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The Decision to Incorporate

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By Thomas L. Hazen*

The Decision to Incorporate†

I. INTRODUCTION

It may appear somewhat anomalous to begin a symposium on corporation law with the suggestion that the corporate form is overused. However, as will be developed herein, several of the so-called advantages of incorporation may prove to be illusory in any given situation.

Recent figures indicate that the number of new corporations is on the rise, with more than eleven new Nebraska corporations and more than sixty-eight new Delaware corporations being formed each business day.¹ In fact, in Delaware the number of new incorporations has increased by more than fifty percent in the four-year

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† This introductory piece is not intended as a comprehensive analysis but rather is aimed at raising some questions to be considered in selecting the form of enterprise. For a more detailed discussion of the issues raised herein, see the authorities cited in notes 4, 13 *infra*.

1. The following chart depicts this rapid growth in domestic corporations based on figures supplied by the Nebraska and Delaware departments of state.

Table I

Year	New incorporations per year	Increase over prior years		Increase over 1975		New incorporations per business day
		Number	Percent	Number	Percent	
Nebraska						
1975	2,555					10.2
1976	2,578	23	0.9	23	0.9	10.3
1977	2,753	175	6.8	198	8.0	11.0
1978	2,851	98	4.0	296	12.0	11.4
Delaware						
1975	11,328					45.3
1976	12,949	1,621	14.3	1,621	14.3	51.8
1977	14,838	1,889	14.6	3,510	31.0	59.4
1978	17,129	2,291	15.4	5,801	51.0	68.5

Letter from Marie C. Schulte, Delaware Department of State, Division of Corporations, to Thomas L. Hazen (January 23, 1979); Letters from Kathy Meyer,

period since 1975.² Although incorporation of an enterprise can provide great benefits from both a structural and tax perspective, planners should not be too quick to opt for the corporate form.

II. ADVANTAGES AND DISADVANTAGES OF THE CORPORATE FORM

Especially when confronted with a smaller business concern³—defined in terms of both the number of owners and size of the enterprise—the planner may adopt incorporation without giving sufficient thought to other business forms because one or more of the corporate advantages seems attractive. However, there are two factors which must not be forgotten: (1) that along with the advantages there may be countervailing drawbacks, and (2) that many of the advantages may be available in the partnership form as well. It follows that one must carefully examine and balance the advantages and drawbacks as well as the availability of alternative structures before adopting the corporation as a *modus operandi*.

Limited liability of the owners usually heads the list of benefits flowing from use of the corporate form. This is followed by free transferability of ownership interests and perpetual existence, which guarantees continuity of life of the enterprise. Of particular importance are flexibility in management structuring and, in particular, centralization of management. Another advantage is flexibility of capital structure. These advantages of corporate form are oft-quoted and have become legion.¹⁵ Still further advantages can

Nebraska Department of State, to Thomas L. Hazen (January 22, 1979; April 5, 1979).

2. See Table I, *supra* note 1.

3. The scope of this introductory piece is limited to the smaller enterprise. As the number of owners grows, the corporate form becomes more inevitable with the slight exception of the few larger enterprises that may be carried on as limited partnerships, unincorporated associations, or as business trusts.

4. For example, in his treatise on corporations Professor Ballantine listed six corporate advantages:

- (1) The capacity to act as a legal unit, to hold property, to contract, to sue and be sued as a distinct entity;
- (2) limitation of or exemption from individual liability of shareholders;
- (3) continuity of existence;
- (4) transferability of shares;
- (5) centralized management by the board of directors;
- (6) standardized methods of organization, management and finance prescribed by corporation acts for the protection of shareholders and creditors, including a more or less standardized system of shareholders' relations, rights, and remedies.

H. BALLANTINE, CORPORATIONS 3 (rev. ed. 1946).

Professor Ballantine then pointed to the correlative disadvantages of the partnership form which must be compared with the corporate advantages:

- (1) lack of recognition of the concern as a separate legal person;
- (2) danger of abuse of wide authority of co-partner;
- (3) risks of unlimited

be found in terms of collateral benefits such as an exemption from the usury laws and the availability of social security benefits to persons who would otherwise be self-employed and thus ineligible.¹⁶

Balanced against these there are various disadvantages. There are usually no filings required for a partnership or sole proprietorship in contrast to the universal corporate requirement that the articles of incorporation be on file with the state.⁷ The corporate filings may also be accompanied by fees⁸ and organizational taxes⁹ far in excess of those accompanying other business forms. In addition to the filings there are other formalities such as the requirements of annual shareholder and formal director meetings,¹⁰ and the necessity of written notice and minutes of shareholder and director meetings.¹¹ The corporate form also requires the adoption of a system of legal accounting that bears no resemblance to accepted accounting principles.¹² In terms of raising additional capital, corporate limited liability may be nothing more than a fiction. Absent individual guarantees the extent of credit is limited to the corporate assets and except in the most prosperous, low risk con-

liability in contract and tort for acts of partner and employees; (4) precarious existence and risks of dissolution.

Id. at 6. See also, e.g., ALI-ABA COMM. ON CONTINUING EDUCATION, THE LAWYER'S BASIC CORPORATE PRACTICE MANUAL 7-21 (2d ed. 1978); 1 W. FLETCHER, CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS §§ 5-7, 10-14 (rev. ed. 1974) [hereinafter cited as FLETCHER]; 1 F. O'NEAL, CLOSE CORPORATIONS § 1.12 (2d ed. 1971); C. ROHRlich, ORGANIZING CORPORATE AND OTHER BUSINESS ENTERPRISES §§ 2.01 to .51 (5th ed. 1975).

5. *E.g.*, NEB. REV. STAT. § 45-101 to -102 (Reissue 1974).
6. See *Stark v. Flemming*, 283 F.2d 410 (9th Cir. 1960) (where this was the sole reason for incorporating). But cf. *Roccograndi v. Unemployment Compensation Bd. of*, 197 Pa. Super. 372, 178 A.2d 786 (1962) (denying unemployment benefits since incorporation was a sham directed solely at procuring such benefits).
7. ALI-ABA MODEL BUS. CORP. ACT. § 55 (1969) [hereinafter cited as MODEL ACT]; DEL. CODE tit. 8, § 103 (1974); NEB. REV. STAT. § 21-2053 (Reissue 1977). In addition, any plan of merger, consolidation, or dissolution must be filed as, of course, is equally true of any amendments to the articles. MODEL ACT §§ 74, 85; DEL. CODE tit. 8, § 251(c) (Supp. 1978); NEB. REV. STAT. §§ 21-2074, -2084 (Reissue 1977).
8. *E.g.*, DEL. CODE tit. 8, § 103(c)(2) (1974); NEB. REV. STAT. § 21-2053 (Reissue 1977); N.Y. BUS. CORP. ACT § 104(e) (McKinney 1966).
9. *E.g.* Neb. Rev. Stat. § 21-303 (Reissue 1977) (annual occupation tax); N.Y. TAX LAW § 180 (McKinney 1966).
10. *E.g.*, MODEL ACT §§ 28, 29, 43; DEL. CODE tit. 8, §§ 141, 211-213 (Supp. 1978); NEB. REV. STAT. §§ 21-2027, -2029, -2042 (Reissue 1977).
11. *E.g.*, MODEL ACT §§ 28, 29, 43; DEL. CODE tit. 8, §§ 141, 211-213 (Supp. 1978); NEB. REV. STAT. §§ 21-2027, -2029, -2042 (Reissue 1977).
12. *E.g.*, MODEL ACT §§ 2(j), 45, 46; DEL. CODE tit. 8, § 154 (1974); NEB. REV. STAT. §§ 21-2002(8)-(15), -2043, -2044 (Reissue 1977). See generally B. MANNING, A CONCISE TEXTBOOK ON LEGAL CAPITAL (1977).

cerns, creditors will not generally advance funds without such guarantees.

In addition to the above-mentioned issues the planner must be aware of taxation factors.¹³ A corporation is a taxable entity apart from its owners,¹⁴ unlike the partnership or sole proprietorship, in which all income, including gains and losses, is passed through to the individual taxpayers.¹⁵ To the extent that the entity pays out profits in the form of dividends taxable to the shareholders, the corporate profits are subject to double taxation. An alternative to distributing corporate profits is to reinvest them for expansion or improvement of the business.¹⁶ This method of operation allows the ownership shares to appreciate in value and results in capital gain treatment upon sale of the interest. Although the capital gains tax on the appreciated value of the stock is still a form of double taxation, it is less vigorous than the taxation of compensation or dividends as ordinary income.

A subchapter S election enables a corporation to enjoy quasi-partnership tax treatment and thereby avoid being a separate taxable entity with respect to corporate income.¹⁷ However, the tax code places additional restrictions on the subchapter S corporation¹⁸ which often make the election impractical or unattractive.

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13. *See generally* Z. CAVITCH, *TAX PLANNING FOR CORPORATIONS AND SHAREHOLDERS* (1974); D. HERWITZ, *BUSINESS PLANNING* 76-188 (1966). C. ROHRlich, *supra* note 4, §§ 301-312. The tax aspects of the partnership form must also be kept in mind. *See generally* W. MCKEE, W. NELSON & R. WHITMIRE, *FEDERAL TAXATION OF PARTNERSHIPS AND PARTNERS* (1977); A. WILLIS, *PARTNERSHIP TAXATION* (1976).
 14. I.R.C. § 6012(a)(2).
 15. I.R.C. § 701.
 16. If cash or unrelated investments "are permitted to accumulate beyond the reasonable needs of the business" in order to avoid taxation on dividend distributions, the corporation will be subject to the accumulated earnings tax in addition to other corporate taxes. I.R.C. §§ 531-537.
 17. I.R.C. § 1372. The subchapter S election does not, of course, result in partnership tax treatment for all purposes as the corporation is still subject to many of the provisions of subchapter C. For example, corporate treatment applies to liquidations and reorganizations. I.R.C. §§ 331-368. In addition, subchapter S taxation differs from partnership taxation in treatment of cash distributions (*compare* I.R.C. § 1373 and *Treas. Reg. § 1.1373-1(d)* (1959), *amended*, T.D. 6960 (1968) *with* I.R.C. § 731(a)); net operating loss carryovers (*compare* I.R.C. § 1374 *with* I.R.C. §§ 702, 172); and capital gains (*compare* I.R.C. § 702(a)(2) *with* I.R.C. § 1378). *See generally* I. GRANT, *SUBCHAPTER S TAXATION* (1974).
 18. A subchapter S corporation is limited to 15 shareholders all of whom must be individuals, except for estates and certain trusts, I.R.C. § 1371(a)(2); moreover, a shareholder may not be a nonresident alien, I.R.C. § 1371(a)(3). The corporation can have only one class of stock, I.R.C. § 1371(a)(4), and a certain percentage of the business must consist of active rather than passive investments, I.R.C. § 1372(e)(5). Additionally, subchapter S status may be adopted only by unanimous shareholder consent, I.R.C. § 1372(a), and may be termi-

At the other end of the spectrum is the fact that as a partnership takes on more of the characteristics normally associated with the corporate form, it runs the risk of being subject to subchapter C's provisions for the taxation of corporations.¹⁹ These are but a few of the tax considerations involved in selecting the appropriate form of business. Although they may be the paramount consideration in many situations, the remainder of this article will be limited to nontax issues.²⁰

The nontax disadvantages to incorporation such as the increased formality and expenses of operation speak for themselves. It is easy to see how they must fit into the calculus of the incorporation decision. Not as clear, however, is the extent to which the advantages of incorporation may be illusory. The discussion that follows is directed towards pointing out some of the pitfalls in relying too heavily upon the supposed advantages. It will become clear that although the corporate form is preferable in a large number of situations, it should not be routinely and mechanically adopted.

A. Limited Liability

Common and preferred shares in corporations are nonassessable and accordingly the shareholders' exposure to liability is generally considered to be limited to their initial investment. It follows that any business planner is well versed in the general black-letter-law proposition that shareholders of a corporation enjoy limited liability. However, such generalities are overbroad and may wane when applied to specific situations; this is especially true in the context of the closely-held concern.

To begin with, as a practical matter a shareholder's potential liability will go further. When a small incorporated concern de-

nated by unanimous agreement, I.R.C. § 1372(e)(2). If the election is terminated, the corporation is ineligible to reelect subchapter S status for five years. I.R.C. § 1372(f). See generally Z. CAVITCH, *supra* note 13, at § 3.01.

19. See generally W. MCKEE, W. NELSON & R. WHITMIRE, *supra* note 13, at ¶ 3.06. The Internal Revenue Service has identified six attributes of corporateness which may result in a partnership being taxed as an "association," or corporation:

- (1) Associates,
- (2) An objective to carry on business and divide the gains therefrom,
- (3) Continuity of life,
- (4) Centralization of management,
- (5) Liability for corporate debts limited to corporate property, and
- (6) Free transferability of interests.

Id. at 3-40 to -41 (footnote omitted). See Treas. Reg. § 301.7701-2(a)(1) (1960).

20. For comprehensive treatment of the tax issue, see authorities cited in note 13 *supra*.

cides to raise funds by borrowing, prudent creditors will require the major shareholders to personally guarantee corporate obligations. Similarly, third parties contracting with the corporation will often require performance bonds or individual guarantees by the shareholders. Accordingly, at least until the enterprise becomes well established and sufficiently stable in the eyes of outsiders, limited liability will be limited in application to insulating the shareholders against tort judgments.

In addition to the demands of the market place, there are various judicially created doctrines that may be applied to extinguish the shareholders' limited liability. Application of these doctrines can work extreme harshness since the lack of predictability of result makes this an extremely difficult risk to anticipate and guard against.

Although the courts have exhibited great reluctance to apply the doctrine,²¹ thin capitalization may be the basis for piercing the veil of limited liability.²² For example, in *Minton v. Cavaney*,²³ Justice Traynor, speaking for the California Supreme Court, held that shareholders of a corporation operating a swimming pool could be held personally liable for a tort judgment against the corporation due to their failure to adequately capitalize the business and thereby provide a cushion to absorb the foreseeable risks of the enterprise.²⁴

Another basis for piercing through the corporation to the shareholders' personal assets is a finding by the court that the shareholders disregarded the corporate entity by operating the corporation as their "alter ego."²⁵ In applying the alter ego analysis, the courts look to such factors as the failure to segregate funds,

21. *E.g.*, *Walkovszky v. Carlton*, 23 N.Y.2d 714, 244 N.E.2d 55, 246 N.Y.S.2d 362 (1968). *But see, e.g.*, *Minton v. Cavaney*, 56 Cal. 2d 576, 364 P.2d 473, 15 Cal. Rptr. 641 (1961).

22. *See generally* C. CARY, CASES AND MATERIALS ON CORPORATIONS 109-49 (4th unabr. ed. 1969); FLETCHER, *supra* note 4, § 44.1; R. HAMILTON, CASES AND MATERIALS ON CORPORATIONS 194-220 (1976); H. HENN, LAW OF CORPORATIONS 250-72 (2d ed. 1970).

23. 56 Cal. 2d 576, 364 P.2d 473, 15 Cal. Rptr. 641 (1961).

24. The tort victim had drowned due to negligence in the operation of the pool. The court held that the operation of a pool creates certain foreseeable risks which must be taken into account in capitalizing the corporation. *But cf. Walkovszky v. Carlton*, 18 N.Y.2d 414, 223 N.E.2d 6, 276 N.Y.S.2d 585 (1966) (refusing, over a vigorous dissent, to pierce the veil of thinly capitalized taxi company, relying on the corporation's compliance with New York's minimum automobile liability insurance policy).

25. *See, e.g.*, *Walkovszky v. Carlton*, 23 N.Y.2d 714, 244 N.E.2d 55, 246 N.Y.S.2d 362, *aff'd*, 29 A.D.2d 763, 287 N.Y.S.2d 546 (1968). *But cf. Berkey v. Third Ave. Ry.*, 244 N.Y. 84, 155 N.E. 58 (1926) (court refused to pierce veil although some of formalities of separate corporate forms disregarded by parent and subsidiaries).

the failure to keep separate books, and the absence of arm's-length dealings between the principal shareholders and the corporation.²⁶ Other activities that fall into this category include the failure to follow corporate formalities such as keeping minutes of the required shareholder and director meetings. To the extent that such a failure exists, as is the case with defective incorporation *ab initio*,²⁷ there is the risk that the shareholders will be held personally liable for the obligations of the corporation. It follows that the diligence required to maintain the *de jure* corporate existence is a significant burden of corporate form.

The cases indicating that the veil may be pierced for noncompliance with corporate formalities present an interesting quandry. On the one hand, in line with the growing trend of cases recognizing the special needs of the closely-held concern—or "incorporated partnership"²⁸—, courts have been willing to forgive such noncompliance.²⁹ In such decisions it is reasoned that insofar as the parties in selecting the corporate form wanted to retain flexibility in defining the parties' relative rights, the courts should recognize this fact in upholding the form selected. Accordingly, special agreements and other devices which might otherwise run afoul of corporate norms and formalities are not only tolerated but are encouraged in the close corporation context.³⁰ However, if shareholders rely on the leniency of this line of cases, they run the risk that their informality will lead to the piercing of the corporate veil and the concomitant elimination of limited liability.

The foregoing discussion should not be taken to indicate that limited liability is too easily lost. This is not the case, as the corporate veil is a benchmark of corporate life. On the other hand, piercing the veil is a risk which should not be minimized. When this risk is coupled with the likelihood that creditors and other third parties will often require personal guarantees before dealing with the corporation, it would be a mistake to give limited liability too much weight in deciding whether or not to incorporate.

26. See, e.g., *Yacker v. Weiner*, 109 N.J. Super. 351, 263 A.2d 188 (1970); *Bartle v. Home Owners Cooperative, Inc.*, 309 N.Y. 103, 127 N.E.2d 832 (1955).

27. See, e.g., *Frontier Ref. Co. v. Kunkel's, Inc.*, 407 P.2d 880 (Wyo. 1965); *Robertson v. Levy*, 197 A.2d 443 (D.C. Cir. 1964); MODEL ACT § 146.

28. See, e.g., *Cressy v. Sharmon Continental Corp.*, 378 N.E.2d 941 (Ind. Ct. App. 1978); *Cain v. Cain*, 75 Mass. App. Adv. Sh. 1121, 334 N.E.2d 650 (1975); *Dona-hue v. Rodd Electrotape Co.*, 367 Mass. 578, 328 N.E.2d 505 (1975). See generally 1 F. O'NEAL, *supra* note 4; Cary, *How Illinois Corporations May Enjoy Partnership Advantages: Planning for the Closely Held Firm*, 48 NW. U.L. REV. 427 (1953); Hornstein, *Judicial Tolerance of the Incorporated Partnership*, 18 LAW & CONTEMP. PROB. 435 (1953).

29. See, e.g., *Galler v. Galler*, 32 Ill. 2d 16, 203 N.E.2d 577 (1964).

30. See generally A. FREY, J. CHOPER, N. LEECH & C. MORRIS, *CASES AND MATERIALS ON CORPORATIONS* 540-616 (2d ed. 1977); 1 F. O'NEAL, *supra* note 4.

A final point to be kept in mind in deciding whether to incorporate is the alternative availability of the limited partnership form of operation.³¹ Although the limited partnership is frequently thought of as a vehicle for establishing tax sheltered investments,³² it is also a viable alternative to the corporate form for small businesses. The primary drawbacks of this form are (1) the limited partners' inability to actively participate in management³³ and (2) the general partner's unlimited personal exposure to liability.³⁴ Accordingly, the limited partnership interest represents a passive investment which may not meet the participants' objectives if they desire some control over their investment. The unlimited liability of the general managing partner may be minimized by incorporation of the general partner.³⁵ However, the passivity of the limited partners' investment is not as readily avoidable since

31. See, e.g., UNIFORM LIMITED PARTNERSHIP ACT [hereinafter cited as ULPA]; NEB. REV. STAT. §§ 67-201 to -232 (Reissue 1976). See generally PLI, LIMITED PARTNERSHIPS: INVESTMENT VEHICLES IN TRANSITION (1975); Coleman & Weatherbie, *Special Problems in Limited Partnership Planning*, 30 SW. L.J. 887 (1976); Kratovil & Werner, *Fixing up The Old Jalopy—Modern Limited Partnership Under the ULPA*, 50 ST. JOHN'S L. REV. 51 (1975); Lewis, *The Uniform Limited Partnership Act*, 65 U. PA. L. REV. 715 (1917); Comment, *The Limited Partnership*, 45 YALE L.J. 895 (1936).

In 1976 the ULPA was withdrawn and replaced by the REVISED UNIFORM LIMITED PARTNERSHIP ACT [hereinafter cited as REVISED ULPA]. To date the revised act has not been adopted in any jurisdiction. 6 UNIFORM LAWS ANNOT. 117 (Supp. 1979). See Hecker, *The Revised Uniform Limited Partnership Act: Provisions Affecting the Relationship of the Firm and its Members to Third Parties*, 27 KAN. L. REV. 1 (1978); Symposium: *Limited Partnership Act*, 9 ST. MARY'S L.J. 441 (1978).

32. See generally Aslanides, Cardinali, Haynsworth, Lane & Niesar, *Limited Partnerships—What's Next and What's Left?*, 34 BUS. LAW. 257 (1978); Dailey & Gaffney, *Anatomy of a Real Estate Tax Shelter: The Tax Reform Scalpel*, 55 TAXES 127 (1977); Comment, *The Limited Partnership as a Vehicle for Syndicated Real Estate Investment: Selected Tax Considerations*, 1973 WIS. L. REV. 1124; Note, *Tax Classification of Limited Partnerships: The IRS Bombards The Tax Shelters*, 52 N.Y.U. L. REV. 408 (1977).

33. ULPA § 7; REVISED ULPA § 303; NEB. REV. STAT. § 67-207 (Reissue 1976). See generally Abrams, *Imposing Liability for "Control" Under Section 7 of The Uniform Limited Partnership Act*, 28 CASE W. RES. L. REV. 785 (1978); Feld, *The "Control" Test for Limited Partnerships*, 82 HARV. L. REV. 1471 (1969); Feldman, *The Limited Partner's Participation in the Control of the Partnership Business*, 50 CONN. B.J. 168 (1976).

34. The general partner has the same exposure to liability as in a general partnership. Even incorporation of the general partner will not always assure limited liability. See 7 TEX. TECH. L. REV. 745 (1976). But see Recent Developments, *Limited Partnership—Limited Control Through a Corporate General Partner*, 53 WASH. L. REV. 775 (1978).

35. For a recent case refusing to pierce the corporate veil of the general partner, see *Frigidaire Sales Corp. v. Union Properties, Inc.*, 88 Wash. 2d 400, 562 P.2d 244 (1977). *Contra*, *Delaney v. Fidelity Lease Ltd.*, 526 S.W.2d 543 (Tex. 1975). See note 34 *supra*.

their limited liability is quite fragile and thus very easily set aside for taking an active role in management.³⁶ While it follows that the limited partnership may not be a viable alternative in many situations, its utility under appropriate circumstances should not be underestimated. This form of operation is one way to assure limited liability while at the same time preserving the flexibility and lack of formality of the partnership form.

Another factor in evaluating the importance of limited liability is the availability and cost of insurance to cover the risks of the enterprise. While it is impossible to insure against a general business failure, many of the risks are insurable. For example, any business involving the use of motor vehicles will want adequate liability insurance³⁷ as would any business owning real property. The nature of the business and the potential exposure of the owners to liability will necessarily be factors, but in many instances insurance may make even the general partnership a viable business form despite its lack of limited liability protection.³⁸

B. Continuity of Existence

Under many of the current corporate chartering statutes, a provision in the articles of incorporation may provide for perpetual existence.³⁹ A slight variation that appears in some of the other acts is that corporate duration is perpetual unless a shorter period is provided for in the articles.⁴⁰ This possibility of immortality contrasts to the black letter common law rule that a partnership dissolves whenever a general partner ceases to hold that position whether it be by virtue of death, withdrawal, or transfer of the partnership interest.⁴¹

While under the Uniform Partnership Act a conveyance of a partner's interest does not of itself dissolve a general partnership,⁴² all of the remaining members may decide to dissolve the

36. See Coleman & Weatherbie, *supra* note 31, at 897-906; Crane, *Are Limited Partnerships Necessary?*, 17 MINN. L. REV. 351, 353-55 (1933); Lewis, *supra* note 31, at 719-20; Comment, *supra* note 31, at 895-99; Recent Developments, *supra* note 34, at 785 n.39.

37. Cf. Walkovszky v. Carlton, 23 N.Y.2d 714, 244 N.E.2d 55, 246 N.Y.S.2d 362 (1968) (refusing to pierce the corporate veil in an automobile injury where the corporation had complied with the state's minimum liability insurance requirements).

38. Cf. Minton v. Cavaney, 56 Cal. 2d 576, 364 P.2d 473, 15 Cal. Rptr. 641 (1961) (discussed in note 24 & accompanying text *supra*).

39. E.g., MODEL ACT § 45(b); NEB. REV. STAT. § 21-2052(b) (Reissue 1977).

40. E.g., DEL. CODE tit. 8, § 102(b)(5) (1974).

41. See H. HENN, *supra* note 22, § 26. See generally Bromberg, *Partnership Dissolution—Causes, Consequences and Cures*, 43 TEX. L. REV. 631 (1965).

42. UNIFORM PARTNERSHIP ACT § 27(1) [hereinafter cited as UPA]; NEB. REV. STAT. § 67-327(1) (Reissue 1976).

entity without breaching the partnership agreement.⁴³ Nevertheless, under the Act either the death or bankruptcy of any partner still operates as an automatic dissolution.⁴⁴ In addition, a person may not become a member of the partnership without the unanimous consent of the existing partners.⁴⁵ In the case of a limited partnership, the limited partnership interests are assignable if so provided in the partnership certificate.⁴⁶ The withdrawal, death or insanity of a general partner dissolves the partnership *pro tanto* unless the business is carried on by the remaining general partners either with the consent of all members or pursuant to a preexisting provision in the partnership agreement.⁴⁷

A reading of the current statutory provisions governing partnerships makes it clear that a corporation's perpetual existence is not unique. Except in the case of a limited partnership with a sole general individual partner, the partners may in essence provide for perpetual existence.⁴⁸ However, since this is one of the key characteristics of corporateness, under the tax laws, perpetual existence may cause the partnership to be taxed as a corporation.⁴⁹ With a general partnership, a contractual arrangement extrinsic to the partnership agreement between and among all of the general partners to reform the partnership after death will probably not suffice to ensure continuity through specific performance, but will at least give a remedy in damages for breach of contract.⁵⁰ The damage remedy does not go far in guaranteeing continuity, especially since in many cases breach and payment of damages may be economically advantageous to the dissident partner. As noted above, in the case of a limited partnership with a single general partner, incorporation of the general partner assures continuity of existence.

An additional factor in evaluating the importance of perpetual

43. UPA § 31(1)(c); NEB. REV. STAT. § 67-331(1)(c) (Reissue 1976).

44. UPA § 31(4)-(5); NEB. REV. STAT. § 67-331(4)-(5) (Reissue 1976).

45. UPA § 18(g); NEB. REV. STAT. § 67-318(g) (Reissue 1976).

46. ULPA §§ 2(1)(a) X & 19; REVISED ULPA §§ 201(a)(7), 702, 704; NEB. REV. STAT. §§ 67-202(a) X & -219 (Reissue 1976).

47. ULPA § 20; NEB. REV. STAT. § 67-220 (Reissue 1976). It follows that the death, retirement or insanity of the sole general partner will necessarily dissolve the partnership. *But see* REVISED ULPA §§ 402, 602.

48. *See* note 47 *supra*.

49. *See* W. MCKEE, W. NELSON & R. WHITMIRE, *supra* note 13, ¶ 3.06[4][a]; note 19 *supra*.

50. When incorporating the family farm or other business, the owners can provide for perpetual existence. For example, by deeding the land or other property to the corporation and by adding a limited purpose clause, a dissident shareholder may be prevented from dissolving the family corporation. However, with a general partnership the dissident could breach the contract and compel dissolution under the statute.

existence in selecting the corporate form is the fact that a corporation may be subject to involuntary dissolution. Failure to comply with the required corporate formalities, including the payment of franchise taxes, may result in an action by the attorney general to dissolve the corporation.⁵¹ This raises problems of predictability similar to those that exist with the risk of losing limited shareholder liability.⁵² A second type of involuntary dissolution may be obtained at the behest of a disgruntled shareholder.⁵³ This may be even more of a factor in the future to the extent that courts become more willing to decree involuntary dissolution upon a shareholder petition in order to accommodate the flexibility and needs of the incorporated partnership.⁵⁴ As a result of this unpredictability, the planned duration of the enterprise may not always be a significant factor in deciding whether to adopt the corporate rather than partnership form.

C. Free Transferability

As is the case with continuity of existence,⁵⁵ in most situations the partnership form's limitations on the free transferability of ownership interests need no longer be a significant factor in the planner's decision to opt for the corporate form. The partnership is not as restrictive as it once was. For example, as noted above, an interest in a general partnership is freely assignable subject to the unanimous veto of the remaining members.⁵⁶ In a limited partnership the limited partners may freely transfer their interests if the partnership certificate so provides,⁵⁷ while an appropriate provision in the partnership certificate may provide for the transferability of a general partner's shares.⁵⁸ Once again, however, the

51. MODEL ACT § 95. Cf. NEB. REV. STAT. § 21-2094 (Reissue 1977) (upon receipt of certification from the Secretary of State, the Attorney General is entitled to file an action against a corporation for its dissolution). In Nebraska a corporation is automatically dissolved for failure to pay corporate occupation taxes. *Id.* § 21-313.

52. See note 27 & accompanying text *supra*.

53. *E.g.*, MODEL ACT § 97(a); DEL. CODE tit. 8, § 284 (Supp. 1978). See generally Comment, *Deadlock and Dissolution in the Close Corporation: Has The Sacred Cow Been Butchered?*, 58 NEB. L. REV. 791 (1979).

54. Comment, *supra* note 53, at 814-24.

55. See text accompanying notes 41-45 *supra*.

56. UPA §§ 27(a), 31(1)(c); NEB. REV. STAT. §§ 67-327(1), -331(1)(c) (Reissue 1976).

57. ULPA §§ 2(1)(a)X & 19; REVISED ULPA §§ 201(a)(7), 702, 704; NEB. REV. STAT. §§ 67-202(a)X & -219 (Reissue 1976).

58. ULPA § 20; NEB. REV. STAT. §§ 67-220 (Reissue 1976). Compare REVISED ULPA §§ 402, 602. Placed in its proper perspective, the transfer of a general partner's interest in a limited partnership is in reality a change in management rather than a change in ownership. Sale of such an interest by the general partner can create sale of control problems. See Hazen, *Transfers of*

presence of free transferability may cause the partnership to be taxed as a corporation.⁵⁹

Conversely, the increasing recognition of special treatment for closely held corporations has led the courts to be extremely tolerant of share transfer restrictions.⁶⁰ The types of transfer restrictions on corporate shares are many and can be readily adopted to meet the needs of a particular situation.⁶¹ Also as the use of these devices has increased, they have become far more sophisticated and are most valuable not only as a means of maintaining limitations of ownership but also as a device for resolving corporate

Corporate Control and Duties of Controlling Shareholders—Common Law, Tender Offers, Investment Companies—And a Proposal For Reform, 125 U. PA. L. REV. 1023 (1977); Note, *Opportunity Lost: More of the Same in Sale of Corporate Control Cases*, 58 NEB. L. REV. 891 (1979).

59. See W. MCKEE, W. NELSON & R. WHITMIRE, *supra* note 13, ¶ 3.06[4] [d]; note 19 *supra*.

60. *E.g.*, *In re Mather's Estate*, 410 Pa. 361, 189 A.2d 586 (1963) (great difference in sale price and fair market value is not sufficient standing alone to strike down a stock purchase option); DEL. CODE tit. 8, §§ 201-202, 349 (1974).

61. Professor O'Neal divides transfer restrictions into nine major categories:

Various types of restrictions on the alienability of shares have been resorted to from time to time in attempts to confine share ownership to persons approved by the original shareholders. The restraints may be classified as follows: (1) absolute prohibitions against the transfer of shares; (2) "consent restraints," requiring approval of transfers by the shareholders, the directors or a stipulated percentage of one of these groups; (3) provisions limiting transfers to specified classes of persons (e.g., families of existing shareholders or the corporation's customers or employers) or prohibitions against transfers to other classes of persons (e.g., competitors of the business); (4) "first option" provisions granting the corporation, its officers or directors, or other shareholders a preemptive right (sometimes referred to as a right of "first refusal") to shares which a holder decides to sell; (5) options empowering the corporation, its officers or directors, or the other shareholders to purchase some or all of the shares of a holder on the happening of specified events (e.g., his death, his becoming disabled, his becoming bankrupt or insolvent, his moving from the city where the corporation's principal place of business is located, his acquiring an interest in a competing concern or a severance of his employment with the corporation); (6) buy-out arrangements for the transfer of a deceased holder's shares (and probably those of a holder who becomes disabled) to the corporation or to the other shareholders at a stipulated price or at a valuation determined by formula; (7) options empowering legal representatives of a deceased shareholder to purchase the shares of surviving holders; (8) provisions for the corporation's repurchase or redemption of the shares of a holder who ceases to be an employee of the corporation or provisions for the other shareholders to purchase his shares; and (9) provisions for the redemption ("call") of common stock at the option of the corporation or its board of directors.

These categories are set up only for convenience of discussion. Actually the restraints are subject to almost infinite variation and combination.

2 F. O'NEAL, *supra* note 4, § 7.05.

deadlock.⁶²

An additional factor to keep in mind is the existence of judicially created limitations on the transferability of corporate ownership interests, at least where control of the enterprise is involved.⁶³ For example, a controlling shareholder has been held accountable for the subsequent looting of the corporation by the control purchaser.⁶⁴ Controlling shareholders who receive a premium too much in excess of the per share value of their holdings may be held accountable to the remaining shareholders. These limitations on the sale of corporate control are based on various theories of the fiduciary obligation flowing from the majority shareholders to the minority.⁶⁵ Along these lines, most significant to the question of which form to select is the Massachusetts Supreme Court's holding in *Donahue v. Rodd Electrottype Co.*⁶⁶ and its progeny⁶⁷ that within the context of the closely held corporation the shareholders owe one another the same high duty of fairness as do members of a partnership.⁶⁸ In addition to providing another example of recognizing the incorporated partnership, the rationale employed in this line of cases minimizes the distinction between these two forms of enterprise.

Although the mechanics may differ, in substance the variations on transferability of ownership between the partnership and corporate form are relatively slight. In both forms of operation the interests can be freely transferable. Alternatively, as is frequently the case, the parties may want to protect both themselves and the business with the use of the types of transfer restrictions discussed above. Although in certain situations the designs of the parties in fashioning transfer limitations may be better adapted to the corporate form, in a vast number of situations this will not be so. Accordingly, as is the case with the other corporate advantages

62. See generally Ludtke, *Planning for Family Corporate Control*, 58 NEB. L. REV. 644 (1979).

63. See generally Hazen, *supra* note 58; Note, *supra* note 58.

64. *Swinney v. Keebler Co.*, 480 F.2d 573 (4th Cir. 1973); *Insuranshares Corp. v. Northern Fiscal Corp.*, 35 F. Supp. 22 (E.D. Pa. 1940); *DeBaun v. First Western Bank & Trust Co.*, 46 Cal. App. 3d 686, 120 Cal. Rptr. 354 (1975); *Gerdes v. Reynolds*, 28 N.Y.S.2d 622 (Sup. Ct. 1941).

65. *Perlman v. Feldmann*, 219 F.2d 173 (2d Cir.), *cert. denied*, 349 U.S. 952 (1955); *Jones v. H.F. Ahmanson & Co.*, 1 Cal. 3d 93, 460 P.2d 464, 81 Cal. Rptr. 592 (1969); *Donahue v. Rodd Electrottype Co.*, 367 Mass. 578, 328 N.E.2d 505 (1975); *Gerdes v. Reynolds*, 28 N.Y.S.2d 622 (Sup. Ct. 1941). But see, e.g., *Clagett v. Hutchison*, 583 F.2d 1259 (4th Cir. 1978); *Thompson v. Hambrick*, 508 S.W.2d 949 (Tex. Civ. App. 1974).

66. 367 Mass. 578, 328 N.E.2d 505 (1975).

67. E.g., *Cressy v. Shannon Continental Corp.*, 378 N.E.2d 941 (Ind. Ct. App. 1978); *Cain v. Cain*, 75 Mass. App. Adv. Sh. 1121, 334 N.E.2d 650 (1975).

68. See text accompanying note 69 *infra*.

that are discussed above, the significance of this factor in selecting the form of enterprise should not be overestimated.

D. Flexibility in Structuring Management

In 1928 Benjamin Cardozo explained the extraordinarily high standards of dealing that govern the partnership relation: "Joint adventurers, like copartners, owe to one another . . . the duty of the finest loyalty. . . . [They are] held to something stricter than the morals of the market place. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior."⁶⁹ This is in sharp contrast to the negligence or even lower standard of care generally applied to corporate management⁷⁰ together with the presumption that it acts within the broad range of valid business judgment.⁷¹ In terms of general standards there is clearly at least a divergence of emphasis in describing the nature of the fiduciary relationship in these two forms of enterprise. The apparent increased deference to the managers that exists with the corporate form can be a distinct advantage over the partnership arrangement. However, this is true only with the caveat that there is a growing line of cases that apply the partnership standard to the directors of closely held corporations.⁷² Of course, in many situations the owners of the enterprise may want to protect themselves against a runaway management. In these instances the higher fiduciary standard is an advantage.

Another divergence between the corporate and general partnership form is the centralization of management. The directors manage the affairs of the corporation⁷³ and these directors, who are elected by the shareholders,⁷⁴ in turn appoint the corporate of-

69. *Meinhard v. Salmon*, 249 N.Y. 458, 463-64, 164 N.E. 545, 546 (1928).

70. "[D]irectors are liable for negligence in the performance of their duties. Not being insurers, directors are not liable for errors of judgment . . ." *Litwin (Rosemarin) v. Allen*, 25 N.Y.S.2d 667, 678 (Sup. Ct. 1940). See generally H. BALLANTINE, *supra* note 4, at 157-62; 1 FLETCHER, *supra* note 4, §§ 5-7, 10-14; H. HENN, *supra* note 22, at 453-59; Shaneyfelt, *The Personal Liability Maze of Corporate Directors and Officers*, 58 NEB. L. REV. 692 (1979).

71. See generally H. BALLANTINE, *supra* note 70, at 160-62; 1 FLETCHER, *supra* note 4, at §§ 5-7, 10-14; H. HENN, *supra* note 22, at 482-83; Note, *Section 21-2040.01: Interested Director Transactions and Considerations of Fairness*, 58 NEB. L. REV. 909 (1979).

72. See notes 66-67 *supra*.

73. *E.g.*, MODEL ACT § 35; DEL. CODE tit. 8, § 141(a) (Supp. 1978); NEB. REV. STAT. § 21-2035 (Reissue 1977).

74. *E.g.*, MODEL ACT § 36; DEL. CODE tit. 8, § 141(d) (Supp. 1978); NEB. REV. STAT. §§ 21-2033, -2036 (Reissue 1977).

ficers⁷⁵ over whom the shareholders have no direct control.⁷⁶ In contrast, the members of a general partnership are all co-managers.⁷⁷ For example, any partner has both the apparent and implied authority to bind the partnership in dealings with third parties.⁷⁸ Of course, utilization of the limited partnership form provides for the same type of management centralization that exists with the corporation. However, this is true only to a limited degree insofar as in the limited partnership the management is not highly stratified as readily as it may be in the corporation,⁷⁹ and too much centralization may result in the loss of partnership tax advantages.⁸⁰

Certainly, to the extent that the enterprise in question requires a sophisticated, stratified management structure, the corporate form is preferable. However, the need for a sophisticated structure is not typical, especially for the small business, but rather is a situation that may occur in a relative handful of situations.

E. Flexibility in Capitalization

The final corporate advantage to be discussed is, standing alone, probably the most utilitarian and hence the most significant in selecting the form of operation. The partnership basically provides for one type of equity or ownership interest with the one variation presented by the limited partnership form. Intrapartnership agreements can, of course, define relative priorities in profit sharing with even more flexibility than is available with the corporate form. However, planners may be reluctant to rely on such contractual definitions because of unfamiliarity. The various types of share classification and senior securities that are available in the corporate form are expressly sanctioned by the corporate statutes⁸¹ and have been subject to much judicial scrutiny,⁸² thus providing guidelines. The absence of statutes and case law in the partnership setting gives more flexibility but provides a lesser degree of certainty. This certainty in the partnership context can only be provided by the far-thinking planner who is able to anticipate and then draft provisions to cover all contingencies with respect to the desired preferences.

75. *E.g.*, MODEL ACT § 50; DEL. CODE tit. 8, § 142 (Supp. 1978); NEB. REV. STAT. § 21-2048 (Reissue 1977).

76. While the shareholders may remove directors, only the directors can remove officers. *E.g.*, MODEL ACT § 51; NEB. REV. STAT. § 21-2049 (Reissue 1977).

77. UPA § 18(e); NEB. REV. STAT. § 67-318(e) (Reissue 1976).

78. *E.g.*, UPA § 9; NEB. REV. STAT. § 67-309 (Reissue 1976).

79. In addition to the stratification of corporate management as a result of the presence of both officers and directors, another example of this flexibility in structuring is the use of the committee system. MODEL ACT § 42; DEL. CODE tit. 8, § 141(c) (1974); NEB. REV. STAT. § 21-2041 (Reissue 1977).

80. *See* W. MCKEE, W. NELSON, & R. WHITMIRE, *supra* note 13, ¶ 3.06[4] [b]; note 19 *supra*.

81. *See* note 85 *infra*.

82. *See generally* 1 FLETCHER, *supra* note 4, §§ 5-7, 10-14.

With respect to debt financing, the chief difference between the partnership (or sole proprietorship) and the corporation is limited liability. However, this need not be a significant factor. As noted earlier⁸³ it is not uncommon for a creditor of a closely held corporation to require the personal guarantees of the principal shareholders. Conversely, with a profitable partnership, a third party may well extend credit with recourse limited to the partnership assets. It follows that the significant difference in financing exists, if at all, in terms of equity interests.

As has been already pointed out, the prime advantage to the corporate form may be nothing more than the ease of adaptability. The ability to issue voting and nonvoting equity interests is readily provided by the statutory schemes.⁸⁴ Additionally, corporate statutes uniformly provide for preferred stock permitting dividend and liquidation preferences.⁸⁵ And the ability to create hybrid securities having attributes of both equity and debt interests is available with the corporate structure. Such devices include the right to cumulative preferred dividends (debt),⁸⁶ participating preferred interests (equity),⁸⁷ the corporate right of redemption (debt), and the ability to have both debt instruments and preferred stock convertible into common stock at the security holder's option.

To the extent that an enterprise seeks to take advantage of these alternatives, the corporate form is a significant advantage. However, for those who prefer partnership single taxation, subchapter S status is limited in availability to corporations with one class of stock.⁸⁸ Thus, the true "incorporated partnership" is not in

83. See text accompanying note 30 *supra*.

84. In some states the use of non-voting common stock is permissible. *E.g.*, DEL. CODE tit. 8, § 151(a) (1974); NEB. REV. STAT. § 21-2014 (Reissue 1977). In a few jurisdictions there are statutory prohibitions against non-voting stock. *See* C. CARY, *supra* note 22, at 255, 411. However, even non-voting stock is allowed to vote for or against organic changes that would affect its relative rights. *E.g.*, MODEL ACT §§ 59(c), 60; DEL. CODE tit. 8, § 242(c)(2) (Supp. 1978); NEB. REV. STAT. §§ 21-2057(3), -2058 (Reissue 1977).

85. *E.g.*, MODEL ACT § 16; DEL. CODE tit. 8, § 151 (1974); NEB. REV. STAT. § 21-2015 (Reissue 1977). *See generally* Buxbaum, *Preferred Stock—Law and Draftsmanship*, 42 CALIF. L. REV. 243 (1954).

86. A right to cumulative dividends means that the stated annual amount accrues from year to year even when no dividends are paid in a given year, thus entitling holders of the preferred shares to payment of accrued dividends before any dividend on the common stock can be paid. Without such a right the preference exists only on a one year basis.

87. Participation can exist with either dividends or liquidation rights and provides that in addition to a preference, *i.e.*, standing in line before the common shareholders up to a stated amount, there is a right to participate equally in the remainder after the preference is satisfied.

88. I.R.C. § 1371(a)(4).

a position to take advantage of corporate flexibility in capital structuring.

III. CONCLUSION

It has been admonished: "When in doubt, don't incorporate."⁸⁹ This advice is well taken. Indiscriminate use of the corporate form will frequently result in a counter-productive situation in which the expense, time and formality will far outweigh any benefit to the enterprise. In deciding which form to adopt the planner should take cognizance of the oft-times illusory nature of the advantages discussed above. When viewed in the appropriate perspective and when properly balanced against the known disadvantages, the optimal form of enterprise will be chosen through an informed rather than a mechanical selection process.

89. H. HENN, *CASES AND MATERIALS ON CORPORATIONS* 99 (1974) (quoting G. SEWARD, *BASIC CORPORATE PRACTICE* 8 (ALI rev. ed. 1966)):

When in doubt, don't incorporate. Many small corporations are formed inadvisedly. The corporate form of doing business is probably disadvantageous for a small new venture. The cost of the privilege of limited liability will probably be too high. Not only is there expense involved in forming and maintaining a corporation which a sole proprietor would not have to pay, but there may be serious tax disadvantages. The double tax on corporate income distributed as dividends makes the corporate form of doing business basically unattractive. Only by taking advantage of the exceptions and the unusual provisions in the law is the corporate form made attractive for the typical small venture. Hence a basic rule: don't incorporate unless the advantages are worth the cost. Time devoted at the outset to determining whether incorporation is advisable, will be well spent.