplated that a limited partner might exercise some degree of control over the conduct of the business in which he invested without forfeiting his limited liability,[47] they failed to specify in the act how much control was permissible.[48] Such omission in the act combined with the paucity of cases[49] which have

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42. *E.g.*, NEW YORK STOCK CORP. LAW § 9(b); NEW YORK BUS. CORP. LAW § 709(a)(1) (effective Sept. 1, 1963).

43. *E.g.*, NEW YORK STOCK CORP. LAW § 9(c); NEW YORK BUS. CORP. LAW § 616(a)(1) (effective Sept. 1, 1963).

44. *E.g.*, NEW YORK STOCK CORP. LAW §§ 9(b), (d); NEW YORK BUS. CORP. LAW §§ 616(a)(2), 709(a)(2) (effective Sept. 1, 1963). See also Katcher v. Ohsman, 26 N.J. Super. 28, 97 A.2d 180 (Super. Ct. 1953). *But see* Bator v. United Sausage Co., 138 Conn. 18, 81 A.2d 442 (1951); Benintendi v. Kenton Hotel, Inc., 294 N.Y. 112, 60 N.E.2d 829 (1945); Goldfarb v. Dorset Prods., Inc., 82 N.Y.S.2d 42 (Sup. Ct. 1948). *Cf.* Mook v. Berger, 6 N.Y.2d 833, 159 N.E.2d 702 (1959). *Cf.* Hornstein, *Judicial Tolerance of the Incorporated Partnership*, 18 LAW & CONTEMP. PROB. 435, 442 (1958); O'Neal, *Giving Shareholders Power To Veto Corporate Decisions: Use of Special Charter and By-Law Provisions*, *id.* at 451, 454; O'Neal, *Moulding the Corporate Form to Particular Business Situations: Optional Charter Clauses*, 10 VAND. L. REV. 1 (1956). The flexibility of a voting trust device may be restricted in so far as trust law principles are read into the law governing such device. See Note, *Control Devices*, 52 NW. U.L. REV. 375, 378-79 (1957).

45. Compare Storer v. Ripley, 1 Misc. 2d 235, 125 N.Y.S.2d 831 (Sup. Ct. 1953), *aff'd*, 282 App. Div. 950, 125 N.Y.S.2d 339 (1953).

46. UNIFORM LIMITED PARTNERSHIP ACT § 7.

47. See Commissioners' Note following § 1 of the UNIFORM LIMITED PARTNERSHIP ACT:

"The draft herewith submitted proceeds on the following assumptions:

"First: No public policy requires a person who contributes to the capital of a business, acquires an interest in the profits, *and some degree of control over the conduct of the business*, to become bound for the obligations of the business; provided creditors have no reason to believe at the times their credits were extended that such person was so bound." (Emphasis added.)

Similar language, also without explanation of the amount of permissible control is found in Lewis, *The Uniform Limited Partnership Act*, 65 U. PA. L. REV. 715, 723 (1917).

48. Section 7 of the Uniform Limited Partnership Act, which imposes unlimited liability on a limited partner who "takes part in the control of the business" does not define "control" and "control" is not defined elsewhere in the act. See Note, *The Limited Partnership*, 45 YALE L.J. 895, 902-06 (1936).

49. Plasteel Prods. Corp. v. Helman, 271 F.2d 354 (1st Cir. 1959); Baumer Foods, Inc. v. Griffith, 166 F.2d 433 (9th Cir.), *cert. denied*, 334 U.S. 828 (1948); Bergeson v. Life Ins. Corp. of America, 170 F. Supp. 150, 159 (D. Utah 1958), *aff'd in part and rev'd in part*, 265 F.2d 227 (10th Cir.), *cert. denied*, 360 U.S. 932 (1959);

construed section 7 has resulted in removing much of the usefulness that the limited partnership device was intended to possess. It has been suggested that a profit sharing creditor may be permitted a greater exercise of control over a business enterprise without incurring exposure to personal liability for business debts if such investor wears the garb of a creditor rather than that of a limited partner.[50] While the suggestion may have some validity with respect to the tendencies of courts in deciding cases, any existent policy reasons behind such distinction are not immediately apparent. Thus while a profit sharing creditor has sometimes been allowed a broad veto power on the ground that such power was necessary for the protection of his investment,[51] the same justifying reason could be urged on behalf of a limited partner, and perhaps with more force since his investment is a subordinated one in respect of return of capital as well as return on capital.[52] If the profit sharing creditor has a subordinated claim to principal as well as to a return on such principal, then his interest

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Grainger v. Antoyan, 48 Cal. 2d 805, 313 P.2d 848 (1957); Holman v. De Escamila, 86 Cal. App. 858, 195 P.2d 833 (Dist. Ct. App. 1948); Sivola v. Rowlett, 129 Colo. 522, 272 P.2d 287 (1954); Rathke v. Griffith, 36 Wash. 2d 394, 218 P.2d 757 (1950); *cf.* Donroy, Ltd. v. United States, 196 F. Supp. 54, 60 (N.D. Cal. 1961), *aff'd*, 301 F.2d 200 (9th Cir. 1962); Toor v. Westover, 94 F. Supp. 860 (S.D. Cal. 1950), *aff'd on other grounds*, 200 F.2d 713, 715 (9th Cir. 1952), *cert. denied*, 345 U.S. 975 (1953).

50. Note, *The Limited Partnership*, 45 YALE L.J. 895, 906 (1936):

> "[A]lthough under the most liberal interpretation of Section 7, the tests as to that degree of participation which will result in the imposition of partnership liability upon the general investor and the limited partner may be alike *in vacuo*, the former may be able to acquire certain privileges which, if exercised by a limited partner, would probably be held to violate Section 7 . . . . the courts have allowed the [profit sharing investor] . . . an extensive veto power, on the ground that it constitutes security for the investment. In a contract of limited partnership, the reservation of any comprehensive privileges cannot so well be made to appear as security."

51. See Martin v. Peyton, 246 N.Y. 213, 221-22, 158 N.E. 77, 79-80 (1927), where the court refused to hold that three defendants were personally liable for the debts of a partnership to which they had transferred a large amount of liquid securities in return for 40% of the profits of the partnership until such securities were returned. Although two of such defendants, in the capacity of "trustees" for themselves and the other transferor possessed a broad veto power over partnership transactions, the court refused to find that the defendants thereby became "partners" in such partnership:

> "The trustees . . . may veto any business they think highly speculative or injurious. Again we hold this but a proper precaution to safeguard the loan. The trustees may not initiate any transaction as a partner may do. They may not bind the firm by any action of their own. Under the circumstances the safety of the loan depended upon the business success of K. N. & K. [the partnership]. This success was likely to be compromised by the inclination of its members to engage in speculation. No longer, if the respondents were to be protected, should it be allowed. The trustees therefore might prohibit it, and that their prohibition might be effective, information was to be furnished them. Not dissimilar agreements have been held proper to guard the interests of the lender."

Compare Douglas, *Vicarious Liability and Administration of Risk II*, 38 YALE L.J. 720, 730-31 (1929). See also Mollwo, March & Co. v. Court of Wards, L.R. 4 P.C. 419 (1872).

52. UNIFORM LIMITED PARTNERSHIP ACT §§ 15, 16, 23.

is identical[53] to that of a limited partner who has made an investment for a similar duration[54] and similar rules should govern both. Whether or not the kinds of control which a limited partner may possess consonant with the limitation on his liability ultimately is equated by the courts with the negative control which apparently[55] can be vested in a profit sharing creditor,[56] the amount of control which may be exercised by a limited partner consonant with the statutory limitation on his liability is presently uncertain,[57] and from the viewpoint of business planning, the problem is compounded by the limitations on the discretion of the draftsman of a limited partnership certificate which safety considerations may impose. While in some instances the partnership form may be able to meet the demands of a new investor for profit sharing, limited liability and some form of control participation by clothing such investor in the garb of a creditor and vesting him with a broad veto power, the flexibility of the partnership form even as expanded by the use of the profit sharing creditor device

53. The financial statements of the partnership would, however, probably differ, depending upon whether an investor's interest is denominated as a limited partnership interest or as a creditor interest.

54. It has been suggested that the profit sharing creditor device may not be capable of combining "participation in the management" with "a continuing stake in the enterprise." Note, *The Limited Partnership, supra* note 50, at 906 n.52; *cf.* Pooley v. Driver, L.R. 5 Ch. 458, 479, 482 (1876).

55. See Martin v. Peyton, *supra* note 51; *cf.* Mollwo, March & Co. v. Court of Wards, *supra* note 51. See also Note, *The Limited Partnership, supra* note 48.

56. The suggestion that the criteria for judging the amounts of control permissible to the limited partner and the profit sharing creditor may be the same was made in Note, *The Limited Partnership, supra* note 48, at 903-04:

> "[I]t may be maintained that when the Act provides that the limited partner shall be liable as a general partner when he takes part in the 'control' of the business, the 'control' referred to constitntes the same standard as that used to determine partnership liability apart from the Act."

57. It would seem that a limited partner may offer advice without destroying his limited liability. Donroy, Ltd. v. United States, *supra* note 49, at 60; Toor v. Westover, *supra* note 49, at 863; Sivola v. Rowlett, *supra* note 49; *cf.* Madison County Bank v. Gould, 5 Hill 309 (N.Y. 1842). Some further amount of participation in partnership affairs may not result in personal liability for partnership debts. Baumer Foods, Inc. v. Griffith, 166 F.2d 433 (9th Cir.), *cert. denied,* 334 U.S. 828 (1948); Rathke v. Griffith, 36 Wash. 2d 394, 218 P.2d 757 (1950). *Cf.* Plasteel Prods. Corp. v. Helman, 271 F.2d 354 (1st Cir. 1959), which held that the selection by the limited partner of the general sales manager of the business and a contractual provision establishing joint control by such sales manager and the general partner of the financial aspects of the business, subject to the power of the general partner to discharge the sales manager and to end the joint control by in effect buying out the limited partner's interest for a nominal sum, did not subject the limited partner to personal liability under § 7 of the Uniform Limited Partnership Act. Compare Holzman v. De Escamilla, 86 Cal. App. 858, 195 P.2d 833 (Dist. Ct. App. 1948), where the limited partners lost their liability limitation through, *inter alia,* selecting a manager. Compare the *Plasteel* case with a stricter view expressed in the pre-uniform act case of Richardson v. Hogg, 38 Pa. 153, 156 (1861). Compare also the powers permitted to be exercised in the above cases with the powers of a limited partner under a pre-uniform act statute in New York described in First Nat'l Bank v. Whitney, 4 Lans. 34, 38-39 (N.Y. Sup. Ct. 1871).

falls short of the varied combinations of control and limited liability possible under the corporate form. Thus it would appear that decisional law lends support only to a "negative" type of control participation in partnership affairs by the profit sharing creditor;[58] and it would further appear that in practice, and especially among a closely knit group of people, the distinction between affirmative and negative participation in control may become extremely hazy.[59]

The adaptability of the corporate form to business structures involving "control" distribution incompatible with the section 7 condition or with a profit sharing creditor arrangement would increase in importance when growth financing necessitates some sharing of control with new equity investors.[60] Even in those partnership structures in which all partners participate on an equal basis in deciding most questions by majority vote,[61] the vote which any individual partner has in decision-making bears an inverse ratio to the number of partners in the partnership; in such cases the imposition of unlimited liability on partners dissenting from the transaction or transactions giving rise to the failure of the business would accentuate the partnership disadvantage of unlimited liability. Growth—

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58. Broad negative powers of control have been held not to transform a profit sharing creditor into a partner in Martin v. Peyton, *supra* note 52. Compare the inference of an affirmative-negative distinction in *Martin v. Peyton*:

> "The trustees may not initiate any transaction as a partner may do."

See also Mollwo, March & Co. v. Court of Wards, L.R. 4 P.C. 419, 436 (1872) in which a creditor was held not liable for business debts although he had power to direct an enlargement of "the establishment," because he "had no initiative power." Compare *A Survey of Statutory Changes in North Carolina in 1941*, 19 N.C.L. Rev. 435, 505 (1941) ("[T]here is always the risk that he [the profit sharing creditor] will be found to have spoken affirmatively and too loudly.") Cf. Note, *The Limited Partnership*, 45 Yale L.J. 895, 906 (1936) ("Of course, the power to initiate and direct the execution of policy will result in the imposition of partnership liability upon either the limited partner or the profit-sharing investor.") The position that there is a clear line of distinction between a negative power of control or veto over predetermined action and an affirmative power of control was also taken in Douglas, *Vicarious Liability and Administration of Risk II*, 38 Yale L.J. 720, 730-31 (1929):

> "A right to veto prices fixed or costs which have been determined upon is at best a clumsy device for getting into force any policy desired. For practical purposes it probably even falls short of a backhanded way of fixing prices or determining costs. Theoretically a thousand nays might be as effective as one yea. Actually business is not and could not be run that way. The use to which such veto can best be put, and for which it is devised, is as a check over improvident judgmeuts, unwarranted acts, flagrant abuses of trust, etc. As a day-to-day business regulator it fails."

It is not clear, however, that a veto power canuot be used to direct policy by letting it be known in advance what courses of action will be acceptable to the holder of the veto power. Furthermore, if the holder of the veto power is permitted to attend meetings of the decision making body of the partuership, the line between disapproving unacceptable action and suggesting acceptable action would seem most hazy.

59. See note 58 *supra*.

60. See pp. 370-71 *infra*.

61. Compare Uniform Partnership Act § 18(h).

here in the number of owners, which might be a necessary incident to growth in total assets—would exert an influence toward the adoption of the corporate form.[62] Again, the partnership form would probably not permit the delegation of substantial supervisory or managerial authority to hired managers to be combined with substantial involvement in supervising or managing any of the operations of the business, including supervision or management limited to operations not so delegated, without risking personal liability for business debts incurred by such hired managers. Thus when expansion reaches the point where the original controlling owners require outside assistance in supervising the affairs of the business but are unwilling to relinquish their own participation in supervising and managing, incorporation would increase in desirability.

IV. TAX FACTORS AND FINANCIAL STRUCTURE AS RELATED TO GROWTH

A. TAX AND OTHER FACTORS RELATED TO FINANCING EXPANSION OUT OF EARNINGS

Earnings from operations, if they exist, are a possible source from which some expansion can be financed. Even when such earnings are insufficient to finance the full amount of needed expansion, they may supplement additional capital secured by the business from other sources.

A decision as to the present advisability of incorporating a preexisting and growing partnership should normally be made only after computing the financial needs of the business related to expansion and the effects that incorporation would have on the ability of the business to finance expansion out of earnings.[63] Earnings on the capital contributions of the owners will be taxed as earned at the

62. The adaptability of the corporate form to flexible arrangements of power allocation would also facilitate business expansion through the acquisition of independent units. Thus in connection with the issuance to the owners of an acquired business of a share in the equity of the acquiring business in payment for the former business' assets, no necessity would arise of such owners being excluded from minority representation on the board of directors of the enlarged business under penalty of their assuming a risk of personal liability for the acts of the majority. *Cf.* Bergeson v. Life Ins. Corp. of America, *supra* note 49.

63. The prime tax advantage of corporate tax treatment from a growth standpoint is the lower tax rate applicable to reinvested earnings. Since the businesses under discussion have an unlimited asset-expansion capability, see pp. 351-52 *supra*, accumulation without reinvestment to which INT. REV. CODE OF 1954, § 535 would apply would not generally occur. Even in the situation in which earnings are not reinvested, the apparent "double taxation" of such earnings, see pp. 366-67 *supra*, may be nonexistent when such earnings are paid out in the form of tax-deductible salaries or in the form of contributions to pension plans qualified under INT. REV. CODE OF 1954, § 401. During the early stages of operation when the owners are active managers and prior to the commencement of a rapid growth process, therefore, the corporate form may have an appeal based primarily on limited liability and pension plan attributes superior to those available under an unincorporated form of organization. See

average tax rate applicable to the owners if the partnership form is retained,[64] unless the owners elect corporate tax treatment under subchapter R.[65] If the business is incorporated, however, such earnings will be taxed at the 30 to 52 per cent corporate rate,[66] unless the ownership structure qualifies for subchapter S treatment and the owners elect such treatment. If the ownership structure does so qualify and the owners do so elect, then such earnings will be attributed to the owners and will be taxed at the average individual tax rates applicable to them.[67] Since the percentage of earnings available for reinvestment will be the reciprocal of the tax rate on such earnings, corporate tax treatment of the non-subchapter S variety will result in more earnings being available for reinvestment whenever the total tax which would be imposed on undistributed business earnings if those earnings were attributed to the owners is in excess of the applicable corporate tax on such earnings.

The growth stage at which corporate tax treatment—obtainable by incorporation, or subsequent to incorporation by revocation[68] of a previously made election under subchapter S or by a partnership electing under subchapter R—becomes advantageous from a standpoint of the taxation of retained earnings, however, cannot be determined in the abstract. The variables, which must be determined in

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Pugh, *Pension and Profit Sharing Plans for Small Businesses*, Texas Tech. Tax Institute, October 27, 1962, Lubbock, Texas. Later, the tax advantages connected with growth will join with the advantages connected with liability limitation and pension plan aspects and may supplant at least the latter as the primary appeal of the corporate form to its owners.

64. INT. REV. CODE OF 1954, § 701.

65. INT. REV. CODE OF 1954, § 1361.

66. INT. REV. CODE OF 1954, § 11. At the present time a "normal" tax of 30 per cent is imposed on all corporate income, *id.* § 11(b)(1), and a "surtax" of 22 per cent is imposed on that part of the income of a corporation which exceeds $25,000, *id.* § 11(c). The total tax which applies to any given corporation thus may vary in amount from 30 per cent to an amount approaching 52 per cent. In the absence of a change in the Code, the normal tax will be reduced to 25 per cent starting with taxable years beginning after June 30, 1963.

67. INT. REV. CODE OF 1954, §§ 1372, 1373. Subchapter S treatment is available only to those corporations which have only one class of stock held by not more than ten shareholders all of which are either individuals or estates and none of which are nonresident aliens. *Id.* § 1371(a). Furthermore an election under the subchapter terminates in any taxable year when the electing corporation derives more than 80 per cent of its gross receipts from sources outside the United States. Such election also terminates in any taxable year in which more than 20 per cent of such corporation's gross receipts are derived from royalties, rents, dividends, interest, annuities, and sales or exchanges of stock or securities. *Id.* §§ 1372(e)(4),(5). The restrictions placed on the capitalization and the ownership of shares in a subchapter S corporation would appear to make the benefits of that subchapter available only in the early stages of growth, since most businesses in the process of expansion would require an enlargement of their ownership structure, and the addition of new shareholders would eventually result in disqualification under that subchapter.

68. INT. REV. CODE OF 1954, § 1372(e)(2). Section 1372(e)(1) may also provide a means of revocation.

every given case, include the amount of anticipated business earnings and the accompanying substantial variation in the corporate tax rate from the 30 per cent low to a high of an amount approaching 52 per cent, the number of partners or other owners among whom the income of the business is attributed for tax purposes and the outside activities of such owners. Thus, all other factors (including ownership shares) being equal, the greater the number of owners among whom the income of a partnership or subchapter S corporation is deemed distributed, the greater is the amount of business income which would be requisite to make the corporate tax rate a lower one. There are some limits or hindrances, however, to financial structure composed of a large number of partnership interests,[69] and the number of owners of a corporation receiving subchapter S treatment cannot exceed ten.[70] Moreover, no conclusion can be based on the business income and the number of partners or other owners without taking into account the relative shares of that income attributable to each such partner or other owner and the individual tax rate which is applicable to each such share, as affected by the items of income and deduction applicable to such partner or other owner which arise from his activities or property interests apart from the business.

Although corporate tax treatment may free more earnings for reinvestment, it may also entail an additional tax upon each of the owners whenever such reinvested earnings are returned to him[71] or whenever he realizes the benefit of such reinvestment by selling his shares for cash.[72] The reinvested earnings of a corporation will be taxable to each shareholder upon his sale of stock in the enterprise (more than six months after its acquisition) or upon liquidation of the business at not more than the maximum capital gains rate of 25 per cent,[73] thus if no earnings were distributed as dividends, the total tax burden on corporate earnings borne by each of the shareholders would be not in excess of 30 to 52 per cent times earnings plus 25 per cent times 70 to 48 per cent times earnings, or a maximum of 64 per cent times earnings.[74] Thus the 25 per cent maximum capital gains tax

69. See p. 371 *infra.*

70. INT. REV. CODE OF 1954, § 1371(a)(1). *But cf.* Treas. Reg. § 1.1371-1(g) (1959). See note 67 *supra.*

71. Such owner will be taxed at ordinary income rates if such earnings are returned in the form of a dividend. INT. REV. CODE OF 1954, § 301(a). He will be taxed at capital gains rates, however, if such earnings are returned on liquidation of the corporation. INT. REV. CODE OF 1954, §§ 331, 1201, 1202.

72. If such sale occurred more than six months after the shareholder acquired such shares, the tax imposed upon him would be at capital gains rates. INT. REV. CODE OF 1954, §§ 1222(3), 1201, 1202.

73. See note 72 *supra.*

74. The corporate rates times earnings times the maximum capital gains rate times the reciprocals of the corporate rates.

amounts in effect to a maximum additional 12 per cent tax on the earnings of the corporation.[75] However, since the additional capital gains tax will be paid by the shareholders, the amount of earnings available for reinvestment is not affected by such additional tax liability; furthermore, the additional 25 per cent maximum capital gains tax on each shareholder's pro rata share of retained earnings could be considered by the shareholders as the price imposed for the use of funds by the business until dissolution (or in the case of a sale of stock by a shareholder, until such sale), or a charge not unlike interest; thus in a situation in which a business reinvested an equal amount of earnings each year for 25 years and then liquidated, such a hypothetical interest charge would work out to be in effect a two per cent annual charge on annual average earnings.

B. External Financing

From the point of view of the original owners, the most desirable type of outside financing would be that which would entail the smallest charge on the earnings of the business and under which they would surrender as little control as possible over the workings of the business.

The total charge on earnings with respect to funds invested in a business is a composite of taxes on such earnings plus interest or other payments paid to investors as compensation for the use of such funds less any tax reduction associated with those payments or otherwise connected with the method of obtaining such funds. The rate of such compensation or the rate of return demanded by a person supplying funds to a business would appear to reflect both the risk of loss[76] by such investor and the risk of not receiving a return on such investment each year.[77] Thus a secured creditor may demand less of a return on investment than would persons having an inferior claim on assets such as a preferred stockholder, a limited partner or a subordinated creditor. Similarly, purchasers of securities having a prior claim on earnings may demand less of a return than purchasers of securities or other interests having an inferior claim; thus the return demanded by the holder of a note or bond having a right to fixed yearly interest payments might be less than the return demanded by the holder of an income debenture, a non-participating preferred stockholder, or a

75. 52 per cent × earnings + 25 per cent × 48 per cent × earnings = 52 per cent × earnings + 12 per cent × earnings = 64 per cent × earnings. 64 per cent − 52 per cent = 12 per cent. *Cf.* Moore & Sorlien, *Adventures in Subchapter S and Section 1244*, 14 Tax L. Rev. 453, 460-61 (1959). Compare Garcia, *When Should a Sole Proprietor Incorporate His Business To Save Income Taxes?*, 35 Taxes 110 (1957); Note, *Corporate Formation*, 52 Nw. U.L. Rev. 352, 358 (1957).

76. 1 Dewing, Financial Policy of Corporations 136, 182 (5th ed. 1953).

77. 1 *id.* at 137.

limited partner whose right to share in annual earnings is limited to an amount equal to a percentage of his investment. A fortiori, it would be less than the share of earnings of a general partner or common stockholder, since the latter ordinarily possess the least preferred claim on earnings but an unlimited participation. The total charge on earnings available for reinvestment, however, will be an amount equal to the out-of-pocket payments constituting such return less any tax reduction associated with those payments or otherwise connected with the method of financing adopted.

1. Financing by Means of Interests Carrying a Right to a Fixed Return on Investment or a Right to a Limited Participation In Earnings

Debt financing, often, but not always, legally obligates the borrower to pay a fixed return on the amount of the loan to the lender; failure to pay such fixed return places the borrower in default and subjects him to the penalties provided in the underlying loan agreement with respect to such default, often including the acceleration of the date on which payment of the entire principal of the loan is due.[78] The penalties to which the borrower is potentially subject can be substantially mitigated while some degree of protection to the lender can be retained by conditioning the lender's right to a periodic return on investment upon the adequacy of the borrower's earnings and by making the right to such payments cumulative, so that an interest payment which is passed because of insufficient earnings is not lost, but will be payable together with interest payments relating to subsequent years if and when the subsequent earnings of the business warrant.[79] The holder of such a debt obligation dependent upon the earnings of the business possesses rights closely resembling those of a preferred stockholder[80] and those of a limited or general partner whose right to share in the annual earnings of the partnership is limited by contract to a percentage of his investment. Since debt, both fixed interest and interest-dependent-upon-earnings variety, preferred stock, and limited or general partnership interests whose participation in earnings are limited to a percentage of the capital represented by such interests possess the common characteristic of not sharing in the earnings equity of the business, they will be treated together in considering possible sources of new investment funds and

78. See, *e.g.*, 2 Rabkin & Johnson, Current Legal Forms With Tax Analysis § 6.66, at 872 (1961).

79. See, *e.g.*, 3 Fletcher, Corporation Forms Annotated § 2550 (1958).

80. Compare Milwaukee & Suburban Transp. Corp., 18 CCH Tax Ct. Mem. 1039 (1959), *aff'd on this point and modified on other grounds*, 283 F.2d 279 (7th Cir. 1960), *vacated on other grounds*, 367 U.S. 906 (1961); *cf.* John Kelley Co. v. Comm'r, 326 U.S. 521 (1946).

the relation of such sources to the form of business organization.

In the case of partnership financing, the type of interest taken by one or more outside investors may affect the amount of earnings available for reinvestment because the determination of how and among whom the deductions available in connection with the operation of the partnership business are to be allocated may depend upon whether the funds secured from outside sources have been loan funds or capital contributions by limited or general partners. Thus an investment in the form of a limited or general partnership interest would seem to entitle its holder to a share in the deductions arising in connection with the operation of the partnership business,[81] while an investment in the form of a loan would not. Securing growth funds by means of a loan or loans, therefore, might be preferable to securing such funds by the sale of partnership interests, not only because of the lower return on investment which might in some circumstances be payable in connection with the former, but also because such financing would reserve to the original partners the benefit of the deductions arising in connection with the operation of the partnership business.[82] To the extent that the loss of such tax benefit to the outside investors in the case of outside investment taking the form of limited or general partnership interests would be offset by a reduction in the amount of return demanded by such investors and to the extent that the partnership would be forced by its credit position or prior loan agreements or otherwise to subordinate claims attaching to new investment funds to some or all of its other creditors, the total charge-on-earnings differential between loan funds and limited or general partnership funds would narrow or be eliminated. In such event the amount and kinds of control and supervision desired by the outside investor over the activities of the partnership might, in conjunction with a desire to avoid risking personal liability for business debts, induce the investor to insist upon utilizing the loan route; thus, for example, some exercise of control over business affairs through the use by an investor of a broad veto power would seem to entail less danger that unlimited liability will be imposed upon him if he possesses the status of a non-profit sharing creditor than the status of a limited partner.[83]

81. INT. REV. CODE OF 1954, §§ 702, 704(b). It would appear at least doubtful whether the partnership agreement or limited partnership certificate could allocate loss items for tax purposes to one or more partners to the exclusion of other partners when the respective shares of income and losses bore no relation to the tax allocation. See 6 MERTENS, FEDERAL INCOME TAXATION § 35.29, at 92 (1957).

82. The effect of § 9 of the Uniform Partnership Act might also discourage financing through the sale of general partnership interests. See note 11 *supra*.

83. Compare pp. 360-63 *supra* and note 51 *supra*. See Waldie v. Steers Sand & Gravel Corp., 54 F. Supp. 585, 586-87 (S.D.N.Y. 1944), *aff'd in part and rev'd in part*, 151 F.2d 129 (2d Cir. 1945) (lender's countersigning all checks drawn on account

In the case of growth financing of an incorporated business, the most beneficial tax treatment will be obtained through the use of debt capital, since the interest payments made to the lender in connection with a loan will be deductible[84] from the corporate income subject to tax, while a return on investment paid to the holder of an "ownership" interest in the corporation would not be so deductible.[85] Although the lower interest rate which might be payable in connection with secured or unsubordinated fixed interest debt would increase the advantage of debt financing, the tax advantage of such financing would continue to make it the most desirable route in respect of conserving the greatest amount of earnings for reinvestment even when contractual commitments or general prudence dictated the use of subordinated loans with interest payable out of income. In either the partnership or the corporate form, however, the injection of a sinking fund requirement in a loan or other investment arrangement may reduce the amount of earnings available for reinvestment to the extent of the required sinking fund payments.[86]

2. *Financing by Means of "Equity" Interests*

Equity interests, in the sense here used, comprise those interests which entitle investors to given percentage shares of earnings as distinguished from interests entitling their holders to given percentage returns on their investments or to given percentage returns on their investments so far as earnings will allow. The normal holder of such an equity interest would be a common stockholder, a general partner, or a limited partner whose right to share in earnings is not contractually restricted to an amount equal to a percentage of his investment; a profit sharing "creditor" also would hold an equity interest in the sense here used. Assuming adequate contractual protection against "dilution" of their interests by the sale by the business of other similar interests at inadequate prices, increased profits resulting from an increased amount of assets would accrue to the benefit of the holders of equity interests.

Since financing growth by selling additional equity interests would confer some of the benefits of such growth on the purchasers of such interests, such financing would tend, in many instances, to be less

composed of loaned funds and business receipts of borrower held not to make a lender a partner). Since the type of investment here involved is a non-profit-sharing one, the danger of the imposition of partnership liability on the holder of an investment in creditor form would seem less than when an investment in such form was a profit sharing one.

84. INT. REV. CODE OF 1954, § 163(a).

85. Treas. Reg. § 1.163-1(c) (1957), as amended, T.D. 6593, 1962-1 CUM. BULL. 22.

86. See Donaldson, *In Defense of Preferred Stock*, in Harv. Bus. Rev., Sept.-Oct. 1962, pp. 123, 133.

favored than debt financing or other financing involving a charge on, as distinguished from a share in, earnings. Equity financing would also be discouraged by the fact that purchasers of such interests, because their claims on earnings and, in most cases, on assets would be the least preferred of all classes of investor claims, would frequently be influenced to demand some voice in the operational control of the business.[87] Debt financing involving a fixed return on investment, however, can not be undertaken by the business indefinitely; the predictable earnings of the business, the asset-debt ratio, other accounting ratios, and general prudence will limit the amount of debt that a business can sustain at any given time.[88] Even debt and other financing involving charges which fluctuate with earnings may not be incurred beyond the point at which there ceases to be a reasonable likelihood that earnings in excess of the upper limits of such fluctuations will be left over for the holders of the equity. Furthermore, to the extent that charges on, rather than participation in, earnings is involved in an investment, the possibility of future growth from internal sources is eliminated. At some point, therefore, equity financing, despite its unfavorable aspects, may be compelled.

Equity financing of a partnership business through the sale of general partnership interests would be feasible only to a limited extent. The sale of any substantial number of such interests would be impeded by the unlimited liability for business debts to which every general partner is potentially subject. Furthermore, the sale of a substantial number of general partnership interests might enlarge the number of general partners to the point where some delegation of control over operations to a central group might become necessary;[89] the existence or the prospect of such centralization might further aggravate the difficulties involved in making such sales because such centralization of decision-making could not be accompanied by limitations on the liabilities of partners not members of the central group. Equity financing through the sale of limited partnership interests might be inhibited by a reluctance of investors to foreswear exercise of the control conditionally prohibited by section 7 and an accompanying reluctance to risk personal liability. The sale of any substantial number of such interests would also be inhibited by the legal

87. See pp. 371-72 *infra*.

88. See 2 Dewing, Financial Policy of Corporations 1026-27 (5th ed. 1953); Finney, Principles of Accounting—Intermediate 543-44 (3d ed. 1946). *Cf.* Donaldson, *supra* note 86, at 133.

89. *Cf.* Treas. Reg. § 301.7701-2(c)(1) (1960):

"The effective operation of a business organization composed of many members generally depends upon the centralization in the hands of a few of exclusive authority to make management decisions for the organization, and therefore, centralized management is more likely to be found in such an organization than in a smaller organization."

impediments to transfers of such interests. Although the profit-sharing creditor device might provide a workable form for one or a few investor interests where limited partnership interests were not feasible, that device also entails risk that personal liability may be imposed on the investors when combined with some types of control participation.[90]

Equity financing through the sale of stock in an incorporated business, however, would not be exposed to the foregoing difficulties. The personal liability problem and the related problems connected with centralization and control participation would be eliminated by the corporate capacity of permitting any combination of participation in profits and exercise of control with liability limited to investment. Thus not only could new investors be issued equity interests represented by additional shares of stock identical to those possessed by the existing owners, but new shares could be tailored to fit the exact claims in respect of shares in earnings and powers of control demanded by such investors and agreed upon by such owners. Unlimited participation in profits or participation up to a limit could be combined with continuing minority representation on the board of directors or such representation only in the event of default in certain agreed-upon provisions governing the investment or majority or exclusive representation upon such default and during such default period. Moreover, since the only legal impediments to transfers-of-interests in corporations are the result of contract, charter or by-law provision, such impediments can be removed by the owners when desired; and if and when the owners decide to sell many equity interests, the reasons for maintaining transfer restrictions over such interests would disappear.[91]

If only one or a few equity interests are to be sold, the corporate form may contain some further advantage to the extent the prospective purchasers of such interests are themselves incorporated. In such event there may be a possibility of narrowing the percentage share of the earnings equity that would have to be transferred to such investor beyond the percentage share of such equity that would have to be transferred to an individual or other unincorporated purchaser, or which would have to be transferred to the same investor if the business in which the investment is to be made were a partnership. Such result might be achieved if the business in which the investment is made makes full use in the negotiating phase of the transaction of the tax deduction accorded a corporate recipient of dividend income in the amount of 85 per cent

90. See pp. 362-63 and note 58 *supra.*

91. See p. 354 *supra.*

of income so received,[92] since the effect of such deduction would be to make every dollar paid as a dividend on stock worth to its corporate recipient slightly less than twice[93] as much as a dollar received as a distribution of the profits of a partnership.

The corporate form might also possess some advantage in the situation in which the original owners of the business failed to expand its ownership base in step with its asset expansion, but instead had caused it to acquire a disproportionate amount of debt and a correspondingly unattractive appearance as an investment prospect to conservative investors. Even though such a business was unable to find purchasers for its pure equity or debt interests, if it possessed growth possibilities it might nevertheless be possible to use such growth potential as a partial inducement for one or more investors to supply funds needed by such business for such growth by offering to such investor or investors options on the business' earnings equity combined with debt interests, thus combining the speculative advantages of an equity investment with some degree of creditor protection. While it might be theoretically possible for a partnership to grant an option to purchase a right to share in its profits to a lender in conjunction with a loan,[94] such an interest might be found to be unmarketable because possible purchasers might doubt their ability to resell such interest as well as the continued existence of the partnership.[95] A more practical alternative might be the sale by a corporation of debt instruments which are either convertible into common stock or have attached to them warrants to purchase common stock;[96] the

92. INT. REV. CODE OF 1954, § 243(a).

93. The investor would realize \$.48 on each dollar received as interest. The effect of the dividend deduction would permit the investor to realize the same amount, *i.e.*, \$.48, if \$.52 were paid by the payor by way of dividend:

$$X-[.15X(.52)]=1-.52(1)$$
$$X-.078X=.48$$
$$.922X=.48$$
$$X=.52039$$

The cost to the payor would still be less if interest payments were made, however, by \$.04039.

94. See Martin v. Peyton, 246 N.Y. 213, 222-23, 158 N.E. 77, 80 (1927), in which such an option was granted.

95. Resale of an option on a general partnership interest might be prohibited by the contract of sale, since general partners would not normally obligate themselves in advance to accept a subsequent vendee as a partner. Resale of an option on a limited partnership interest would be inhibited insofar as the interest contained no safeguards against improvident action by the general partners. The resale of both types of options might be inhibited by uncertainty as to the continuance of the partnership in existence. See note 8 *supra*.

96. Detachable warrants attached to debt instruments would enable the purchaser of such instruments to share in the growth of the issuer even after the debt instruments had been paid or sold. Compare S. REP. No. 833, 86th Cong., 1st Sess. 5 (1959), note 102 *infra*. Although the issuance of convertible securities and warrants has been subject to some criticism on the ground that the corporate issuer and its stockholders

easier transferability of such interests might be helpful in securing a purchaser for such instruments, since to the extent the purchaser was assured of some degree of transferability he would have some of the freedom of liquidity[97] although he had no present intention of using it. Such a transaction would not only supply some of the capital presently required by the business, but, if the business grew as anticipated and the purchaser accordingly converted the debt instruments or exercised the warrants attached to them, it might also assist in pulling the business out of its difficult debt position—through the substitution of equity for debt capital in the former case and through the injection of further equity capital and a possible improvement in the asset-debt ratio in the latter—and into a stage of ownership base expansion. If the purchaser sold to the public[98] either the debt instruments or the stock which he had obtained by conversion or exercise of warrants, the business would also be assisted into the stage of public trading of its stock.[99]

An incorporated[100] business which possesses growth possibilities, but is in the overextended debt position described, and which cannot obtain a purchaser for its debt instruments from usual sources even by combining an option on its equity with such instruments, may be able to sell such instruments to a Small Business Investment Corporation. The willingness of such a purchaser to acquire such instruments would result from the enhancement of the inherent investment attractions of a combination of a debt security and an option on the equity of the debtor[101] which is brought about by tax provisions de-

are not always fully cognizant of the extent to which corporate stock may, as a result of such issuance, be required to be sold at a bargain price and the extent to which the equities of the existing shareholders may thereby become diluted, the issuance of convertible securities or of warrants would seem justified where such issuance is a sine qua non of a loan. *Cf.* BERLE & MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY 201-02 (1932):

> "[W]here a corporation as a last resort is forced to issue warrants as . . . additional 'sweetening' to make bonds more attractive, or otherwise, in order to get money which it needs to avoid disaster or serious trouble, the financing can be supported, on the ground that it is this or nothing."

97. Liquidity would seem often to constitute an important component of value. *Cf.* Hornstein, *supra* note 44, at 446; McLain, *supra* note 3, at 38. *Cf.* note 1 *supra.*

98. Sale of such instruments to the public might require registration under the Securities Act of 1933 unless an exemption were available. See Securities Act of 1933, §§ 5, 4, 2(11), 48 Stat. 74, 15 U.S.C. §§ 77e, 77d, 77b(11) (1958). See also SEC Rule 155, 17 C.F.R. § 230.155 (Supp. 1963).

99. See p. 352 *supra.*

100. Small Business Investment Companies are authorized to invest in convertible debentures of incorporated "small business concerns." Small Business Investment Act of 1958, § 304, 72 Stat. 689, as amended, 15 U.S.C. § 684 (Supp. III, 1962). They are authorized only to grant long term loans to unincorporated small business concerns. *Id.* § 305, 72 Stat. 689, 15 U.S.C. § 685 (1958). For the reasons stated in text, however, in most cases a sale of an option of a share of the equity of a partnership might not be very marketable even were such an investment authorized.

101. See p. 373 *supra.*

signed to encourage investment by Small Business Investment Corporations in incorporated "small business concerns" in the form of convertible debentures.[102] These provisions reduce the impact of a loss incurred on convertible debentures and stock acquired pursuant to such conversion privilege by permitting such loss to be treated as an ordinary income loss;[103] they also encourage the holding of equity interests by making the receipt of dividends by a Small Business Investment Corporation from a "small business concern" tax free.[104] Such enhancement would also be present in cases in which the business could obtain funds from other sources; in such cases the foregoing factors would enable the Small Business Investment Corporation to receive, at a lower yield on its investment, the benefits received by another investor at a higher yield, and accordingly might enable the business to obtain its required financing at a lower cost from a Small Business Investment Corporation.

V. Conclusion

The foregoing discussion would indicate that the corporate form would normally become increasingly advantageous to the owners of a business as the business grows in the size of its asset base, in the size of its earning power, and in the number of its equity owners. Corporate advantages are related to the limited liability feature of the corporate form, which becomes increasingly meaningful as the expansion of the business' scope of operations releases the business from reliance on owner guarantees and as the sizes of business commitments become increasingly larger in proportion to the financial resources of its owners. They are also related to the connection between liability limitation and the control structure, especially in the light of the increasingly centralized control structure that growth will necessitate and the comparative lack of adaptability of the limited partnership

102. Int. Rev. Code of 1954, §§ 1243, 243(b). Prior to 1960 convertible debentures were the only form of investment in which Small Business Investment Companies were authorized to invest. Small Business Investment Act of 1958, § 304(b)(3), 72 Stat. 689, 15 U.S.C. § 684(b)(3) (1958). In 1960 the act was amended to permit investment by Small Business Investment Companies in small business concerns by means other than the purchase of convertible debentures. 74 Stat. 196, 15 U.S.C. § 684 (Supp. III, 1962). Compare S. Rep. No. 833, 86th Cong., 1st Sess. 5 (1959):

> "The greater flexibility obtained by this amendment of section 304 would permit, among other forms, the issuance of debentures with detachable warrants. In this situation the SBIC could recapture the principle amount advanced, either by disposition of the debenture in a secondary market, or by repayment, and still retain an opportunity for some profit for the risk taken."

Although the act itself was amended, the related § 1243 of the Internal Revenue Code which provides ordinary loss treatment for Small Business Investment Companies with respect to losses on convertible debentures was not amended to conform to the change in § 304.

103. Int. Rev. Code of 1954, § 1243.

104. Int. Rev. Code of 1954, § 243(b).

form to an intermediately centralized control structure. They are related to the comparative freedom of transferability of interest which the corporate form can afford and which will become increasingly important as the number of owners increases. They are also related to the effect of taxation on the availability of earnings for reinvestment and to variations in financial structure to which the corporate form is adptable.

This correlation of attractiveness with growth possessed by the corporate form is due in most part not to the inability of the partnership form to imitate various corporate attributes, but to the inability of that form to combine such attributes in one business organization. Thus the partnership form can possess a control structure of any degree of centralization, it can confer limited liability on the vast majority of its members, it can receive the benefits of corporate taxation of earnings, its members can possess various and sundry rights to receive information and to inspect books, and its members can transfer their rights to receive business earnings without legal hindrance. However, the combination of such of the foregoing attributes as are desirable in any given case in one business organization can often be accomplished only if the business is incorporated, and the combination of all of such attributes in one organization would be impossible other than in a corporation.

When incorporation becomes desirable in a specific case, however, can be determined only by balancing the combination of business attributes deemed desirable (including attributes not primarily connected with growth) against those aspects of corporate tax treatment and contractually unmodifiable corporate attributes which are undesired in the context of the concrete case. Thus, for example, the point in growth at which the interplay of limited liability and the control structure would make incorporation particularly desirable may not coincide with the point at which the tax consequences of incorporation would be beneficial.