Re-Examination of the Desirability of the Corporate Form of Business Organization

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RE-EXAMINATION OF THE DESIRABILITY OF
THE CORPORATE FORM OF BUSINESS
ORGANIZATION

By HAROLD HOLMES BREDELL*

In view of economic and political developments of recent
times it would seem that we might profitably re-examine our
prevailing form of business organization, viz: the corpora-
tion, to determine whether that form still retains the benefits
which it once possessed; whether it is still desirable. The
notion that the corporate form is an indispensable need to
any business organization seems to have, for the past genera-
tion, permeated the thinking of the entire business community
from the great national businesses to the smallest local busi-
ness operated by a single individual. Usually the business-
man's first request to his lawyer is that a corporation be
formed.

The corporation as used today is a modern device. It is
true that the corporation was known to ancient law, and has
been attributed by various writers to Roman law, the Hellenic
law of the time of Solon, pre-Norman Anglo-Saxon law, and
to various other origins. It is not the purpose of this article
to consider the historical basis of the corporation. So far

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as practical present problems are concerned the corporation
did not appear in general common usage in the United States
until the 19th Century, and in fact it is only in the past fifty
years that the corporation has been used so extensively. Prior
to the general usage of the corporate form, enterprises carried
on by more than one individual were organized into partner-
ships. The common partnership possessed many obvious dis-
advantages, and in the face of the advantages (hereinafter
discussed) offered by the corporate form of organization, the
partnership came into comparative disuse. It is, however,
used to a greater extent than commonly supposed, and numer-
ous big businesses are still conducted as partnerships. For
example, practically all brokerage houses are carried on as
partnerships or as individuals, and are required to be so by
the rules of various stock exchanges, but there is a movement
now current to require incorporation of such firms as an aid
to public control.¹

However, advantages of the corporation were such as to
attract most businesses into that form of organization. Al-
though the corporate form possessed many benefits, the prin-
cipal ones were two-fold: (1) unity of organization with
continuity of existence unaffected by death or change of mem-
bers composing the organization; and (2) protection of in-
dividual members of the business organization from personal
liability to creditors of the business. In the beginning there
were few, if any, penalties placed by the various governments
upon the corporation as such, and therefore it was natural
that businessmen should rally to the corporate standard.
However, a generation of restrictive regulation and taxation
has changed the original situation, and therefore it might
prove beneficial to weigh by modern standards the benefits and
detriments of the corporate form; or, in other words, we
might ask the question: Is business paying too high a price
for corporate advantages, and is there any way by which
those advantages may be secured without paying that price?

¹ Meyer, Law of Stock Brokers and Stock Exchanges, (1931) Sec. 8, p. 86;
Constitution of New York Stock Exchange, Art. XX. See also N. Y. Herald
Tribune, March 31, 1938, pp. 23-24, "Incorporating Exchange Firms Urged."
The major disadvantages which have been placed upon the corporate form result from governmental regulation and from taxation, both state and federal. We would first consider certain of the restrictions and regulations which are placed upon the corporation but not upon the individual. It should be pointed out that we are considering solely the restrictions upon business in general and not upon business affected with a public interest, such as utilities that are subjected to special regulation. These regulations are generally statutory in character, and, for purposes of example, let us consider the regulations of the State of Indiana as indicative of the type and extent of regulation generally found in this country.

(a) The first general restriction is that relating to the purpose and function of the corporation. Although modern legislation has liberalized the scope of corporate authority, the question of ultra vires acts is still a problem. For example, the Indiana Statutes give to corporations the capacity of natural persons, but limit the corporate authority to “only such acts as are necessary, convenient or expedient to accomplish the purposes for which it is formed.”

Thus the question naturally will arise with respect to corporate action as to whether such action is necessary, convenient or expedient to accomplish the limited purposes of the corporation. The corporation is further restricted with regard to its general operations, the representation accorded to the owners of the corporation, the time and place of meetings of its governing body, and many other such regulations too numerous to be considered at length.

(b) The financial affairs of a corporation are also under strict governmental supervision. The nature and amount of its capital stock, the method of transfer of shares of stock,

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4 Burns Ind. Stats. Anno. 1933, Sec. 25-205.
5 Uniform Stock Transfer Act, Burns Ind. Stats. Anno. 1933, Sec. 25-701 et seq.
the right to dispose of the assets of the corporation, the right to reduce the amount of capital stock, the right to distribute the earnings of the corporation, and various other matters relating to the financial affairs of the corporation are subject to restrictive regulation. In some instances the regulations conflict with other regulations and with practical aspects of business. For example, the Indiana law forbids the declaration and payment of dividends if such payment would impair the capital of the corporation. On the other hand, the federal government levies a tax upon the annual net income that is undistributed; thus a corporation might earn a profit in one year but would still have a deficit carried over from previous years, so that the corporation would be forbidden to declare dividends under the Indiana law, but would be taxed under the federal law for not distributing the profits of the current year.

(c) The corporation is also burdened with the necessity of filing reports to various units of government, and is thus forced to disclose its operations to a greater extent than required of individuals. The most universally required reports are annual reports to the government of the state in which the corporation was organized or admitted to do business, and such reports generally require a disclosure of the amount of capital, the classification of shares, the amount of the cash or other consideration received for shares, the amount of business transacted during the year, tangible property employed within the state, etc. One disclosure particularly disliked by corporations is the report required by the federal government showing the names of all officers or employees receiving compensation of more than $15,000 per year.

(d) One of the benefits of corporate form deemed important by businessmen was that the managers of the business

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7 Burns Ind. Stats. Anno. 1933, Sec. 25-229.
8 Burns Ind. Stats. Anno. 1933, Sec. 25-211.
9 See Note 8.
12 Sec. 148 Revenue Act of 1936.
could operate as a Board of Directors and escape personal liability. Because of the abuses practiced by certain individuals, legislative restrictions have been erected which have imposed so great a personal responsibility upon directors as practically to destroy this particular advantage. For example, in Indiana there has been imposed by statute a liability upon directors for the debts and contracts of a corporation in case a director knowingly declares or assents to the payment of a dividend or withdrawal of assets if the corporation’s capital is thereby impaired, or if the director knowingly assents to the making of a loan to a director or officer without complying with certain requirements, or if the director shall certify to any report which is false in any material particulars, etc. 13 Such regulations are typical of those found in most jurisdictions. Various other regulations, such as those imposed by the Federal Securities and Exchange Act,14 make the duties of a director most burdensome and expose the director to a risk almost as great as if he were transacting business in his individual right.

(e) Most jurisdictions have strict laws requiring corporations to maintain agents for service of process and in case of failure by the corporation to designate an agent, then some state official, most often the Secretary of State, is arbitrarily designated by law as agent for the corporation. For example, under the Indiana law a domestic corporation may be sued wherever it has an office or agency, and a foreign corporation may be sued in any county in the state where any property or credits of the corporation may be found.15 The requirement that a foreign corporation must designate an agent for service or be deemed to have acquiesced in the arbitrary appointment of some public officer as its agent has led to sad results in certain cases in which default judgments have been entered against corporations although the responsible cor-

14 Title 15 U. S. C. A. Sec. 77 et seq.; providing, among other matters, liability of directors for statements in prospectus.
15 Burns Ind. Stats. Anno. 1933, Secs. 2-706 and 2-708. See also Sec. 2-804, providing the manner in which process may be served against both foreign and domestic corporations.
porate officers did not have notice of the action; and such default judgments have been uniformly upheld.\textsuperscript{16} Of course an individual is not subject to suit except in jurisdictions where he may be found, and in the case of a partnership the partners may not be sued except in jurisdictions where the partners may be found; except that individuals and partners are subject to suit in the county where an office is maintained if action is based upon business arising out of that office.\textsuperscript{17}

(f) One of the most serious problems of the corporation is that of doing business in more than one state. Whenever a corporation engages in business in any state other than the state of its incorporation it must subject itself to whatever burdens the foreign state cares to impose upon it as a condition of doing business. It is well established that since a state may entirely exclude a foreign corporation it may also impose whatever conditions it sees fit, subject, however, to the rights accorded by the Federal Constitution.\textsuperscript{18}

Thus a state may require the qualification of a foreign corporation by the filing of reports, the obtaining of permits or certificates, and the payment of fees therefor.\textsuperscript{19} Likewise,
the state may levy a tax at any rate it pleases as a condition of admission of a foreign corporation into the state;\textsuperscript{20} this tax may be at a different rate than the tax upon domestic corporations or individuals;\textsuperscript{21} the tax may be based upon the number of shares of capital stock which is proportionate to the amount of business carried on within the state to the amount of total business,\textsuperscript{22} or the tax may be based upon the capital employed in the state.\textsuperscript{23} An example of the broad scope permitted to the states is found in the recent case\textsuperscript{24} involving the Louisiana state chain store tax. In that case the United States Supreme Court upheld a tax, the rate of which was based upon the number of units of a chain outside the state as well as those within the state.

Although corporations have not been considered as included within the constitutional safeguard with respect to "privileges or immunities of citizens of the United States," corporations have been accorded protection under the "equal protection of the laws" and "due process" clauses of the Fourteenth Amendment.\textsuperscript{25} The Supreme Court has made a distinction between the conditions which may be exacted for the privilege of admission to the state and the conditions which may be imposed upon a foreign corporation after its admission, and it has been held that inequalities against foreign corporations with respect to the admission of the corporations do not conflict with the Fourteenth Amendment, but after admission into the state the foreign corporation is entitled to the equal protection of the laws of that state.\textsuperscript{26}

\textsuperscript{20} Hanover Ins. Co. v. Harding, 272 U. S. 494, 510 (1926).
\textsuperscript{21} Cheney Bros. Co. v. Massachusetts, 246 U. S. 147 (1918); People v. Latrobe, 279 U. S. 421 (1929); Kansas City etc. R. R. Co. v. Stiles, 242 U. S. 111 (1916).
\textsuperscript{22} State v. Siosi Oil Corp., supra.
\textsuperscript{23} Adams Express Co. v. Ohio State Auditor, 166 U. S. 185 (1896).
\textsuperscript{26} Hanover Ins. Co. v. Harding, supra.
However, the dissenting opinion of Mr. Justice Black in the recent case of *Connecticut General Life Ins. Co. v. Johnson*, is disturbing not only to foreign corporations but to domestic corporations as well, because he takes the view that corporations are not entitled to protection under the Fourteenth Amendment to the Constitution, and he openly states that the court should now overrule all cases since 1882 which have interpreted the due process and equal protection clauses of the Fourteenth Amendment as including corporations. In a rather lengthy discussion of the history of the Fourteenth Amendment he concludes that it was meant to cover only natural persons. If such ideas should gain support in the court it would seem to leave corporations at the mercy of the various legislative authorities and would permit any state to tax corporations, both domestic and foreign, without federal constitutional restraint. The expression of such ideas would seem to be another evidence of the tendency to make the corporate form of organization entirely subject to unrestrained governmental regulation and taxation.

(g) A new attack upon the corporation is found in the proposed Federal Corporate Licensing Bill, now pending in Congress. If enacted, all corporations (with certain exceptions) engaged in "commerce" must procure a federal license to do business, and the price of a license would be submission to such restrictions as: all stockholders given equal voting rights regardless of charter provisions; Federal Trade Commission would name the person who could act as a stockholder's proxy; corporate indebtedness could not exceed value of capital and surplus; compliance with all federal laws and Federal Trade Commission rulings, including minimum wages, collective bargaining, equal wages for women, uniform accounting practice, etc.

Various other examples of governmental regulation could be discussed but the foregoing will serve to demonstrate the type of problem confronting the corporation under modern governmental regulation.

28 S. B. 3072—75th Congress, 2nd Session; O'Mahoney-Borah Bill.
Perhaps the most serious disadvantage to the corporate form of organization is the ever increasing tax burden placed discriminatorily upon the corporation. The following are types of taxes imposed upon the corporation which represent an additional burden over and above the tax imposed upon a business enterprise conducted by individuals rather than by corporations:\(^{29}\)

(a) The first and most universal tax is the normal federal corporate income tax, which, under the 1936 Revenue Act, ranged from 8% to 15% of the net income of the corporation, and has been increased by the 1938 Revenue Act from 12½% to 16½% of net income. So long as dividends received by the stockholders were exempt from taxation in the hands of the stockholders this normal corporate tax was not discriminatory. However, under the present federal law the individual stockholder must pay a tax upon the income of the corporation which he receives as a dividend and therefore even the normal corporate tax represents double taxation of a single business income.\(^{30}\)

(b) In addition to the normal tax, there is also imposed a tax upon profits of the corporation which are in excess of 10% of the adjusted declared value of the capital stock of the corporation.\(^{31}\) This tax varies from 6% to 12%, depending upon the percentage of profit. This tax has been particularly criticized because it is coupled with a Capital Stock Tax,\(^{32}\) which is a tax based upon the declared value of the capital stock of the corporation. Once this value has been declared it cannot be changed, and since the excess profit tax is based upon this arbitrarily declared value the corporation’s officers are forced to guess as to future corporate earnings.

\(^{29}\) Wherever practicable the provisions of the new Revenue Act of 1938, recently enacted, have been taken into account in the following discussion, although the variations in the exact rates of the taxes do not affect the propositions here demonstrated.

\(^{30}\) Sec. 22 of Revenue Act of 1936; Secs. 13, 14 of Revenue Act of 1938.

\(^{31}\) Sec. 602, Revenue Act of 1938.

\(^{32}\) Sec. 105 of Revenue Act of 1935, as amended in 1936; see Title 26 U. S. C. A., Sec. 1358a.
If the future earnings are underestimated then the corporation becomes liable for a large excess profits tax, whereas if the future earnings are overestimated the corporation has been paying an unnecessarily high capital stock tax. Thus these two taxes place a corporation in a very difficult position. It appears that this hardship will be mitigated by the 1938 Revenue Act, which permits a change in declared value every three years.

(c) Sec. 14 of the Revenue Act of 1936 created what is known as an undistributed profits tax, which is a complicated tax upon net profit which is not distributed in dividends. This tax ranges (under the 1936 Act) from 7% to 27% on the undistributed income, but has been reduced to $2\frac{1}{2}\%$ under the 1938 Revenue Act (Secs. 13, 14, and 27); various credits and exemptions are allowed, which need not be considered here.\(^3\) The effect of this tax is to force distribution of earnings, which is often detrimental to the corporation's financial affairs; and throws the corporate earnings into the stockholder's taxable income.

(d) In the past, certain persons in the higher income brackets have utilized the corporate form so that business profits would not accrue directly to the individuals, or be charged against individual returns. Any such benefit has now been cut away by the Revenue Acts of 1936 and 1938 (Sec. 102), which impose a special tax upon corporations which are deemed to have improperly accumulated a surplus for the purpose of preventing the imposition of a surtax upon the shareholders of the corporation. This section of the 1938 Act imposes a tax of 25% to 35% upon the retained net income of the corporation, depending upon the amount of the income and the classification of the corporation. Thus this advantage, to whatever extent it had been utilized, is now virtually destroyed.

(e) Sec. 351 of the Revenue Act of 1936 imposed a tax upon what were designated as personal holding companies,

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\(^3\) For discussion of this tax, see Miller "The 1936 Federal Corporate Surtax," XII Ind. Law J. 19 (Oct., 1936).
that is, corporations owned by a small number of persons. As amended in 1937 (Title 26 U. S. C. A., Secs. 331-337d) and in 1938 (Sec. 402, Revenue Act of 1938) the rate for this tax was established at 65% on the first $2,000, and 75% in excess of $2,000 of the undistributed net income of such corporations.

(f) Social Security Taxes—old age and unemployment—are additional factors to be taken into account. Although the extent of the burden varies in different states, and in different businesses, it should be observed that in many cases the corporation is paying a tax upon salaries of the active owners of the business that would be unnecessary if the same payments were made to the owners as profits.

(g) In addition to federal taxation most states now levy various types of taxes upon corporations. For example, in Indiana corporations are subject to a gross income tax which is at the same rate as against individuals, but since the shareholder is subject to this tax upon his dividends from the corporation this amounts to a double taxation of the same income.

The extent to which a state may tax corporations, and particularly corporations engaged in interstate commerce, is shown by an extensive review of the authorities in the opinion of the United States Supreme Court in the recent case of Western Live Stock v. Bureau of Revenue et al., wherein it is shown that a state may tax gross receipts of interstate commerce in certain situations.

Certain of the taxes hereinabove considered may be modified or repealed by future legislation. However, it is clear that the corporation is ever at the mercy of changing laws and the shifting economic, social, and political views of the law makers; certainly taxation in the future will not become any less complex and burdensome. The corporation, as such, offers a convenient source of governmental revenue and the corporation can never be free from the fear of legislation which will place the corporation at an economic disadvantage.

in business competition. For example, the 1938 Revenue Act has given relief in rates in some situations, but the structure is still the same, and the possibility of an upward revision of rates is therefore a constant menace.

Therefore it would seem only natural that businessmen should ask of the lawyer whether there is any means of escape from this heavy hand.

III

Although business enterprise would like to be free of the disadvantages placed upon corporate organization by modern law, it is doubtful if businessmen would be willing to surrender the benefits of corporate organization in order to attain this freedom. Therefore our problem is whether the principal corporate benefits of continuity of operation and freedom from personal liability can be obtained in some other form of business organization.

The form of organization often resorted to is that of a business trust in some varied form of the type commonly known as the "Massachusetts trust," i. e., a business operated like a corporation by trustees instead of directors, under some form of trust created by the owners of the business who are the beneficiaries of the trust. Many variations have been grafted on this form in recent years in an attempt to give it a character which will avoid governmental regulation and taxation. However, from a consideration of the authorities it is very doubtful if any form of business trust will effectively achieve the desired result.

In the first place, the courts of the various states are in conflict as to the treatment to be accorded to such business trusts. They are generally held to be valid, but are given widely different legal effects. For example, in Massachusetts, the native land of the business trust, it is given validity as a trust except where the beneficiaries are really the organizers and managers of the business; and where they have associated themselves together in such situation, the organization is
treated as a partnership; in Wisconsin business trusts are made valid by statute; in Missouri the trust is held valid where the beneficiaries have no control, but the trustees are held personally liable; in Illinois the trust is held valid and trustees are not liable as partners if the contracting party deals with them as trustees. Some states have held such a trust to be a corporation for practically all corporate purposes. On the other hand, in certain states such trusts are expressly prohibited from doing business, or have been held to be partnerships or joint stock companies, and in one state such an organization is held to be a foreign trust company and must qualify under trust company laws. In Indiana the question has not been squarely decided, but in one case the Indiana Supreme Court recognized that a common law trust association had the power to hold property, while the Indiana Appellate Court has held that where the party dealing with the organization had no notice of the trust the organization as to such person is treated as a partnership. The Court there inferred that there might be a different result if notice had been given, though the Court seemed to frown upon the idea of a business trust as an attempt to evade both corporation and partnership law. Thus it is seen that the validity and effect of a business trust depends upon the view expressed in a particular jurisdiction, and even in those states where business trusts are held to be valid there can be no

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37 Darling v. Buddy, 318 Mo. 784, 1 S. W. (2d) 163 (1927).
39 Hemphill v. Orloff, 238 Mich. 508, 213 N. W. 867 (1927); Wagner v. Kelson, 195 la. 959, 193 N. W. 1; Home Lbr. Co. v. Hopkins, 107 Kan. 153, 190 Pac. 601. (But see Linn v. Houston, 123 Kan. 409, 255 Pac. 1105, where trust was held to be a partnership and trustees personally liable if contracting party did not have notice of limited liability.)
40 State ex rel. v. Paine, 137 Wash. 566, 247 Pac. 476 (1926).
41 Willey v. Hoggson Corp., 90 Fla. 343, 107 So. 408.
43 Ridge v. State, 192 Ind. 639 (1922).
absolute assurance that this form of organization will afford protection from a personal liability or escape the burdens of corporation laws.

It also seems clear that this form of organization cannot afford any relief from the federal corporation taxes because, from the pronouncements of the United States Supreme Court, it would seem that the business trust is treated as a corporation for federal tax purposes. The Revenue Act of 1936 (Sec. 1001) defines the term "corporation" as including "associations." The United States Treasury Department has, by Article 1001 of Regulations 94, amplified the definition contained in the statute, and has held that a corporation as the term is used in the Revenue Act includes any organization, whether incorporated or unincorporated, which has the corporate attributes of representative management and continuous unity of operation; and it includes a voluntary association, a joint stock company, a business trust, Massachusetts trust, investment trust, and any other organization which is not an ordinary trust or partnership. The test made by the Treasury regulations as to whether an organization is an ordinary trust or a business trust is one of purpose and if a trust is created for the purpose of carrying on a business for profit where the property of the trust is supplied by the beneficiaries and certain designated persons are acting as managers, such a trust will be deemed to be a corporation whether or not the beneficiaries are given any control over the managers. A leading case on this subject which has replaced earlier tests is that of *Morrissey v. Commissioner of Internal Revenue*, in which the United States Supreme Court upheld the definitions made by the Treasury Department. This case has been followed in later decisions of the Supreme Court.

From these opinions of the Supreme Court it would seem to be very difficult, if not impossible, to form a business trust which would not be regarded by the federal taxing

45 296 U. S. 344 (1935).
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authorities as a corporate association subject to federal corporation taxes. Therefore it would seem that the business trust, in whatever modified form, cannot be relied upon as an alternative form of business organization which will retain corporate benefits and escape corporate disadvantages.

The same is true of limited partnerships of the type where all members of the firm are limited partners, because the Treasury regulations specifically include as corporate associations "the type of partnerships with limited liability or partnership associations authorized by the states of Michigan, Pennsylvania, and a few other states."47 This does not, however, apply to partnerships in which some are general and others are limited partners. Such types of partnerships will be hereinafter discussed.

IV

An elimination of the business trust as a feasible form of business organization leaves as an alternative for collective action only the general partnership with whatever modifications have been or can be grafted upon it. Of course the general partnership affords relief from corporate taxes because the partnership as such is not subject to tax,48 but at the same time a heavier tax burden is thrown upon the individual partners in certain cases because all profits of the partnership, whether distributed or not, are assessed against the individual partners. If the partners have large enough net incomes to place them in the higher personal income tax brackets, then the increase in personal taxes might in some cases nullify any savings in the corporate tax, although, as previously pointed out, recent enactments have had the effect of forcing the distribution of all or a large part of the corporation net income to the corporate owners.

The greatest objection to the general partnership form is that it exposes its members to a personal liability that businessmen generally seem unwilling to assume; yet, as here-

47 Art. 1001-5, Regulations 94 under Revenue Act of 1936.
48 Sec. 181 et seq., Revenue Act of 1936.
tofore pointed out, personal liability to some extent has also been forced upon corporate directors. Even today certain large businesses, such as the brokerage business, where the risk of personal liability is relatively great, are carried on as general partnerships in spite of the risk of personal unlimited liability.

In many states, as in Indiana, partnerships are permitted in which some members may be limited or special partners providing that there are some general partners in the firm.\textsuperscript{49} As hereinabove stated, such partnerships are treated as ordinary partnerships by the federal taxing authorities. Under the Indiana Act such a partnership is not only given the attribute of limited liability as to some of its members, but is also given partial continuity of operation because it is expressly provided that the partnership is not dissolved by the sale of the interest of a special or limited partner, or the death of such partner. However, the special partner’s name may not be used and he may not transact any business for or be employed by the firm without being deemed to be a general partner.

While such statutes alleviate to some measure the risk of personal liability it still leaves the unrestricted personal liability of the general partner and the necessity for dissolution of the firm upon the death or retirement of a general partner. It would seem, however, that the risk of personal liability can be greatly minimized even as to general partners. Tort liability has now been practically eliminated by the general practice of carrying insurance to guard the business against all possible tort liability. We must still find, however, a method of limiting liability for debt and contract. This raises the question whether a firm may not, by some appropriate means, limit the rights of creditors and other contracting persons to recourse out of the funds used in the

business. It would seem to be fairly clear that this may be
done in the case of business trusts.\footnote{50} If this may be done in the case of business trusts what is
to prevent its application to the case of a general part-nership? The authorities on this subject are not extensive, ap-
parently because this practice has not been widely followed;
however, the existing authorities would indicate that this
might be done. Story on Partnership, Chap. VIII, Sec. 164,
states the rule as follows:

"There is certainly nothing illegal in a creditor's agreeing to such a
limited responsibility, as a qualification or condition of his contract.
. . . But a qualification agreement of this nature must be proved
and is never presumed without some reasonable proof thereof."

In an early Pennsylvania case\footnote{51} the Court held that mere
knowledge on the part of the plaintiff that the defendant
was only a special partner was not enough to limit the plain-
tiff's right of recourse against that partner, but the Court
further stated:

"Had there been a contract, I agree it would be a good defense, as
the parties are competent to make it. But such a contract must clearly
appear."

Professor Warren states his conclusions as follows:

"A petitioner is liable upon every partnership liability to the last
penny of his fortune, unless there has been an effective agreement with
the partnership creditor to the contrary.\footnote{52}"

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"We see from these authorities that all the judges have agreed that,
as a general rule, if there is in the contract between the partnership
and a stranger, an express and explicit agreement that the liability of
the partners shall be limited, effect will be given to such agreement.\footnote{53}

\footnote{50} McCarthy v. Parker, 243 Mass. 465, 138 N. E. 8; Schumann-Heink v.
Folsom, 328 Ill. 321, 159 N. E. 250, 253: "It is not against public policy to make
an agreement with a creditor that he shall, in case of default in payment, look
exclusively to a particular fund for his reimbursement."

\footnote{51} Andrews v. Schott, 10 Pa. St. 47, 55.

\footnote{52} Warren: Corporate Advantages Without Incorporation (1929), p. 355.

\footnote{53} Ibid, p. 367.
In one Texas case it was held that the members of a partnership could not evade personal tort liability under the master-servant law, by a contract with an employee for limited liability; however, such tort liability is now eliminated by various forms of insurance and would not seem to interfere with the right to limit contract liability which has been generally approved by the courts.55

From these authorities it would appear that the limitation of liability must be clearly spelled out by the contract. It is conceivable that in some lines of business such limitation of liability might handicap the business enterprise as in a situation where there is competitive bidding and the purchaser might give preference to a business organization which did not so limit its liability. However, in most situations where a business enterprise would be seeking credit it could limit the right of recovery to the business assets if its credit standing as a corporation would have justified such credit. It is a common practice, particularly in the case of smaller corporations, for financial institutions to require the endorsing of contracts and obligations by the principal owners of the business as well as by the corporation. Thus it is doubtful if any substantial business handicap would result from the limitation of liability to the business assets, and thus the corporate benefit of limited liability might be secured without the corporate disadvantages.

The question as to the value of limited liability has been raised by the recent report of a special committee of the New York Stock Exchange, in which it is urged that the members of the Exchange be required to incorporate.56 The purposes sought to be achieved by this proposal are stated to be a more direct governmental control over the business affairs of the

54 Fisheries Co. v. McCoy, 202 S. W. 343, 348 (Tex. Ct. Civ. App. 1918), p. 348: “We shall take it for granted that there is a general rule that trustees and partners can, by previous contract, exempt themselves from personal liability for contracts and torts,” but where the law gives a special status such as master-servant then such a contract for limited liability is invalid.


firms, a greater ability of the firms to secure capital funds, and the maintenance of an invested capital fund permanently available to the firm creditors. In answering the argument that creditors would be deprived of the present unlimited liability of the partners, the committee points out that, as a practical matter, unlimited liability is not as great an advantage to the creditors nor as great a disadvantage to the partners as is generally thought, and the report states that in no case of the bankruptcy of an Exchange firm had the creditors ever recovered anything substantial from the personal assets of a partner.\(^5\) This report would seem to indicate that the disadvantage of unlimited liability incurred in the case of a general partner is not of such real detriment as to deter the adoption of the partnership form of organization, even if the devices for securing the limited liability heretofore considered were not used.

The other major advantage desired, namely, continuity of operation, is now possible for a partnership as a practical proposition by the use of business life insurance, which provides funds for the settlement of a partner's share without liquidation of the business.

V

From the foregoing propositions it seems that the following conclusions may be fairly drawn:

(1) That the corporation has been subjected to such discriminatory taxation and regulation as to make the corporate form of business enterprise so expensive that its disadvantages equal if not outweigh the advantages of incorporation.

\(^5\) Ibid "As a practical matter there are no advantages in maintaining unlimited liability, the report contended. It states that in no case of bankruptcy has the public ever recovered anything substantial for the outside assets of a partner. If they are men of integrity all assets have already been put at the disposal of the firm, and if they were not men of integrity their assets would already have been hidden before bankruptcy was announced. Personal creditors also have a prior lien on outside assets and by the time a firm is bankrupt such debts are usually so large that nothing remains for firm creditors."
(2) That the form of organization known as the "business trust" is not more advantageous, because it is also subject to corporate taxes and because of the confusion in various jurisdictions as to the status to be accorded to it.

(3) That a strictly limited partnership is not an advantageous alternative form of organization because it is still subject to federal corporation taxes.

(4) That a general partnership, with special or limited partners, may be advantageously used because it seems that such a form of organization is now free from the burden of corporate taxes; and the corporate benefits of limited liability and the continuous operation may be achieved by the use of incidental safeguards such as contracts to limit personal liability, insurance against tort liability, and business life insurance to cushion the effect of dissolution.

A note of caution should be given with respect to these conclusions. The partnership form of the nature here discussed should not be regarded as a panacea in all cases. Many situations, too numerous to consider here in detail, show that there are many pitfalls which must be carefully avoided in the reorganization of a business from a corporate to any alternative form. Each business must be considered upon its own particular facts. For example, in some cases the federal capital gains tax might be such a heavy burden upon the distribution of corporate assets as to off-set whatever gains might be realized by some other form of business organization. It may be that the corporate form is the only one possible for large business units with numerous and scattered stockholders. On the other hand, many small closely held businesses might profitably consider business organization along the lines here suggested.

The tax problem is continually shifting, and it is impossible to predict from one year to the next what course would be most advantageous and, therefore, any change in the organizational structure of a business should be cautiously undertaken only after careful study and with expert guidance with respect to the peculiar problems presented by each business organization.