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# ACTION AGAINST CONGLOMERATES — WILL IT HURT SMALL BUSINESS?

J. MALCOLM SWENSON\*

During the hearings on the Tax Reform Act of 1969, held before the House Ways and Means Committee, it appeared that the Act, as then envisioned, might have an effect not intended by those advocating its passage. Although the legislation was not designed to restrict the activities of small business, its pervasiveness seemed to threaten just that. In attempting to resolve the ambiguities extant under prior tax law regarding the substitution of debt for equity, particularly where the substitution served as an impetus to agglomeration, earlier versions<sup>1</sup> seemed to limit the use of debt that is vital to the existence of many small corporations. It is a credit to those in the House, Treasury and Senate who designed the Act and engineered its passage that such is apparently not the case. The Act, as passed by the Senate and signed into law,<sup>2</sup> is indeed an instrument under which small business can prosper and grow. The reasons why it favors small business reveal much about its relationship to anti-conglomerate legislation generally, as well as to conglomerates and other large corporations themselves. Preliminarily, therefore, we shall consider the situation, problems, and probable development of small business.

In many respects, small corporations, with sales ranging from a few hundred thousand to a few million dollars per year, are now particularly embattled. The economic pressures exerted on them are part of the general business environment, but are particularly severe. A recent survey finds 85 percent of small businesses reporting sharply dropping earnings.<sup>3</sup> It can be assumed that the pressures referred to, particularly those resulting from the high cost of debt, rising labor costs, and difficulty in maintaining or expanding sales and market share, have strongly influenced this depression of earnings.

The high cost of debt, caused by current interest rates, has hurt small business by both increasing the cost of its financial support and restricting its access to funds. Since most small businesses rely on debt consisting of loans from commercial banks, the increase in the cost of those loans has had a direct effect on operational costs. With the supply of funds itself restricted, it has been increasingly difficult for these companies to develop new sources for borrowing. This has resulted in debt just not being available to many companies, forcing them to restrict expansion plans.<sup>4</sup> Because of this, some

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<sup>1</sup> H.R. 7489, 91st Cong., 1st Sess. 227 (1969).

<sup>2</sup> Tax Reform Act of 1969, Pub. L. No. 91-172 (Dec. 30, 1969).

<sup>3</sup> Wall Street Journal, Dec. 10, 1969, at 1, col. 6.

<sup>4</sup> *Id.*

of the most successful have experienced restricted growth. This restriction has been exemplified by the fact that the Small Business Administration, a major source of small business borrowings, has recently lacked funds for direct loans beyond some special programs.

In addition to the increase in the cost of loans, rising labor costs have been especially severe in their effect on smaller corporations. The prime element in these costs has been the rapidly increasing wages of hourly employees. While major national corporations and, as an industry, the construction industry, have been able to transfer the cost of wage increases to the consumer, most small companies have seen labor costs rise and the labor supply evaporate without being able to pass on their costs. Even though some small businesses in our area pay their employees relatively low wages and might expect problems during a period of generally rising wages, companies which pay relatively high wages have also incurred problems caused by increasing labor costs and diminishing labor supply. Although our own company, for example, is one of the highest wage payers in our area and industry, we feel pressures resulting from these problems. Small business in general, and our own company in particular, operating within very narrow market areas, are not in a position to transfer increasing costs to customers. A larger, multi-market corporation, or a general contractor, is obviously in a different position.

Were most small businesses engaging in several different markets, the possibility of reducing these pressures would be greater. Unfortunately, they are not. In many instances changing marketing demands make it increasingly difficult to maintain market position in single market areas. In our own industry, marketing and manufacturing patterns have changed substantially over the past few years. Overall market growth has been accompanied by a need for an increasingly high level of technical performance. Firms offering an increasingly higher level of technical competence to the market have generally prospered and increased their market shares. In the same sense, firms that have not responded to the technical demands of the market have experienced declining market shares and, in several cases, have failed. However, our industry contains both very small and quite large companies. Even the successful small companies, in order to succeed over a period of time, will have to compete effectively with much larger companies possessing greater resources.

In our own case, we compete with a wide variety of firms, ranging from small organizations where the family owners form part of the plant work force, to divisions of large companies. At present, we are competing effectively. To be able to continue this in the future, however, we will have to offset the financing, research and management available within a large organization. In this competition the fact that our company, like many other small companies, offers one basic product to the market, is both a help and a hindrance. In research, for example, our size does not necessarily hinder us;

indeed we have already offered more technical developments to the industry than have substantially larger competitors. Thus, bigness alone is no assurance of invention or innovation. In financing, however, size and closely-held stock has proven a hindrance. We are essentially limited to internally-generated cash and bank borrowings as sources of funds. With these limitations on our financial flexibility, our growth is, in a very real sense, restricted. Our growth is also restricted by a highly cyclical and narrow market (building granite) where a continual expansion of facilities could leave the company exposed during low market periods. Both these constraints on our growth tend to lessen our ability to attract talented management. This restriction is most serious since a small company cannot defer to its competitors in the quality of its management and compete effectively. How we react to this problem and the others impeding us will largely determine our future success. How other small companies react to these same sets of problems will have considerable influence on the success of small business, as such, in the future.

Although each small company, perforce, must seek its own solutions, and thus react somewhat differently to these problems, answers must be found. Very few small companies can fail to react to a combination of increasing cost pressures and limited market growth. Our own company's reaction to this situation is an example of one company's solution of these problems. In its relationship to anti-conglomerate legislation it is quite relevant.

Our company is almost entirely a single-product concern. Although we supply a relatively small amount of granite for highway curbing and bridge facing, 90 percent of our sales are generated by a single product, *i.e.*, dimension granite for the facing and plazas of buildings. This granite is typically furnished in two inch thick panels, finished on one side and cut to specific dimensions. Most of it, in dollar terms, is used on major, highrise buildings.

In recent years, the market for this granite has demonstrated real growth, better than 10 percent per year since 1965.<sup>5</sup> Within this growth, our company has doubled its market share and shown strong profit performance. In many ways, we might be considered a successful small company. It is highly debatable, however, whether we can remain the small company we are today and maintain this success over any period of time. We are almost entirely exposed to a single market and its whims. While that market is growing, it is highly cyclical and limited in the amount of growth it will support. To the degree that its growth is limited, the company's ability to attract the essential resources of business, management as one example, is restricted. In turn, to the degree that the company is both operationally and strategically constrained, it is placed in a higher risk position than those companies not so restricted. This, of course, leaves our stockholders' investment in a relatively high-risk position.

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<sup>5</sup> NATIONAL BUILDING GRANITE QUARRIES ASSOCIATION, ANNUAL REPORT (1968).

In order to minimize this risk and make more accessible the elements which support corporate growth, it appears entirely reasonable for us to diversify into additional product areas. Since we are a small organization with limited means for generating new products and entering new product areas, we can best achieve this diversification by avoiding the cost of product development and market entry and entering through extant companies. Diversification through merger and acquisition provides this opportunity while allowing us to maintain an old, well-established company. For ourselves, mergers and acquisitions constitute the lowest risk alternatives available. We would not be sound, in the management of our stockholders' investment, if we ignored this opportunity for financial diversification. Because of this, it is questionable whether any rationale exists for restricting the merger of small units, like those we contemplate. Since such mergers can increase the growth and strength of small corporations, it is difficult to determine whom they would damage.

Mergers and acquisitions provide more than merely an opportunity for growth in a small corporation. Indeed, they allow the small businessman to dispose of all, or a part, of a small company's ownership. The reasons for these sales are many and important. For example, they often provide the liquidity necessary to meet retirement and estate needs. From the standpoint of the small companies, such sales often provide a continuity of ownership and continuance at the small business level. Among small businesses generally, it is important that alternatives for investment liquidation exist since the opportunity for ownership in small businesses is a principle reason for individual involvement. At present, an individual selling his interest in a small business can take one of two approaches and still maintain his business at the small business level.

One of these alternatives is to sell his business to a party outside his present management group. This could be either an individual or another small company, like our own. Such a sale would allow the businessman to liquidate his investment while maintaining his company as an independent unit of a relatively small organization. This smallness can be important when there is a need for a very personal input by the acquiring party, to compensate for the strong role the selling businessman often maintained both within his organization and with his customers. Such a transaction is often on a cash basis as the small acquirer company typically does not have publicly valued securities available. The acquiring company has to use a combination of its own cash and borrowed funds. Since the payment is in "real dollars" and the acquiring party's stock valuation does not readily benefit from the earnings of the acquired company, as no publicly traded stock is involved, there is a maximum of market restraint on such transactions. They have to make a great deal of sense in relation to the acquiring company's operational performance and growth. Where they do make sense, such combinations aid both the purchaser and small business.

Small business also benefits greatly from the other alternative available to a small businessman selling his interest within the small business community. This alternative is the sale of ownership in a business to a member or members of its present management group. In family businesses, the individuals involved are usually relatives. Purchasers realize the meaningful ownership mentioned as a prime motivation for individual involvement in small business, while the seller is able to liquidate his investment and see his company continue independently under its own management. In instances where the company is not attractive to an outside party, because of depressed earnings or other factors, the seller may still sell his interest through such an inside sale. In these transactions, however, the purchaser usually does not have enough cash to make an outright purchase. In fact, the purchaser often does not have the funds available to make an installment purchase without a substantial deferral in the principal payment. This lack of funds does not imply that these transactions are unsound business arrangements which benefit only the seller and purchaser. Rather, by maintaining a small enterprise they serve the economy as a whole. Indeed, they often enable small businesses to proceed with a continuity of direction when they might not otherwise be able to proceed at all. In doing this, they allow businesses to remain contributors to both the communities in which they are located, and to the tax base.

To the degree that both internal and external sales of business ownership aid small business, they aid the economy. To be reasonable for small businesses, such sales must be sound and contribute to profits. If they are sound, it is difficult to determine how they threaten to reduce the tax base or to lead to any serious centralization of economic power. Rather, as the sound growth of small business is encouraged, the base of economic power is broadened. Discouraging the growth of small business, on the other hand, contributes to many of the possible problems of national interest raised before House Ways and Means Committee hearings, last spring, by increasing economic concentration and reducing local control over business enterprises.

If the Tax Reform Act of 1969 restricted the small businessman in either of the alternatives discussed as incidents of the sale of his ownership interest, it would have hurt small business as an entity by reducing its ability to meet present business pressures and reducing the transfer of ownership between and among small businesses. It appears that the Act, as revised, will not be detrimental to small business. During its evolution, however, it appeared that earlier versions would contain provisions restricting the ability of small business for ownership transfer. These provisions would have restricted the deduction of interest and severely limited the installment method of reporting gains on the sale of real property.<sup>6</sup> An investigation of these

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<sup>6</sup> H.R. REP. 413, § 221, at 72, § 412, at 107.

limiting provisions reveals how small business might have been restricted, and the way in which the Bill provided specific exemptions for it.

The disallowance of the deduction of interest payments under certain conditions was, of course, intended to restrict the tax incentives for merger available when acquiring corporations used debt instruments, such as convertible debentures which were essentially equity. The recipients of these debentures benefitted from many of the advantages of equity, and the acquiring corporation received the tax deduction available for interest payments on debt.<sup>7</sup> While this type of transaction is far removed from small business, action against it carried the real potential of restricting small business. For example, the House Bill<sup>8</sup> contained tests for determining whether or not interest payments on bonds issued for an acquisition would be disallowed. One of these tests required that, for interest deductibility, the bonds would have to be issued by a corporation with a ratio of debt to equity less than two to one or with an annual interest expense of its indebtedness covered by earnings more than three times greater than that expense.<sup>9</sup> It would be entirely possible for an old, conservatively managed small company to fail to meet this test.

Consider such a company with its assets carried in the following forms: its land, largely at purchase prices determined in the 1800's or early 1900's, and its buildings and equipment, at substantially depreciated values. With its asset values so understated, it is not difficult for it to fail the debt to equity test of two to one. In addition, it is possible for the company to fail the interest coverage test. As enacted, this company, and all small companies, is well protected by a provision which exempts the first \$5 million of yearly interest payments from disallowance.<sup>10</sup> While this exemption is more than adequate, the potential for damage to small business did exist.

Potential restriction of normal small-business activities also existed in regard to the Tax Reform Act's limitations on the installment sale provision.<sup>11</sup> These limitations were intended to restrict the use of the installment method of reporting gains when readily marketable securities were received by the seller and provided immediate sources of cash. Although acquisitions financed by marketable debentures or securities are not common in small business, the installment-sale provision is. It is vital to ownership transfer between, and within, small companies. As mentioned before, because small companies or individuals seldom have the purchase price in cash available, ownership transfer at the small-business level is often only possible through

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<sup>7</sup> I.R.C. § 163.

<sup>8</sup> STAFF OF JOINT COMM. ON INTERNAL REVENUE TAXATION, 91ST CONG., 1ST SESS., SUMMARY OF H.R. 13270, TAX REFORM ACT OF 1969, at 58 (Comm. Print 1970). These were enacted as a part of the Tax Reform Act and now comprise part of I.R.C. § 279(b).

<sup>9</sup> I.R.C. § 279(b)(4)(A).

<sup>10</sup> *Id.* § 279(a).

<sup>11</sup> H.R. REP. NO. 413, 91st Cong., 1st Sess., § 412, at 107 (1969).

the availability of the installment sale. In altering its conditions, the House Bill was dealing with something extremely important to small business. In regard to debentures, the House version provided some protection to small business by only restricting the election of the installment sale in cases where the debentures were readily tradeable on an established securities market. Most small businesses certainly do not have such tradeable securities. However, the House Bill also established a strict, and inflexible, method of payment which would have been required in installment sales. This provision called for the payment of at least 5 percent of the principal at the end of the first quarter of the installment period, 15 percent at the end of the second quarter, and 40 percent at the end of the third.<sup>12</sup> This payment provision itself could have made transactions impossible where the purchaser did not have a substantial portion of the purchase price available in cash. In instances where one or more members of a management purchase a retiring member's ownership, that cash is often not available. In addition, the very inflexibility of this provision would have made its use by small business difficult. Within small-business transactions, it is entirely possible for emergencies to arise which affect the purchaser's ability to pay the seller without an extension of the payment period. Lacking the flexibility for any such extension, the installment-sales provision would have been much less useful to small business. Fortunately, the restrictive-payment provision was deleted by committee amendments.

The deletion of that provision was the final step necessary to make the Tax Reform Act of 1969 a very workable one for small business. Instead of generally restricting the use of debt by small corporations, as well as the abuses of some large ones, the Act is specific and exact in its protection of small business. It establishes an umbrella under which small business can utilize debt to finance acquisitions. In this, it leaves small business with all the financial flexibility which it has had in the past. For the small businessman selling his company, or ownership in it, the final version retains the installment-sales provision, vital to maintaining such sales at the small-business level. It would be difficult to state that the Act does not maintain the factors necessary for financial growth within, and ownership transfer between, small businesses.

Even with the Act's workability for small business, it is not at all certain that tax legislation is the proper vehicle with which to restrict merger activity. Although the Tax Reform Act of 1969 is specific in regard to small business, tax legislation, as such, always carries with it the danger of being sufficiently general to alter and restrict activities which are not intended to be restricted. Tax legislation is certainly an area where the implications can range far beyond the original intent. It is significant that the part of the present Act perhaps most damaging to small business, that establishing the inflexible plan for installment sales, was among the last to be deleted from

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<sup>12</sup> *Id.*

it. It is entirely possible that it could have remained and small business could have suffered accordingly.

Because of that, it appears that tax legislation should be, perhaps, the last step, instead of the first, against economic concentration. This is not to suggest that inequities in taxation should not be corrected as soon as possible (the use of readily marketable debentures in installment purchases is an example). However, before tax legislation should be employed as a general instrument against conglomerates, many other actions, closer to mergers and acquisitions, should be taken. Some action should be taken by non-governmental bodies, such as the Accounting Principles Board's forthcoming ruling on pooling of interests.<sup>13</sup> Other action should be taken by such regulatory agencies as the Securities and Exchange Commission.<sup>14</sup> Only after such bodies as these have taken action, and, if the need exists, specific legislation restricting mergers and acquisitions has been enacted by the Congress, should tax legislation be employed to complement the actions of the above. To determine the need for any such action, the Justice Department should be able to speak specifically to the changes in, and any resulting dangers to, our economic structure resulting from the merger movement.

For the small businessman, mergers and acquisitions often provide the needed opportunities mentioned to either strengthen their businesses or to liquidate their interests in them. As practiced within the community of small business, mergers can benefit it and the economy in general. Although the Tax Reform Act of 1969 thoughtfully avoids restricting their transfer of ownership, the danger of restriction in future legislation is always present. To avoid placing limitations on small business, legislation in the merger area will have to be continually evaluated in terms of its effect on all business, not just the conglomerates. If any future legislation restricts small business, it will, in all probability, be furthering many of the problems it is attempting to solve.

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<sup>13</sup> AICPA, *Pooling of Interests*, APB No. — (publication forthcoming).

<sup>14</sup> The Securities and Exchange Commission has taken steps in some areas. See, e.g., SEC Securities Act Release No. 4988 (July 14, 1969) (modifying line of business reporting requirements of SEC Securities Act Release No. 4949 (Feb. 18, 1969) and Release No. 4922 (Sept. 4, 1968)).

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