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Equine Bnsiness Orgauizations

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Using the thoroughbred horse racing industry as background for his analysis, the author addresses the problem that lawyers generally face when advising as to the appropriate businεss form for their clients' investments. He borrows the model of leading American business law writer W.A. Klein to examine equine business organizations as "bargains" among participants rather than as categories of abstract legal rules. These legal rules, he argues, fail to account adequately for tlie very particular economic relationships found in racing and breeding firms. Accordingly, the author considers tlie different forms of business association used in the industry from tlie point of view of their functional elements: control, return, risk, duration and constraints. By initially considering how these aspects of the business-bargain should best be allocated among participants, horsemen and business-people generally can make more effective use of the legal rules available to them to organize their business affairs.

En se servant de l'industrie hippique comme arrière-plan de son analyse, l'auteur étudie le problème auquel font généralement face les avocats qui conseillent leurs clients sur le type d'entreprise le plus approprié à la nature de leurs investissements. L'auteur emprunte le modèle d'un important spécialiste américain du droit des affaires, W.A. Klein, afin de considérer les diverses entreprises reliées aux chevaux pur-sangs non comme des ensembles de règles juridiques abstraites mais plutôt comme des "ententes" négociées entre un nombre quelconque de participants. Ces règles juridiques abstraites, selon l'auteur, n'expliquent pas adéquatement les relations économiques très particulières que l'on retrouve dans les entreprises de course et d'élevage de chevaux. L'auteur envisage donc les différentes formes d'associations commercialcs hippiques du point de vue de leurs éléments fonctionnels: le contrôle, la rentabilité, le risque, la durée et les contraintes. En examinant d'abord comment ces aspects de l'"entente" négociée seraient le mieux répartis parmi les participants, les investisseurs dans l'industrie du cheval et les gens d'affaires généralement pourraient exploiter plus efficacement les règles juridiques disponibles pour organiser leurs relations commerciales.

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Synopsis

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I. Introduction

This essay is a study of how to play the horses. It is also an examination of the law of business associations which traces the economic and legal reasons investors organize thoroughbred racing and breeding ventures in one business form rather than another.

When isolating the criteria governing the choice of business organization, lawyers have traditionally focused on the positive law characteristics of each form as the basis on which their clients' choice should be made.[1] This approach is grounded in a view of sole proprietorship, partnership, limited companies and the like as distinct categories of legal rules or, as one critic has put it, "airtight compartments".[2] Perhaps out of force of habit, business lawyers have preferred to ask "what" instead of "why".

As part of the same tradition, equine lawyers tend to study the cart intently without seriously considering the horse. Advice to clients generally centres on the abstract legal rules attaching to one or another business form.[3] Often the unique business context in which the equine business form will eventually be situated is ignored or at least not given the attention it deserves.[4] Not only must this be a source of frustration to horsemen, but it might also threaten to undermine the effectiveness of their investment.

A proper legal inquiry should include an evaluation of the commercial and economic considerations affecting the participants' choice as to how they will organize their resources for an equine business venture. The purpose of this essay is to isolate the underlying economic influences and observe how they find expression in the legal rules governing the chosen business organization. This approach results from a view of the firm not as an entity or as an actor in its own right, but rather as a legal fiction which serves as a "nexus for ... a multitude of complex relationships (i.e. contracts) between

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[1]See, *e.g.*, D.R. Cameron, "The Form and Organization of the Business Entity" in Law Society of Upper Canada, *Advising the Small Businessman* (Toronto: Law Society of Upper Canada, 1976) 1; and G.D. Gibson, "Selecting the Form of Entity for Small Business" (1962) 18 Bus. Law. 100.

[2]W.A. Klein, *Business Organization and Finance* (New York: Foundation Press, 1980) at 41.

[3]See, *e.g.*, J.J. Kropp, J.A. Flanagan & T.W. Kahle, "Choosing the Equine Business Form" (1982) 70 Ky L.J. 941.

[4]The problem of consulting experts without inside industry knowledge is raised by J.E. Burch, "Choosing Your Adviser" in *Thoroughbred Ownership: A Guide for Potential Owners and Breeders* (Elmont, N.Y.: Thoroughbred Owners & Breeders Ass'n, 1984) 10 [hereinafter *Thoroughbred Ownership*].

the legal fiction (the firm) and the owners of labor, material and capital inputs and the consumers of output".[5] Consequently, it is inappropriate to consider the positive law attributes of a racing or breeding firm outside the context of the economic relationships that it represents.

In his important article, "The Modern Business Organization: Bargaining Under Constraints", William Klein provides a useful framework for a lawyer's study of business associations:

> [T]he most useful way to analyze the modern business enterprise is to interpret the terms of the economic arrangements of a firm (partnership, corporation, cooperative) and the terms of the related economic arrangements that should not be analyzed separately from the firm (distributorship, loan agreement, employment contracts) as a *series of bargains* subject to contraints ... .[6]

Klein would argue that it is not useful simply to enumerate the legal rules governing a given equine business, but rather that one should focus on the *bargain* between the participants and how, at law, they would allocate resources, profits and losses. He suggests that each bargain is made up of four basic elements: control, return, risk of loss and duration of the venture. Furthermore, the constraints which may limit a given bargain include government regulation, the inability of parties to plan for all contingencies and the conflicting interests and goals of the participants.[7]

This study will apply Klein's criteria to the business forms available to the thoroughbred investor in order to gain insight into the legal consequences of investment decisions. After a brief introduction to the business of raising and racing horses, this paper will examine sole proprietorship, partnership, limited partnership, syndication and closely-held and public companies as vehicles for the bargains struck between participants in the thoroughbred firm.

II. Industry Background

The history of the thoroughbred and the history of thoroughbred racing, best told elsewhere,[8] have their origins in England in the seventeenth century. The transition from sport to business, however, is very much a twentieth-century phenomenon, and is still not wholly accepted by those outside

[5]M.C. Jensen & W.H. Meckling, "Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure" in R.A. Posner & K.E. Scott, eds, *Economics of Corporation Law and Securities Regulation* (Boston: Little, Brown, 1980) 39 at 41.

[6](1982) 91 Yale L.J. 1521 at 1521 [emphasis added].

[7]*Ibid.*

[8]See, *e.g.*, I. Herbert, ed., *Horse Racing: A Complete Guide to the Turf* (New York: St Martin's Press, 1981) c. 1. For an interesting insight into the Canadian business history of racing, see Canada, *Report of the Royal Commission in [sic] Racing Inquiry*, (sessional paper 67) (Ottawa: King's Printer, 1920)(Commissioner: J.G. Rutherford).

the industry.[9] In Canada, both thoroughbred racing and breeding are centred mostly in southern Ontario where recent government reports have ranked the industry as one of the province's most important.[10] An estimated 40,000 people are directly employed in racing and breeding activities in Ontario, and provincial taxes collected from industry activity in 1984 amounted to some $60 million.[11] Ontario alone boasts 21 race tracks, including one of North America's most sophisticated thoroughbred facilities, Woodbine race track in Toronto.[12]

Racing has always been subject to significant government restrictions;[13] and today it is one of the most regulated sports in Canada,[14] subject to both federal legislation[15] and, more importantly, provincial laws governing race tracks and horse racing. The Ontario *Racing Commission Act*,[16] for example, creates the Ontario Racing Commission which is empowered to make rules for the conduct of racing, including the licensing of its participants.[17] Horsemen often lament the regulation of their business, but government intervention is generally recognized as a necessary cvil.[18] It is certainly a factor to be reckoned with when choosing a business form.

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[9]See K. Hollingsworth, "Introduction to the Equine Law Symposium" (1982) 70 Ky L.J. 889 at 905.

[10]See Ontario, Legislative Assembly, *Report of the Ontario Racing Industry Study Committee* (June 1985) at 1 (Chair: F. Drea) [hereinafter the *Drea Report*]; Ontario Racing Commission, *Improving the Viability of the Horse-Racing Industry in Ontario* by Thorne Stevenson & Kellogg, Management Consultants (November 1982) [unpublished] at 12 [hereinafter the *ORC Report*].

[11]*Drea Report, ibid.* at 1. Though these statistics are impressive, there is considerable concern for the health of the industry among horsemen who attribute the decline in track attendance to competition from state-run lotteries, other forms of entertainment, and industry mismanagement: *ORC Report, ibid.* at 106ff.

[12]The Ontario racing and breeding markets, though small in comparison to their American counterparts, are extensive and the consensus is sanguine as to the industry's potential: *Drea Report, ibid.* at 12-13 and *ORC Report, ibid.* at 107.

[13]See J. Disney, *The Laws of Gaming, Wagering, Horse-Racing and Gaming-Houses* (London: Butterworth, 1806) at 27 where the author observes that "[t]he benefits which have been derived to our country by the improvement in the breed and management of horses, have induced the Legislature to put the amusement of horse-racing under certain regulations . . . ."

[14]J. Barnes, *Sports and the Law in Canada* (Toronto: Butterworths, 1983) at 69. See, by the same author, "Sports" 31 C.E.D. (3d) Title 135.1, para. 27ff.

[15]These are mostly rules concerning wagering: see, *e.g.*, *Criminal Code*, R.S.C. 1970, c. C-34, s. 188; *Pari-Mutual Payments Order*, C.R.C. 1978, c. 432.

[16]R.S.O. 1980, c. 429.

[17]*Ibid.*, s. 11. These rules of the Commission have been held to be of an administrative, not a legislative nature and consequently need not be registered as official statutory regulations: *Kingston* v. *Ontario Racing Comm'n* (1965), 2 O.R. 10, 49 D.L.R. (2d) 395 (H.C.), aff'd 2 O.R. 10 at 10n., 49 D.L.R. (2d) 395 at 395n. (C.A.).

[18]See the colourful judgment of O'Rear J. in *State Racing Comm'n* v. *Latonia Agricultural Ass'n*, 123 S.W. 681 at 683-84 (Ky C.A. 1909) where the legislative authority to regulate racing was held to be constitutional in that it sought to "promote a breed of horses whose powers and qualities are of such great value" and to discourage the "[m]oral laxity" of its partisans.

It may seem incongruous to think of a sport, especially one having notorious associations with kings and book-makers, as being a business at all. Observing the organization of the equine venture is revealing, and on close examination many breeding, racing[19] and even betting[20] activities prove to be well-organized enterprises run ruthlessly for profit. Practically, the issue as to whether racing and breeding are in fact businesses is of interest principally for tax purposes.

Under the *Income Tax Act*, "farming" is defined to include "raising" and "maintaining" horses for racing,[21] so that where the taxpayer is engaged in these activities as a business, his income and losses will be treated as business income and losses.[22] Tax courts have been reluctant to characterize purses won by racehorses as income from a business but for "exceptional circumstances showing that the owner of the horse had so organized his activities that in fact he was conducting an enterprise of a commercial character."[23] The tax treatment of a given business form is, of course, a central consideration for its appropriateness.

Outsiders generally do not realize how well developed the commercial markets for racehorses are and how much money can be involved in thoroughbred transactions. A review of statistics from recent yearling (*i.e.*, one-year-old horse) auctions is revealing. At the July 1985 Keeneland, Kentucky Selected Yearling Sale, 256 untried and untrained horses were sold for

[19]Racehorse owners in Ontario may have a difficult time arguing that they had a reasonable expectation of profit following a 1982 survey in which two-thirds of the respondents claimed to have lost money on their racing operations that year: *ORC Report*, *supra*, note 10 at 18-19.

[20]See, *e.g.*, *Graham* v. *Green* (1925), [1925] 2 K.B. 37, [1925] All E.R. Rep. 690, and *Badame* v. *M.N.R.* (1951), 3 Tax A.B.C. 226.

[21]R.S.C. 1952, c. 148 as am., s. 31.

[22]As to what constitutes a business, see D.A. Ward et al., *Ward's Tax Law and Planning*, vol. 2 (Toronto: Carswell, 1983) at para. 40.1. Tax courts have not been shy to find horsemen, even very wealthy ones, engaged in the business of horse racing and breeding: see, *e.g.*, *Taylor* v. *M.N.R.* (1961), 27 Tax A.B.C. 278. Where horsemen cannot show that their chief occupation is farming, they are limited to $5,000 as losses deductible from income under s. 31 of the *Income Tax Act*, *ibid.* Not surprisingly, the industry is lobbying for the repeal of this "disincentive to racing": see, *e.g.*, L. Butcher, "Section 31 of the *Income Tax Act*" *Canadian Horse* (July 1984) 74; and D. Teubner, "Restricted Farm Loss Changes" *Horse Sport* (April 1985) 6. Both the *Drea Report*, *supra*, note 10 at 25 and the *ORC Report*, *supra*, note 10 at 116 recommend the repeal of s. 31.

[23]*Hammond* v. *M.N.R.* (1971), [1971] F.C. 341 at 346, [1971] C.T.C. 663 (T.D.). Where the courts have perceived that a horseman is unable to afford to lose money on a hobby, they have inferred this commercial character: *M.N.R.* v. *Walker* (1951), [1952] Ex. C.R. 1, [1951] C.T.C. 334. As to the hobby-business distinction in the United States, see T.C. Patrick, "Business versus Hobby: Determination of Whether a Horse Activity is Engaged in for Profit" (1982) 70 Ky L.J. 971. Generally, U.S. courts have viewed the business of horse racing with a favourable eye: see, *e.g.*, *Wilson* v. *Eisner*, 282 F. 38 (2d Cir. 1922) and *Commissioner* v. *Widener*, 33 F.2d 833 (3d Cir. 1929).

U.S.$137,505,000, averaging U.S.$537,129 a head. The top-priced colts included two sired by Nijinsky II which were sold for U.S.$13.1 million and U.S.$7 million respectively. Two chestnut fillies by stallion Northern Dancer were sold for U.S.$2.5 million each. Buyers include partnerships, limited partnerships, and both private and public companies.[24] Prices at the top of the Canadian yearling market are equally impressive.[25]

A wide variety of business ventures have been set in motion to cash in on this very active market. Though the traditional form of sole proprietorship still predominates, D.L. Heckerman points out that "[t]he nature of investment in the Thoroughbred industry is changing" and that recent years "have seen a rapidly accelerating movement towards multiple ownership of racing and breeding stock."[26] By 1986, public stock issues, limited partnerships and complicated syndication schemes have become a part of racing and breeding. The horseman is presented with investment choices heretofore unknown in the industry.

The issue of the appropriate choice of business form is best introduced by way of an example. On 19 July 1975, Mickey and Karen Taylor and Jim Hill entered into partnership in order to buy a thoroughbred yearling racehorse at a public auction in Kentucky. For U.S.$17,500 the partners acquired a dark bay colt, of respectable but not royal breeding, which had never worn a saddle much less seen a race track. The colt, later named Seattle Slew, was sent to Florida to train in preparation for the 1976 racing season.

The partnership easily recouped its investment during the horse's first year at the track. After an undefeated season as a two-year-old, Seattle Slew was named Horse of the Year in the United States at three, delighting his owners by winning the three legs of the American Triple Crown of racing: the Kentucky Derby, the Preakness Stakes and the Belmont Stakes. Seattle Slew retired after his fourth year with track earnings of U.S.$1,208,726. The partners sent the horse to stud at Spendthrift Farm, a large Kentucky breeding operation. Conscious at once of both Seattle Slew's immense potential as a stallion and the risk that the horse would not realize this potential, the partners decided to divide the risk with others. Seattle Slew was syndicated into forty fractional shares which were sold to a wide group of investors at U.S.$300,000 each.

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[24]K. Hollingsworth *et al.*, "Keeneland Select Sale" *The Blood-Horse* (27 July 1985) 5058 at 5058ff. Although the top of the yearling market is clearly quite healthy, sales figures of middling and lower quality pedigree horses are not keeping pace. This is a cause for concern among horsemen for the overall well-being of the industry.

[25]At the Woodbine Yearling Sale on 5 September 1985, a colt by Northern Dancer out of mare Running Around sold for $3.7 million, setting a new Canadian record: see T. Slater, "Colt Sells for $3.7 Million" *The Toronto Star* (6 September 1985) F4.

[26]D.L. Heckerman, "Taking Stock of Shares" *The Blood-Horse* (14 January 1984) 256 at 256.

Seattle Slew proved to be more successful at stud than he had been at the track. From the first two crops of foals emerged a number of top stakes-race winning horses, including Slew o' Gold, Landaluce, and 1984 Kentucky Derby winner Swale. Each of the roughly fifty annual rights to breed mares to Seattle Slew quickly appreciated in value. The price of the shares in the stallion sky-rocketed: in 1984 two shares changed hands for U.S.$3 million and U.S.$2.9 million respectively. The value of the horse today is estimated as high as U.S.$140 million.[27]

Although the story of Seattle Slew is by no means typical, it does serve to raise the fundamental business law issue facing investors: through what legal form can and should one invest in thoroughbred horses? The original owners of Seattle Slew chose to race the horse as partners. When the horse was sent to stud, the decision was made to divide ownership in the stallion among forty shareholders. A consideration of the traditional legal forms in their true economic context will show why.

III. Sole Proprietorship

The majority of racehorses are owned by individuals in their own names or in the names of unincorporated (and often non-existent) racing stables.[28] This is especially true at Ontario race tracks where, owing to the quality of most horses, the cost of acquiring them is not prohibitive.[29] In law, sole proprietorship exists where an individual carries on business for his own account without using the medium of any other form of business organization or involving the participation of other individuals except as employees.[30]

The legal characteristics of sole proprietorship are deceptively simple. Title to the assets of the business rests with the sole owner to whom the income of the venture is attributed personally and who is responsible for

[27]This account of the business history of Seattle Slew is taken from J. Lohman & A. Kirkpatrick, *Successful Thoroughbred Investment in a Changing Market* (Lexington, Ky: Thoroughbred Publishers, 1984) at 22-24.

[28]This remains true in spite of the increasing trend towards co-ownership in response to the astronomical start-up costs associated with the acquisition of race horses and breeding stock. In "Solo Owners Becoming a Dying Breed" *The [Toronto] Globe and Mail* (21 July 1984) 52, journalist Jennifer Hunter observes that prices have "made single ownership of thoroughbreds prohibitive for many who at one time could have afforded it". Hunter's comments are certainly true of the top-priced animals, but she ignores the fact that the great majority of race horses can be acquired for less than $25,000 and that $13.1-million yearlings, though they make for good headlines, are exceptions to that rule.

[29]*ORC Report*, *supra*, note 10 at 102-3.

[30]D.C. Ross, "Methods of Carrying on Business" in Law Society of Upper Canada, *Corporate and Commercial Law 1983-1984* (Toronto: Law Society of Upper Canada, 1984) 1 at 1.

all the business's debt.[31] The relatively simple legal structure of a sole proprietorship may in fact disguise a large and complex business involving many people which can "plainly be an 'organization' in the nonlegal sense of the term".[32] A sole proprietorship is not a single entity but is rather a catch-phrase for a "series of bargains" made with one individual. The commercial complexities of some equine sole proprietorships have legal consequences which affect control, risk, return and duration and may, in certain circumstances, call into question the appropriateness of the business form itself.

A. Control

Lawyers who focus on the sole proprietor's right of ownership often argue that this right gives the proprietor complete control over the venture and consequently must be regarded as one of the great advantages of this business form.[33] The element of control is, of course, relevant to the choice of sole proprietorship as an equine business form. However, it is simplistic and even incorrect to view the sole proprietor's "absolute" ownership of the business as giving him absolute control of the venture. The firm is more than the sole proprietor's right of ownership in its assets. It is, as economist Eugene Fama suggests, a "set of contracts among factors of production".[34]

Though the sole proprietor may own his horse, his stable and his farm, closer examination reveals a complex set of relationships between the owner and his trainer, his jockey, his farm-hands, his lawyer and perhaps his bank or other lenders.[35] All of these non-equity inputs are relevant to the allocation of the right to control within the business.[36] Where the sole proprietor

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[31]R.L. Simmonds & P.P. Mercer, *An Introduction to Business Associations in Canada* (Toronto: Carswell, 1984) at 43.

[32]Klein, *supra*, note 2 at 1. Simmonds & Mercer, *ibid.* at 43-44, point out that such complexities might include a sole proprietor's reliance on outside sources of finance and on the services of others. Both of these inputs are essential to the sole owner in the horse business who finds that his right to complete control is restricted by other participants.

[33]C. Rohrlich, *Organizing Corporate and Other Business Enterprises*, 4th ed. (New York: Bender, 1967) at 33. Kropp, Flanagan & Kahle's expression, *supra*, note 3 at 941-42, of the notional link between ownership and control for the equine sole proprietorship is typical:

> The most important advantage available to a sole proprietor is absolute control of business income, assets and management decisions. This is especially important in the horse industry. Many horse industry people have experienced the cumbersome nature of decision-making in joint ownership arrangements.

[34]E.F. Fama, "Agency Problems and the Theory of the Firm" in Posner & Scott, *supra*, note 5, 56 at 56.

[35]Horseman Terence Collier, "Acquiring a Horse" in *Thoroughbred Ownership*, *supra*, note 4, 16 at 19, contends that proper advisors and staff are the key to the success of an equine sole proprietorship.

[36]See Klein, *supra*, note 2 at 41, who notes that "the nonowner contributors to the economic venture may to various degrees share in ownership attributes ... such as ... control".

depends on outside sources of capital and labour, his "[u]nrestricted control of the business may be eroded as a result".[37] By touting absolute control as a positive law characteristic of sole proprietorship, equine lawyers do their clients a disservice.

Where the sole proprietor seeks capital from an outside source, he may only be able to obtain it on terms that encroach on his "absolute" power of control. Though lenders have traditionally been suspicious of advancing funds for the purposes of racing, banks and financial institutions have recently shown more confidence in the industry and, quite often, a horseman will obtain a loan by granting a security interest in his horse or stable.[38] The terms of the loan might easily frustrate the debtor's control over the destiny of his business. Interestingly, where the power granted to the creditor is broad enough to affect the very nature of the firm, the creditor may be held to be a partner in the equine business venture.[39]

There are many owner-trainers and some owner-jockeys, where permitted by the local rules of racing, but few horsemen can fulfil all these roles at once. Outside labour is a necessity in the horse business and horse owners rely on employees to perform a wide variety of tasks.[40] Generally trainers and jockeys work for a *per diem* amount plus a fixed percentage of the horse's winnings, while "hot-walkers" and other stable staff are paid a straight salary.[41]

Given the notional link between ownership and control, lawyers traditionally do not consider employees as sharing any of the "ultimate" power of control within the firm. Though much of the day-to-day decision-making

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[37]Simmonds & Mercer, *supra*, note 31 at 44.

[38]See, generally, R.D. Lester, "Security Interests in Thoroughbred and Standardbred Horses: A Transactional Approach" (1982) 70 Ky L.J. 1065. In Ontario, a horse would qualify as a "good" eligible as collateral under the *Personal Property Security Act*, R.S.O. 1980, c. 375, s. 1(k) as would (perhaps surprisingly) the young of horses after conception: s. 13(1). Interestingly, some U.S. banks, including New Jersey's Midlantic National Bank, advertise their willingness to accept horses as collateral for loans: *The Blood-Horse* (7 September 1985) at 6131.

[39]See, *e.g.*, *Ex parte Delhasse: Re Megevand* (1878), 7 Ch. D. 511, 38 L.T.R. 106 (Eng. C.A.) and *Martin* v. *Peyton*, 158 N.E. 77 (N.Y.C.A. 1927). In the latter case, where creditors demanded a share of the firm's profits and certain powers of control, they were held to be partners of the debtor. F.H. Buckley & M.Q. Connelly, *Corporations: Cases, Texts and Materials* (Toronto: Emond-Montgomery, 1984) at 24-25, suggest that this reasoning may apply in Canada.

[40]Some of these employees are, at law, "independent contractors". As to the distinction, see F.M.B. Reynolds & B.J. Davenport, *Bowstead on Agency*, 14th ed. (London: Sweet & Maxwell, 1976) at 12-13.

[41]Lohman & Kirkpatrick, *supra*, note 27 at 136. The particulars of any of these arrangements depend on the custom at the track and the generosity of owners and trainers.

may be delegated to employees, the legal relationship of principal and agent is said to assure the sole proprietor of his controlling interest.[42]

Generally it is thought that a trainer, for example, is subject to the control of the horse owner as a result of the agency relationship. Anyone familiar with the workings of the industry, however, would point to the indisputable control and interest in control that these "agents" have over their principal's venture. The trainer usually decides which race a horse will enter.[43] At the track, decisions that a jockey makes on behalf of the owner have a most immediate effect on the outcome of the venture. The interests of the jockey and trainer in controlling the business are reinforced by their ten per cent participation in the proceeds. As Klein suggests, it is naive to look to the law of agency and its rules giving authority to the principal as an explanation of control within the firm.[44] Jockeys and trainers are managers. As such they have an interest in the control of the enterprise. Even in a sole proprietorship, employees can be viewed as contributors to a "joint economic enterprise" with, in certain circumstances, interests that resemble those of co-owners.[45] The sole proprietor who views the fiduciary relationship as inadequate may negotiate with the manager to ensure his proper behaviour.[46] Ownership alone, however, is a poor indication of control within sole proprietorship.

B. Return

Return, and the cost at which it is secured, are essential aspects of the bargain represented by a sole proprietorship. Ross points out that "[a]ll benefits flowing from the business accrue to the exclusive enjoyment of the sole proprietor."[47] For income tax purposes, the business income or loss

[42]"Agency" was defined by the American Law Institute as "the fiduciary relation which results from the manifestation of consent by one person to another that the other shall act on his behalf and subject to his control, and consent by the other so to act": *Restatement (Second) of Agency*, (St Paul, Minn.: American Law Institute, 1958) § 1.

[43]Indeed it is a well-known trainers' maxim that for success at the track, owners should be treated like mushrooms — kept in the dark and up to their necks in manure: Lohman & Kirkpatrick, *supra*, note 27 at 35.

[44]Klein, *supra*, note 6 at 1542.

[45]Klein, *supra*, note 2 at 12. In "Conflicts of Interest: Efficiency, Fairness and Corporate Structure" (1978) 25 U.C.L.A. L. Rev. 738, A.G. Anderson states that for control purposes, a distinction should be drawn between upper-level managers and low-level employees less interested in actively participating in firm decision-making. (Contrast a trainer, *e.g.*, with a stable-hand.)

[46]Anderson, *ibid.* at 771. An example of this would be giving a trainer a share of the winnings to ensure that his interest coincides with those of the owners. Anderson suggests that the sole proprietor's only other alternative is to monitor the activities of the manager, which might be expensive or impractical.

[47]Ross, *supra*, note 30 at 1.

will be included with the individual proprietor's income or losses from other sources.[48] An individual's marginal tax rate and his income or losses from other sources should be important considerations in the decision to use this business form.

The sole proprietor can, of course, engage in "bargaining" with outsiders to alter the nature of his stake in return. He necessarily does so when he agrees to give ten per cent of his racehorse's winnings to his trainer. As an alternative to finding a partner or selling part of his business, a sole owner might lease part of his stable to give himself a more even return and lessen his risk.[49] Contracting which affects risk and return is an integral part of the complicated joint venture poorly designated as sole proprietorship.

Not all returns in the horse business are necessarily pecuniary. The prestige attached to owning a successful racehorse is a form of return that an owner might not want to share with partners or shareholders. Many horsemen value the opportunity to enter the winner's circle and might feel that this aspect of return is important in deciding whether to go into business alone or jointly with others.

C. Risk

The flip-side of the owner's residual right of return in sole proprietorship is his personal assumption of the risks involved in the venture. Ownership of the business implies personal responsibility for its obligations. Thus, in satisfying their claims, the business's creditors (secured or unsecured) are not restricted to the assets of the business. They can seek execution of judgment for their claims against the personal assets of the owner. As a rule, lawyers consider the risk associated with unlimited liability to be a key factor in deciding on the appropriateness of sole proprietorship for any given venture.[50] This is especially true in the high-risk thoroughbred industry.

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[48]*Income Tax Act*, *supra*, note 21, para. 3(a). See *Ward's Tax Law and Planning*, vol. 1, *supra*, note 22 at para. 12.4, where the authors note that the one exception in this regard is the restriction on farm losses at s. 31. Where the horseman's chief source of income is not farming, it might be in his interest to operate the business in another form to avoid the s. 31 restriction.

[49]A breeder may lease the breeding qualities of a mare for a set rent rather than bear the risk of breeding himself. Recently, thoroughbred leasing has been arranged by companies such as Thoroughbred Equity Co. for a variety of purposes, among them financing: C.E. Harris II, "TECO: Constructing an Infrastructure for Leasing" *The Horsemen's Journal* (July 1981) 116 at 117.

[50]Cameron, *supra*, note 1 at 1-2, advises that "[i]f a substantial uninsurable risk is possible, a limited partnership or corporation is preferable to limit the proprietor's liability to the amount of capital he has invested and isolate his personal assets from execution to satisfy liabilities of the business."

It is simplistic, however, to regard unlimited liability as the final word on risk in sole proprietorship. Incorporation alone does not necessarily reduce the risks involved in the business, since sole shareholders are often asked to give personal guarantees for company loans.[51] Furthermore, it is customary for a horse owner to achieve effective limited liability by purchasing insurance.[52]

Moreover, where equine managers have a quasi-proprietary right in the sole proprietorship, risk is shared by them as well. The stallion manager of the farm at which the sole proprietor's horse may stand at stud, for example, is paid a fixed rate and also benefits from breeding rights for his services. Compensating him in this manner gives the manager a greater interest than that of a mere employee. Klein explains this phenomenon:

> The presence of an element of *incentive compensation* like a bonus based on profits shifts some of the *risk* of the business to [the manager]; that is an attribute of any residual, as opposed to fixed, claim. It makes [the manager's] own objectives and interests more similar to those of [the owner].[53]

Though lawyers tend to evaluate a participant's stake in a business venture according to the nature of his contribution,[54] a functional analysis demonstrates that risk of loss within the business organization turns on the nature of the claims of the various participants.[55] The highest order risk claim is that of the sole owner, and the lowest is that of secured creditors. Employees earning a fixed salary, since salary is not a secured claim, have a stake in the success of the business. The hot-walker and groom working for a small stable share in the risk of the stable's success in that their salaries depend in part on this return. There is a greater risk attached to the claims of trainers or jockeys whose return is fixed as a percentage of the income of the business, and whose reputation in the industry may be riding on the venture's success.

Finally, the risk involved in assuming the staggering costs of acquiring and maintaining a thoroughbred are of course important in deciding how an investor should embark on a venture. While start-up costs vary according to the quality of the horse acquired, fixed costs for training and maintaining

[51] Klein, *supra*, note 2 at 123. A sole proprietor may, however, achieve a *de facto* limited liability by negotiating non-recourse loans with his creditors.

[52] Equine insurance policies may cover horse mortality, fertility and protect an owner from liability for damage caused by a horse. Dozens of insurance companies have entered the industry in recent years: see D.L. Heckerman, "Mortality, Brokers, Agents, Underwriters, Premiums" *The Blood-Horse* (17 April 1982) 2686.

[53] Klein, *supra*, note 2 at 44-45.

[54] The proprietor is conventionally seen to bear the full risk of loss as a result of his 100 per cent ownership. The stake of highly-placed managers is thus ignored.

[55] Klein, *supra*, note 6 at 1534.

racehorses tend to be uniformly expensive.[56] These costs might serve as a barrier to entry to the prospective sole proprietor.

D. *Duration*

Not only are the legal and business rules concerning duration of the venture critical to understanding the nature of the bargain but these rules are also important in deciding the appropriateness of the form itself to the objectives of the participants. In spite of its importance, this element of the bargain is often ignored by both scholars and participants.[57]

The duration of a sole proprietorship is limited only by the sole owner's desire or ability to do business.[58] This may pose a problem in ventures that take time to mature, but the active racing and breeding life of a horse limits to some extent the durational problem.[59] Nonetheless, the untimely death of a sole proprietor can spell disaster for the venture unless careful estate planning has been done.[60]

E. *Constraints*

Klein observes that certain constraints, including government regulation and conflicting interests and goals among participants, provide the background against which business people choose the form for their joint venture.[61] The equine sole proprietorship operates subject to these constraints. Though government regulation can often pose stifling transaction

[56]Maintenance costs depend on whether a horse is kept for racing or breeding. Lohman & Kirkpatrick, *supra*, note 27 at 131ff. set out in detail the costs involved in either venture. Training alone, *e.g.*, can run as high as $25,000 per horse per year.

[57]Klein, *supra*, note 6 at 1546. Some commentators signal the desirability of perpetual existence as a factor speaking in favour of the corporate form over the sole proprietorship. See *infra*, note 252 and accompanying text.

[58]Simmonds & Mercer, *supra*, note 31 at 45, observe that termination of sole proprietorship occurs where the owner "stops doing business, either voluntarily or because of death or incapacity".

[59]Generally, a racehorse is in its prime at 3 or 4 years old, though it is not rare to find racehorses still at the track at 7 or 8 such as gelding John Henry, retired at age 10 in 1985, with record career earnings of over U.S.$6.5 million. Some stallions are still active at stud into their twenties, such as Raise A Native and Northern Dancer, both foaled in 1961 and still standing as stallions in the United States.

[60]But not too careful. In *Blake Construction Co.* v. *United States*, 572 F.2d 820 at 820 (Ct Cl. 1978), a dying sole proprietor of a stable of horses sold his business to a corporation controlled by his sons, "to make his mind easy as to the welfare of horses and as a means of utilizing tax losses"[headnote]. The Court of Claims found that the purchaser corporation and its shareholders knew nothing of the horse business and consequently could not be said to have acquired the sole proprietor's business with a reasonable expectation of profit for tax purposes, and the deduction of losses was disallowed.

[61]*Supra*, note 6 at 1553.

costs for the formation of a business, at common law there are no formalities for the creation of a sole proprietorship.[62]

The industry has rules imposing certain costs on doing business. The Ontario Racing Commission requires that "every person who practises his or her profession, trade or calling, on a race track" hold a licence from the Commissioner in order to engage in racing.[63] There are other industry-imposed costs, including the obligation to register both the pedigree of a horse with the Jockey Club (New York)[64] and the owner's colours or silks.[65] These minor regulatory constraints imposed on the horse owner can hardly be viewed as a deterrent to doing business as a sole proprietor.

A conflict of interest among the participants in the equine sole proprietorship may be a more serious constraint. Where the proprietor seeks to improve on the profitability of his venture by securing outside sources of capital and labour, conflicts of interest will arise where these "outside" participants have different goals than those of the sole proprietor.[66] Given the absence of a formal structure, sole proprietorship is particularly vulnerable to conflicts arising among participants "as a result of differences in objectives and in perception on which strategies will maximize returns".[67] As we have seen, the sole proprietor's legal right of ownership is not sufficient to give him control of the enterprise. Other participants with a stake in the business might steer the venture the wrong way. A trainer, for example, might enter a sole proprietor's horse in an inappropriate race to coincide with his interests in other horses. The safeguard that the law provides against this sort of activity — the fiduciary duty arising out of the agency relationship — is illusory where the owner-principal is not in an informational

[62]Simmonds & Mercer, *supra*, note 31 at 45. In Ontario, a horse owner carrying on business under a style or name other than his own must file a declaration with the Registrar of Partnerships at the Ministry of Consumer and Corporate Relations. The *Partnerships Registration Act*, R.S.O. 1980, c. 371, s. 9, requires registration of a person engaged in "trading", which would include both breeding and racing. It is common for a sole proprietor to use the name of a stable as his business style. The registration costs are a relatively insignificant obligation in comparison to those associated with starting up other forms of business organization.

[63]Ontario Racing Commission, Rules of Thoroughbred Racing, Rule 4.01.1 [made under authority of *Racing Commission Act*, R.S.O. 1980, c. 429, s. 11; hereinafter the Ontario Rules]. The costs associated with licensing are negligible. A new owner, *e.g.*, had to pay $25 for a 1985 licence.

[64]*Ibid.*, Rule 6.01.

[65]*Ibid.*, Rule 5.01.

[66]Anderson, *supra*, note 45 at 762-63.

[67]Klein, *supra*, note 6 at 1555.

position to monitor properly the behaviour of his trainer agent.[68] This is a recognized problem in the horse industry.[69] The "agency costs" of monitoring a trainer's activities are, necessarily, at the expense of the owner's other activities within the firm. An obvious answer to the problem is to choose a business form in which the agent's interests coincide exactly with those of the principal. This may make the trainer-owner partnership an attractive alternative to the sole proprietorship but partnership suffers from its own series of conflicts of interest.[70]

IV. Partnership

In law, partnership is the "relation that subsists between persons carrying on a business in common with a view to profit."[71] Lawyers have spilled a great deal of ink analyzing the "three essential elements" of a partnership: a business, two or more persons carrying on the business in common and a profit motive on the part of those persons.[72] Yet the legal literature has, for the most part, ignored the functional elements of this business form which are the key to understanding its appropriateness to the equine business venture.

The basic economic motivation to organize as a partnership rather than as a sole proprietorship is, as Klein observes, excessively obvious: "we observe joint ownership when the efficient scale of an enterprise is large enough to require resources beyond those available to any single individual who might otherwise be able and willing to engage in it".[73] The need to pool

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[68]Economists Jensen & Meckling, *supra*, note 5 at 39 explain:

> The principal can limit divergences from his interest by establishing appropriate incentives for the agent and by incurring monitoring costs designed to limit the aberrant activities of the agent. ... However, it is generally impossible for the principal... at zero cost to ensure that the agent will make optimal decisions from the principal's viewpoint. [emphasis deleted]

[69]See, *e.g.*, I.J. Weiner, "Legally Speaking: An Agent's Duty to His Principal" *The Florida Horse* (October 1980) 86, where the author describes a situation in which a bloodstock agent undertook to purchase a specific horse for his principal, then bought it for himself in breach of his fiduciary duty. The author notes that "[w]hile there are, indeed, many protections afforded the principal under the law, enforcement can be expensive and time consuming." See also *Keck* v. *Wacker*, 413 F.Supp. 1377 at 1383 (Dist. Ct Ky 1976) where a vendor was held liable for the misrepresentation of his bloodstock agent who had described a horse as being "barren" rather than as having miscarried her foal. The principal was held liable for the act of his agent even though he did not know of the misrepresentation.

[70]See *infra*, note 102 and accompanying text.

[71]*Partnerships Act*, R.S.O. 1980, c. 370, s. 2 [hereinafter *OPA*]. The definition, taken from the English *Partnership Act 1890* (U.K.), 53 & 54 Vict., c. 39, is found in most common law jurisdictions.

[72]See, *e.g.*, E.H. Scamell & R.C. I'anson Banks, *Lindley on the Law of Partnerships*, 15th ed. (London: Sweet & Maxwell, 1984) c. 2.

[73]Klein, *supra*, note 2 at 43.

resources might be satisfied by a relationship between participants which amounts to "carrying on a business in common with a view to profit". Conversely, a sole proprietor might seek debt rather than equity capital from others such that the venture falls outside the traditional legal pigeonhole of partnership.[74] Is it right to draw such a distinction? Surely in certain circumstances there is no functional difference between the stake that a heavy lender and a co-owner have in a venture.[75] Indeed, courts have struggled with the question of whether or not a partnership exists using legal rules as a bench-mark rather than invoking more useful economic criteria.[76]

The parties themselves may not be of any help in ascertaining whether or not a partnership exists. They often vary the rules of the game by express agreement and, in this connection, three problems can arise. First, the parties may agree to a *de facto* partnership and call it something else in order to avoid undesirable legal incidents of the business form. This generally meets with little success.[77] Second, the participants may misstate their intended manner of organizing the venture. Klein notes, with tongue firmly in cheek, that this is often a problem when the lawyer consulted relies more on a "boilerplate" than on any real understanding of the business which the

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[74]See *OPA, supra*, note 71, s. 3 which enumerates certain factors to be considered in determining whether or not a partnership exists at law.

[75]See Klein, *supra*, note 2 at 47 and 49 where the author suggests that circumstances may exist where there is no functional difference between an equity contribution and a loan or contributions in services. See also *Ex parte Delhasse: Re Megevand* and *Martin* v. *Peyton, supra*, note 39.

[76]See, *e.g.*, *Cox* v. *Hickman* (1860), 11 E.R. 431, 3 L.T.R. 185 (H.L.) [hereinafter cited to E.R.] in which two creditors were appointed as trustees for a debtor to manage the business on behalf of all the creditors. Profits were to go first to repaying the creditors with the residue to be paid to the debtor. Lord Cranworth, *supra* at 446, decided that the creditors were not partners with the debtor: "The debtor is still the person solely interested in the profits, save only that he has mortgaged them to his creditors." A more fruitful analysis might have turned on the functional aspects of the venture. Here the creditors bore the risk, enjoyed the returns and exercised control over the venture. Should the fact that they were not technically owners be relevant to their liability as joint venturers?

Courts are not all so oblivious to underlying economic relationships between participants. In *Graham* v. *Central Mortgage & Housing Corp.* (1973), 13 N.S.R. (2d) 183, 43 D.L.R. (3d) 486, the Nova Scotia Supreme Court (Trial Division) held that an arrangement between a finance company and a builder, whereby unfinished homes were sold to individuals with mortgage financing from the company, gave rise to the liability of the finance company for the builders' defects in workmanship. The Court held that the parties' mutual management and control of the venture meant that they were partners, and that the narrow issue of the sharing of profits was not determinative. (Note that Jones J. employed the term "joint venture" rather than partnership.)

[77]See, *e.g.*, *Adam* v. *Newbigging* (1888), 13 App. Cas. 308 at 315 (H.L.) where Lord Halsbury L.C. stated that "no concealment of name ... will prevent the substance and reality of the transaction being adjudged to be a partnership".

participants want to set up.[78] Finally, the participants might not write anything down. An oral agreement, though difficult to prove, can result in an enforceable partnership in Ontario,[79] and where the participants have not provided their own rules, the *Partnerships Act* will imply the terms of the partnership. This "informality" problem is particularly keen in the horse business where industry custom puts great faith in the value of a handshake in the paddock. General partnerships have a longstanding history in the industry[80] and remain a very common equine business form, especially for lesser quality racehorses. Their functional elements may be examined in light of the positive law of partnership.

A. Control

Many of the economic factors affecting sole proprietorships are relevant to partnerships as well. Just as with sole proprietorships, lawyers focus too narrowly on ownership as the hallmark of control in partnerships.

Section 24 of the Ontario *Partnerships Act* sets out the rules for the interests of partners in the partnership property and their rights and duties in relation to the partnership, subject to any agreement between them. Subsection 24(5) gives each partner the right to take part in the management of the business, while subsection 24(8) sets down a majority rule with one partner, one vote, for "ordinary matters connected with the partnership business". This has generally been seen as the beginning and end of the question of control.[81]

It is not at all clear, however, that the legal right to equal control represents the reality of the division of power within the partnership. In fact, the right to equal control at law serves only as a point of departure from which joint venturers allocate responsibility among themselves on the basis of what they each do best. This may happen in a tailor-made partnership or, more informally, during the everyday operation of the business. The

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[78]Klein, *supra*, note 2 at 58: "Some lawyers, believe it or not, are lazy or incompetent, or both . . . . [They] are quite capable of pulling a form partnership agreement out of the drawer, filling in a few blanks, having it typed, and passing it on to the clients for signature as if it were the product of some serious effort to cope with their special problems."

[79]*Robert Porter & Sons* v. *Armstrong* (1926), [1926] S.C.R. 328, (*sub nom. Porter & Sons* v. *Foster & Armstrong*) [1926] 2 D.L.R. 340 [hereinafter *Porter* cited to S.C.R.].

[80]See, *e.g.*, the former Newmarket Rules of Racing in E. Weatherby, C.T. Weatherby & J.H. Weatherby, eds, *The Racing Calendar for the Year 1898* (London, 1898) at xxxvii, which required, at Rule 94, that partnerships be registered and placed onerous restrictions on the transfer and termination of partnership arrangements.

[81]See, *e.g.*, *Lindley on the Law of Partnerships*, *supra*, note 72, c. 15, in which discussion of the right to take part in the management of the firm occupies only five of the some 1200 pages of the book.

well-known partnership agreed to in a trainer's paddock regarding the ownership of the champion thoroughbred Phar Lap is a case in point. A wealthy owner purchased Phar Lap as a yearling and lost faith in the horse before it saw the track. His trainer convinced the owner not to sell Phar Lap, and the two men struck a partnership deal whereby the trainer would contribute his time freely in exchange for a half interest in the purses won by the horse.[82]

In law, the partners had equal power to manage the venture. In fact, however, it was the trainer who decided where and when Phar Lap would race. Functionally, the partnership was organized around the talents of its participants. Klein explains that control should properly be thought of as a product of specialization:

> Specialization affects not only the operation of the modern business venture, but also (though less frequently recognized) its organization or formation. Individuals with different contributions and different tastes for returns on their contributions are able to combine their resources and establish mutually satisfactory claims.[83]

Thus the choice to organize the Phar Lap venture as a partnership had little to do with the legal right of each of the participants to control the business, but rather turned on their "functional" right to control. Partnership was attractive because it allowed for this "bargain" between the participants.

The importance of specialization in the industry and the need to agree on outside contributions of capital and labour suggest that the right to control should be allocated among the participants by way of a private partnership agreement, altering the statutory regime.[84] The participants might trade off certain control aspects of the venture against other elements of the bargain, such as a lesser responsibility for risk of loss.[85] Equine lawyer John Kropp contends that all partners, irrespective of their expertise, should participate in a decision to sell horses owned by the partnership, or to enter a

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[82]Phar Lap was purchased in New Zealand for 160 guineas. The gelding won virtually every major race in Australia, making both trainer-owner and investor-owner very rich, before dying under mysterious circumstances at the peak of its career: Herbert, *supra*, note 8 at 36.

[83]Klein, *supra*, note 6 at 1544-45. Kropp, Flanagan & Kahle, *supra*, note 3 at 949-50 recognize the importance of specialization to the efficiently-run equine partnership.

[84]Some authors have argued that partnership law is essentially contractual. Whether by private agreement or within the context of the "contractualist" statutory regimes, participants "agree" to carry on business together according to certain rules: see, *e.g.*, T. Hadden, R.E. Forbes & R.L. Simmonds, *Canadian Business Organizations Law* (Toronto: Butterworths, 1984) at 94-95. This view fits nicely with economists' view of a business organization as a series of bargains. An alternative approach is that the private partnership agreement constitutes a form of business organization unto itself, distinct from statutory partnerships.

[85]See Klein, *supra*, note 6 at 1559-63 where the author describes a process of "negotiation" over elements of risk, control and duration.

horse in a claiming race (which could result in its sale).[86] Indeed, this is generally the position taken by the administrative bodies charged with overseeing racing.[87]

B. Return

In law, partnership, like sole proprietorship, is said not to be an entity separate from its members,[88] and consequently all partners are entitled to share equally in the capital and profits of the business unless they agree otherwise in the partnership agreement.[89]

Critical to understanding the significance of "return" is the income tax treatment of partnership income. Arthur Scace and Douglas Ewens explain that for tax purposes, the computation of partnership income is made at the partnership level, and "[t]his resulting income is then attributed to the partners according to their respective interests in such income."[90] Needless to say, partners' differing marginal tax rates give them different stakes in return. The tax consequences of a prospective equine partnership may make or break the "bargain". Indeed, proof positive of the importance of tax consequences to equine business ventures is the quantity of legal literature the issue has generated.[91]

As with sole proprietorships, participants in the venture who are not owners in the legal sense may share in the returns of the partnership: a

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[86]Kropp, Flanagan & Kahle, *supra*, note 3 at 952.

[87]See, *e.g.*, the Ontario Rules, *supra*, note 63. Rule 32.06 reads in part, "[t]he part owner of any horse shall not sell or assign his or her share or any part of it without the written consent of the other partners and such consent shall be filed with the [Ontario Racing] Commission."

[88]Is the better view that a partnership is a separate entity or is it merely an aggregate of its members? Simmonds & Mercer, *supra*, note 31 at 48-49 and Klein, *supra*, note 2 at 58-60 note the doctrinal debate. Though generally lawyers contend that a partnership has no legal personality, its members can be sued in the name of the firm (see, *e.g.*, Ontario, *Rules of Civil Procedure*, O. Reg. 560/84 as am., Rule 8.01). Economists Jensen & Meckling, *supra*, note 5 at 41 adopt the aggregate approach: "*The firm is not an individual.* It is a legal fiction which serves as a focus for a complex process in which conflicting objectives of individuals are brought into equilibrium within a framework of contractual relations."

[89]*OPA*, *supra*, note 71, s. 24(1).

[90]*The Income Tax Law of Canada*, 5th ed. (Toronto: Carswell, 1983) at 329. Under para. 12(1)(l) of the *Income Tax Act*, *supra*, note 21, a taxpayer must include partnership income in income from business and property. The rules for the calculation of partnership income are contained at ss 93-103. These rules are immensely complex, but for our purposes it is important to note paras 96(1)(f) and 96(1)(g) which attribute the income and losses of the partnership to the partners to the extent of each partner's share in the income of the venture.

[91]See, *e.g.*, T.A. Davis, ed., *The Horse Owners and Breeders Tax Manual* (Washington: American Horse Council, 1983) which runs over 800 pages and is addressed exclusively to matters pertaining to American tax law. Other U.S. sources include C. Trower, T.A. Davis & A.J. Geske, "Taxation of Equine Partnerships: Selected Problems" (1982) 70 Ky L.J. 1021.

jockey, for example, through his percentage of the winning purse, and a lender through his (albeit fixed) return on money loaned to the partnership. To suggest that only the owners of a partnership have a stake in its success is a narrow and perhaps naive view of this form of business organization. The appropriateness of the partnership as the chosen form for the venture turns in part on the interests outsiders have in return.

C. *Risk*

The risks associated with general partnership are two-fold and simply stated. Together they may amount to the most serious deterrent to the formation of a general partnership for an equine venture.

First, every partner in a firm is liable jointly with the other partners for all debts and obligations of the firm incurred while he is a partner.[92] Second, partners are jointly and severally liable for wrongful acts or omissions of a partner acting in the ordinary course of business and for the misapplication of a third party's money or property.[93] The legal rules governing the ambit of this responsibility are complicated,[94] but essentially a prospective partner must understand that "if partnership assets have been exhausted and if a partner has personal assets, sooner or later the creditors are likely to get at them".[95] This, of course, applies to equine partnerships, as confirmed in the Ontario Rules of Thoroughbred Racing.[96]

The role of liability is made more onerous by the agency relationship so fundamental to the law of partnership. Briefly stated, for the purpose of the business of the partnership, every partner is an agent of both the firm and his other partners. The acts of every partner in what is or what appears to be the ordinary course of business bind the partnership.[97]

Lawyers have wrestled with the niceties of agency law extensively, but from a functional point of view, it is important to view these rules in the context of the risk element in the bargain between the parties. As I.J. Weiner observed in a recent article in *The Florida Horse*, when horsemen enter into a partnership for the purpose of breeding or racing horses, too often they do so without a clear understanding of the risk involved.[98] The risks inherent

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[92]*OPA*, *supra*, note 71, s. 10.

[93]*OPA*, *ibid.*, ss 11-13.

[94]See, *e.g.*, *Lindley on the Law of Partnerships*, *supra*, note 72, c. 13.

[95]Klein, *supra*, note 2 at 84-85.

[96]*Supra*, note 63. Rule 32.08 states that for general partnerships, "[a]ll parties to a partnership and each of them shall be jointly and severally liable for all stakes, and other obligations."

[97]*OPA*, *supra*, note 71, s. 6. The partners may agree otherwise, but third parties must have notice of the agreement before it can be effective (s. 9).

[98]"Legally Speaking: Partnerships — Some Drawbacks" *The Florida Horse* (November 1982) 1166 at 1166.

in general partnership may make other forms, such as limited partnership, the corporation or arguably even secured debt, more attractive to the risk-averse investor.

D. Duration

One of the central problems with the statutory regime of general partnership in Ontario and in other common law jurisdictions concerns the duration of the venture. Horsemen may find that the rules governing dissolution of the partnership bring an untimely end to their business. In the absence of an agreement to the contrary, for example, a partnership is dissolved under the Ontario *Partnerships Act* by the death or insolvency of a partner.[99] By rendering the business vulnerable to losses from premature termination, these rules put an enormous strain on the appropriateness of the statutory regime of partnerships.[100] Imagine the effect of a dissolution of a partnership on the day of the Kentucky Derby because of the accidental death of a partner! Indeed, the rules are particularly inappropriate to an equine venture given the importance of timing to the value of a horse. Great races and well-planned breeding opportunities are impossible to rerun or to rearrange.

The problem of duration can, to a certain extent, be obviated by a well-drafted partnership agreement. The participants can agree among themselves to exclude the statutory grounds for dissolution and to set their own rules for the termination of the venture. In theory, the termination clause should be the result of tough bargaining among participants who are likely to have different interests at stake as to duration. (A risk-averse horseman, if such a creature exists, may want to have the option of getting his investment out of the business on short notice, for example.) One solution is some form of buy-sell provision which would enumerate grounds for withdrawal and prescribe a method for the disposition of a partner's interest (such as a right of first refusal or terms for sale to outsiders).[101] Moreover, given the volatility of prices of racehorses and breeding stock, the participants should agree in advance as to how their shares should be evaluated.

[99] *OPA*, *supra*, note 71, s. 33. Furthermore, s. 32 of the *OPA* outlines three other circumstances in which the partnership will dissolve: if entered into for a fixed term, at the expiration of that term (s. 32(a)); if entered into for a single undertaking, at the termination of that undertaking (s. 32(b)); if entered into for an indefinite time, by a partner giving notice to the other partners of his intention to dissolve the partnership (s. 32(c)).

[100] Klein, *supra*, note 6 at 1551.

[101] See, *e.g.*, Simmonds & Mercer, *supra*, note 31 at 55; and Klein, *supra*, note 2 at 89.

E. Constraints

Like sole proprietorships, equine general partnerships are not subject to wide-ranging government regulation. Since the business of the partnership must be conducted under the firm name, third parties are assured of disclosure of who makes up the partnership through partnership registration requirements.[102] The rules of racing generally contain disclosure requirements as well, essentially to maintain order and honesty at the race track.[103]

The owner-licensing requirement also applies to horses owned in partnership, and in the Ontario Commission's zeal to keep track of all participants in the partnership, it has created an annoying constraint on doing business. Where the partnership is made up of "no more than 4 individual persons ... each individual must own a minimum of 15 per cent of each horse and they all must be licensed as an owner."[104] The rationale for this 15 per cent rule is mysterious. Flat restrictions as to the number of persons entitled to own a horse (as opposed to percentage owned) have traditionally been justified on the grounds that it is the industry's way of excluding undesirables and monitoring those participating in what, to say the least, is a sport that sometimes attracts an undesirable element.[105] This is not the case in Ontario, where the Rules set no upper limit on the number of owners. In cases where more than four individuals own a horse in partnership, the Ontario Rules require that "a major shareholder of the partnership" be designated to represent the entire ownership of, and be responsible for, the horse as the licensed owner. Only this person and three other major shareholders have the right to enter the paddock and winner's circle[106] (a right considered very important in the sport). More surprisingly, the Rules require that "[d]ocumentation, including the conditions and agreements of the partnership" be on file with the Commission,[107] which may be a significant constraint for those who value confidentiality in their investments.

The other important constraint is the possibility of conflicting interests and goals. A.G. Anderson observes that conflict of interest problems in

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[102] See, *e.g., Partnerships Registration Act, supra*, note 62, s. 1.

[103] The preamble to the Ontario Rules, *supra*, note 63, states that the main purpose of "close supervision" is to ensure, *inter alia*, that "every owner ... seeking to enter a horse in competition is a person of good character and of financial responsibility". See, *e.g.*, Rule 32 which requires disclosure of changes in partnership interest.

[104] *Ibid.*, Rule 32.09(a).

[105] E.L. Bowen, "Multiple Ownership: The Rules: License for Concern" *The Blood-Horse* (17 April 1982) 2700 at 2700-1 where the author notes that in New York the maximum number of owners is set at 15. Horsemen circumvent the rule by leasing an otherwise non-qualifying horse to a single licensed owner.

[106] Ontario Rules, *supra*, note 63, Rule 32.09(b). Note, however, that all persons sharing in the partnership must be licensed.

[107] *Ibid.*, Rule 32.09(c).

partnerships have two facets. First, the opportunity to "cheat" is substantial given the authority partners have as agents to bind the partnership. On the other hand, co-ownership with unlimited liability reduces a partner's incentive to cheat, since he bears responsibility for part of the loss owing to his own misconduct.[108] Given that relatively few people are involved in the sport, it is very likely that partners will have investments in horses that are in competition in one way or another. Accordingly, the industry has special rules designed to minimize the temptation to "fix" the outcome of a race.[109] The problem is more serious in the world of breeding where people often own interests in partnerships of different stallions which compete within the less regulated market. This may be one of the reasons that syndicated co-ownership for individual stallions, in which each co-owner enjoys certain rights separately from other co-owners, is preferred to traditional partnership.

V. Limited Partnership

W.C. Campbell, President of Dogwood Farm Inc. of Kentucky and general partner of a large number of closely-held thoroughbred limited partnerships, considers the increasing popularity of limited partnership for the ownership of thoroughbred racing and breeding stock:

> Your liability (or exposure) will be limited, you will have someone else manage the horse and handle the details of ownership and you will be able to acquire better quality prospects through the pooling of resources.
>
> The disadvantage is that you won't have control of the horse and its career. If that's what you want, you had better go another route.[110]

The advent of equine limited partnerships in Canada, particularly public issues, has received significant attention within the business community[111] and provoked a complete overhaul of the Ontario Rules in November 1984

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[108]Anderson, *supra*, note 45 at 772. Note also that the *OPA*, *supra*, note 71, ss 29-31, imposes a legal duty on partners obliging them not to compete with the firm and holding them responsible to the firm for certain private profits resulting from conflict of interest situations.

[109]See Ontario Rules, *supra*, note 63. Rule 6.13.1 states that with certain exceptions, not more than two horses of the same ownership or interest shall be entered into a race. Rule 6.14.1 requires that all horses owned wholly or in part by the same person, or his or her spouse, or trained by the same trainer, be coupled and run as one entry. Thus, a bet on one is also a bet on the others.

[110]"Partnerships" in *Thoroughbred Ownership, supra*, note 4, 21 at 21.

[111]See, *e.g.*, B. Smith, "Racehorse Enthusiasts Welcome Syndication Changes" *The [Toronto] Globe and Mail* (11 March 1985) B14; G. Riehl, "Taxation: Horse Racing May Be A Good Bet" *The [Toronto] Globe and Mail* (6 May 1985) B2. Though these limited partnerships have won the attention of Canadian business writers, they have not been uniformly well-received by investors: A. Robinson, "Horse Partnerships Slow Off the Mark" *The [Toronto] Globe and Mail* (26 August 1985) B1.

to accommodate this new form of equine business venture.[112] Limited partnerships are used not just for racing, but also for breeding ventures as a device for the joint ownership of broodmares.[113]

A. Control

The statutory regime for limited partnership, unlike that governing general partnership, requires two types of participants: general and limited partners.[114] Indeed the purpose of limited partnership legislation is to provide a way for an investor to give up the power to control the venture in exchange for limited liability.[115] The general partner enjoys the same rights and liabilities as he would in a general partnership, subject to the limitations in the statute and to those in any partnership agreement.[116] A limited partner's right to affect the outcome of the venture is closely circumscribed. He has a statutory right to disclosure of information and, importantly, the right to obtain dissolution of the partnership by court order.[117] Furthermore, he may lend money to and transact business with the partnership, though not in such a way as to give him control over the partnership.[118] Finally, the statute permits a limited partner, from time to time, to give advice as to the venture's management, and to act as an agent, employee, or surety of the limited partnership.[119] Horsemen investing as limited partners in such an arrangement do enjoy a degree of control over the enterprise, nevertheless their limited liability status requires them to respect the bounds of their influence on the firm.

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[112]*Supra*, note 63.

[113]Recent Canadian examples filed with the Ontario Securities Commission include: Canadian Thoroughbred Investors, Prospectus (18 January 1985), a $2,500,000 breeding and racing venture [hereinafter the CTI Prospectus]; Doyle 1985 Thoroughbred Breeding Partnership, Preliminary Prospectus (12 March 1985), a $3,000,000 venture principally for breeding [hereinafter the Doyle Prospectus]; Stonebridge Arabian Partnership Prospectus (25 June 1985), a $2,850,000 venture for the breeding of Arabian horses [hereinafter the Stonebridge Prospectus]. There are, of course, many privately-arranged equine limited partnerships.

[114]See, *e.g.*, *Limited Partnerships Act*, R.S.O. 1980, c. 241, s. 2(2) [hereinafter *OLPA*].

[115]R.D. Flannigan, "The Control Test of Investor Liability in Limited Partnerships" (1983) 21 Alta L. Rev. 303. The exchange is spelled out in s. 12(1) of the *OLPA*, *ibid.*:

> A limited partner is not liable as a general partner unless, in addition to exercising his rights and powers as a limited partner, he takes part in the control of the business.

[116]See *OLPA*, *ibid.*, s. 7, which restricts a general partner's authority with respect to, *inter alia*, any act which makes it impossible to carry on the ordinary business of the limited partnership.

[117]*OLPA*, *ibid.*, s. 9.

[118]See, *e.g.*, *OLPA*, *ibid.*, s. 11(1) which precludes limited partners from holding collateral security over limited partnership property.

[119]*OLPA*, *ibid.*, s. 11(2).

Industry examples serve to clarify this limited right of control. On 2 November 1984, a limited partnership agreement was signed between Canadian Thoroughbred Investors Inc., as general partner, and horseman Clifford F. Haughton, as the first limited partner, creating Canadian Thoroughbred Investors, a limited partnership governed by the laws of Ontario. On 15 January 1985, 500 limited partnership units priced at $5,000 each were offered to the public under the terms of a prospectus filed with the Ontario Securities Commission.[120] The limited partnership was organized to carry on the business of owning thoroughbred racehorses for the purpose of earning revenue from breeding and racing. Under the terms of this agreement, the general partner was granted "sole control of the business and the management of the affairs of the Partnership".[121] This authority was to include the full power to "buy and sell and breed racehorses" and to "enter the horses in races".[122] The rights of the limited partners were restricted to disclosure of partnership information, which excluded them from participating in control.[123] This agreement, therefore, preempted even the statutory provision allowing limited partners to "advise" general partners as to management from time to time.[124] This very strict limitation of authority is standard practice in the industry.[125]

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[120]See CTI Prospectus, *supra*, note 113, and "Agreement of Limited Partnership" annexed as Schedule A at 44 [hereinafter CTI Agreement].

[121]CTI Agreement, *ibid.*, art. 10.1(1).

[122]*Ibid.*, art. 10.1(a) and (b).

[123]*Ibid.*, arts 11.3 and 11.4.

[124]Under the CTI Agreement, *ibid.*, a corporation was appointed general partner (its sole shareholder benefiting from the limited liability protection afforded by the corporate veil) and its shareholder, Clifford Haughton, was appointed first limited partner. Under the terms of the agreement, Haughton was also manager of the limited partnership. His claim to limited liability was, to say the least, precarious. This is most likely the reason why the agreement included a provision, at art. 11.6, whereby the general partner agreed to indemnify limited partners if the latter lost their limited liability status.

As Hadden, Forbes & Simmonds, *supra*, note 84 at 108 point out, this manipulation of limited liability is standard practice. The case law, however, is divided as to its effectiveness. See *Delaney* v. *Fidelity Lease Ltd*, 526 S.W.2d 543 (Tex. S.C. 1975) where limited partners lost their protected status because of their control of the firm. In contrast, see *Frigidaire Sales Corp.* v. *Union Properties Inc.*, 562 P.2d 244 (Wash. S.C. 1977).

[125]A limited partnership organized under the laws of Virginia, *e.g.*, was formed by Catoctin Stud, Inc. in December 1983, to acquire, train and race 71 thoroughbred racehorses under the name Catoctin Thoroughbred Partners II. On 24 February 1984, the general partner offered for private sale 115 limited partnership units at $100,000 per unit through a private placement memorandum. Art. 6.2 of this limited partnership agreement stated that "[n]o Limited Partner shall take part in, or interfere in any manner with, the management, control, conduct or operation of the Partnership, or have any right, power or authority to act for or bind the Partnership." Catoctin Thoroughbred Partners II, Private Placement Memorandum (24 February 1984) [unpublished] [hereinafter Catoctin Memorandum].

In keeping with a functional analysis of equine business organizations, the giving up of control by a limited partner may be characterized as a "bargaining chip" traded away in order to obtain limited liability. Note how the business form here resembles a contract rather than a fictional entity. To this point we have assumed that control is a desirable attribute of a business venture. Klein suggests that prospective limited partners "may find lack of control in the group of which they are members to be a virtue".[126] With this in mind, limited partners bargain for the most they can get in respect of the other relevant deal points: return, risk and duration.[127]

The limited partners' preference for a passive role may explain the few cases on loss of limited liability status due to overzealous partner participation. Indeed, R.D. Flannigan notes that no Canadian case has interpreted the words "takes part in the control of the business" in section 12 of the Ontario *Limited Partnerships Act* or its equivalents in the other provinces.[128]

When do limited partners lose this limited liability by "taking part in the control of the business"? The simple non-legal answer is when limited partnership is not the appropriate business form for their desired participation in the venture. If the limited partner oversteps the bounds of control he loses his limited liability protection since in so doing he has "breached" the bargain struck with the general partner and, as is generally true in contract law, his end of the bargain will not be enforced. Needless to say, thinking horsemen will consider the relative importance of control and limited liability before settling on the limited partnership form.

B. Risk

The risky nature of the initial contribution is a key aspect of a limited partner's investment, as every equine prospectus grudgingly discloses.[129] Risk is also intimately connected with the concept of control in limited

[126]Klein, *supra*, note 6 at 1560.

[127]In the case of both the Canadian Thoroughbred Investors Partnership and the Doyle 1985 Thoroughbred Breeding Partnership, the other deal points were clearly not sweet enough. These public offers were withdrawn from the market because of lack of demand for the units: Robinson, *supra*, note 108.

[128]*Supra*, note 115 at 306. In the United States, the same words in the *Uniform Limited Partnership Act* § 7, 6 U.L.A. 561 (1969), have also been the focus of little judicial attention, though learned commentary abounds. See, *e.g.*, A.L. Feld, "The 'Control' Test for Limited Partnerships" (1969) 82 Harv. L. Rev. 1471; and M.K. Pierce, "Limited Partner Control and Liability under the Revised Uniform Liability Partnership Act" (1979) 32 Sw. L.J. 1301.

[129]The "Risk factors" section of these documents are, in spite of their dressed-up language, most revealing. See, *e.g.*, the Doyle Prospectus, *supra*, note 113 at 3 and 14, where potential investors were warned of the speculative nature of the securities and of the difficulties of succeeding in the industry.

partnership. Subject to the conditions imposed by statute or private agreement, a limited partner's risk is restricted to his contribution,[130] whereas a general partner assumes personal responsibility for the obligations of the venture.[131] This personal assumption of risk by the general partner makes the venture workable since it "motivates [him] to make sensible and productive business decisions".[132] Is assuming risk in order to secure control a good bargain for the general partner? Is sacrificing control in order to limit risk a good deal for the limited partner? The trade-off cannot fully explain the attractiveness of limited partnerships, since parties can limit their liability and participate in control under the corporate business form.[133] Indeed even where a limited partner has invested without a view to participating, that option is available to him as a shareholder in a limited company. In short, risk and control do not account for the whole of the bargain struck between limited and general partners. Given the substantial risk involved in racing and breeding horses, other "deal points" must be present to render the limited partnership form attractive.

C. Return

Limited partners, under the Ontario statutory regime, share in the limited partnership assets both for the return of their contributions and for profits in proportion to their respective investments.[134] The Ontario *Limited Partnerships Act* provides for instances in which a limited partner has the right to demand and to receive the return of his contribution.[135] It also sets a system of ranking for the settling of accounts on dissolution which depends on who the participant is (*i.e.* creditor, limited or general partner) and on the nature of his claim.[136]

Understanding the appropriateness of limited partnership turns, in part, on the position bargained for in this pecking order. In a low-risk venture, priority may not be an issue, but given the high-risk nature of the horse business, ranking is critical.[137] Yet because investors are individuals with

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[130] *OLPA, supra,* note 114, s. 8.
[131] *OLPA, ibid.,* s. 7.
[132] Flannigan, *supra,* note 115 at 309.
[133] Klein, *supra,* note 2 at 90.
[134] *OLPA, supra,* note 114, s. 13.
[135] *OLPA, ibid.,* s. 14.
[136] *OLPA, ibid.,* s. 23.
[137] It is suggested, however, that it may be less important for a breeding venture than for a racing venture, given the lower level of risk involved. See R.B. Jones Jr, "Investing in Breeding Stock vs Racing Stock" in *Thoroughbred Ownership, supra,* note 4, 7 at 7-8.

individual tastes for risk and return, we can expect them to weigh each of these factors differently in striking their own bargain.[138]

In most thoroughbred limited partnerships, the statutory rules for the allocation of returns are altered by express agreement. The CTI Agreement, for example, inverted the statutory ranking of the limited and general partners' claims by providing that 20 per cent of the net income be allocated to the general partner and the balance of the net income and any net loss be allocated among the limited partners on a per unit basis.[139] Private agreement as to the allocation of return may reflect the true positions bargained for by the parties. However, when a general partner uses his superior understanding of the horse business to his advantage, the bargain that the business form represents may not involve, to use contractual language, a true meeting of minds.[140]

Furthermore, it is standard practice within the industry that the general partner receive compensation for the management of the partnership's thoroughbred operations. This amount is generally characterized as an expense of the partnership, distributed prior to profits whether or not the partnership meets with success.[141] General partners, in choosing the business form, are provided not just with a vehicle for investment but also with an independent source of employment income.

The tax treatment of limited partnership income and losses, so important to understanding "return" for the venture, is sometimes considered to be the *raison d'être* for equine limited partnerships.[142] In Canada, the tax rules governing limited partnerships are the same as those relevant for general partnerships: income is taxed not in the hands of the partnership but in the hands of the partners.[143] A special problem arises, however, with respect to losses taxed in limited partners' hands. As we have seen, subsection 31(1) of the *Income Tax Act* restricts the deductibility of losses from

[138]In the case of public-issue limited partnerships, this "bargaining" may be restricted to refusing to sign the standard form agreement.

[139]CTI Prospectus, *supra*, note 113 at 24. A modified 80/20 split was proposed in the agreement contained in the Doyle Prospectus, *supra*, note 113 at 7.

[140]In the Catoctin Memorandum, *supra*, note 125, under the heading "Snitability — Who Should Invest", potential investors in limited partnership units were encouraged to seek out independent legal advice presumably to preclude later claims based on notions of inequality of bargaining power.

[141]See, *e.g.*, CTI Prospectus, *supra*, note 113 at 24, which set a fixed $30,000 "management fee" for the general partner. In the Stoncbridge Prospectus, *supra*, note 113 at 8-9, the general partner was entitled to receive an "annual minimum management fee" of $25,000. Conversely, in the Doyle Prospectus, *supra*, note 113 at 7, the general partner was entitled to a yearly management fee of one per cent of the gross proceeds of the offering.

[142]See Trower, Davis & Geske, *supra*, note 91.

[143]*Income Tax Act*, *supra*, note 21, ss 96 and 12(1)(1).

farming businesses carried on by a taxpayer where the taxpayer's "chief source of income for the taxation year is neither farming nor a combination of farming and some other source of income". Only where a passive limited partner can show that raising and maintaining racehorses is his major "preoccupation" will he be entitled to fully deduct the losses of the partnership as farm losses.[144] Otherwise the *Income Tax Act* limits the deductible loss to $5,000.[145] Why then do equine limited partnerships continue to flourish? Arguably the attractiveness of the other deal points make the "bargain" workable. Another possible explanation, however, is that the predilection for this business form has been inappropriately adopted by Canadian lawyers observing the more active American equine market. Tax treatment of limited partnership interests is more favourable in the United States,[146] where tax reasons represent a genuine incentive to organize a venture under this form.

D. Constraints

Constraints on limited partnerships are two-fold. Participants bargaining should be aware of possible conflicts of interest and of the exigencies of government regulation.

The possibility of a conflict of interest between general partners and their passive co-owners is significant. The built-in monitoring function of unlimited liability for all partners is not present; limited partners do not have either the incentive or the ability to monitor closely the general partner's activity. The community of interest between partners may be a disincentive for cheating by the general partner though the differing share in returns may undermine any sense of community. Reliance on the fiduciary duty between partners may only be as good as the parties' ability to monitor adherence to that duty. Limited partners, with their restricted right to participate in the venture, may find their ability to monitor properly held to the few disclosure requirements imposed by statute or agreement. Interestingly, however, Anderson points out that "courts will be stricter in imposing

[144]The meaning of "chief source of income not farming" was explained in *Moldowan* v. *R.* (1977), [1978] 1 S.C.R. 480, [1977] C.T.C. 310 and again recently in *Buchanan Forest Products Ltd* v. *M.N.R.* (1984), [1984] C.T.C. 2281 (Tax Ct).

[145]*Income Tax Act*, *supra*, note 21, subpara. 31(1)(a)(ii). This is a recognized drawback to equine limited partnerships; however the problem is lessened somewhat by the possibility of claiming a capital loss on disposition of a unit where losses have caused a drop in the value of the investment.

[146]In a limited partner's hands, farm losses are more easily deductible, and it is also possible to depreciate an interest in a thoroughbred: see, *e.g.*, Trower, Davis & Geske, *supra*, note 91 at 1023; and Catoctin Memorandum, *supra*, note 125 at 45.

fiduciary obligations on the partner with the greater discretionary ability to cheat".[147]

Furthermore, since the general partner is more likely to be active in other facets of the thoroughbred industry, there is a high probability that he will find himself in a conflict of interest position in the partnership.[148] In the Catoctin limited partnership agreement, for example, the general partner is expressly permitted to "engage or possess an interest ... in other businesses ... [including] racing, breeding and sale of Thoroughbreds ... in competition with the Partnership or otherwise".[149] This potential for conflict should be considered by the prospective participants before deciding on this as the vehicle for their investment.

The other substantial constraint for the "bargain" represented by a limited partnership stems from regulation by government and from within the industry. In Ontario the rules of racing were recently revised, along the model adopted by the Régie des loteries et courses du Québec for standardbred racing,[150] in order to substantially deregulate multiple ownership of racehorses. Rule 32 of the Ontario Rules now specifically accommodates limited partnerships, with special rules regarding the licensing requirements for the venture.[151] By streamlining the regulation of multiple ownership, it is hoped that a wider participation in horse ventures will be possible without threatening the honesty and integrity of racing.[152]

Though government imposes certain basic regulation requirements on the formation of limited partnerships,[153] the major constraint imposed on

[147]Anderson, *supra*, note 45 at 772.

[148]D.L. Heckerman raises this problem in "Opportunities and Warnings in Issues of Stock" *The Blood-Horse* (21 January 1984) 472 at 473ff. He suggests that a significant level of general partner investment is the best way to keep them honest.

[149]Catoctin Memorandum, *supra*, note 125, art. 5.4.

[150]See *Rules Regarding Standardbred Horse Racing*, 1 December 1984, G.O.Q. 1984.II.3535, and *Rules Respecting Certification*, 1 December 1984, G.O.Q. 1984.II.3568 [both *Rules* made pursuant to *An Act Respecting Lotteries, Racing, Publicity Contests and Amusement Machines*, R.S.Q., c. L-6, ss 20, 33, 47 and 56].

[151]See, in particular, Rule 32.13, *supra*, note 63, which provides that the limited partnership itself, the general partner (and, if it is a corporation, its directors and major shareholders) and certain limited partners holding a major interest in the venture must be licensed.

[152]Smith, *supra*, note 111 at B14.

[153]A declaration of limited partnership must be filed with the Ontario Registrar of Partnerships disclosing all of the important information concerning the venture: *OLPA*, *supra*, note 114, s. 3.

this form of venture arises in connection with public offerings of the partnership units.[154] The application of Ontario securities regulation will turn on whether, in the circumstances, the limited partnership unit constitutes a "security", and whether the "distribution" of the units involves a "trade" as these terms are defined in the *OSA*.[155] The chief consequence of securities regulation, as Klein points out, is the enormous cost and delay involved in disclosing the required information.[156] Horsemen are painfully aware of the high transaction costs associated with doing business as a public limited partnership.[157] An alternative is structuring the issue so that it fits one of the statutory exemptions from disclosure requirements. For example, it is common for the issuer to raise funds via an exempted "private placement" limited partnership issue where the aggregate cost of each unit is at least $97,000.[158] Even where an exemption is unavailable, if the benefit of soliciting funds from the public outweighs the costs and delays, a public limited partnership may be the appropriate form of organization in spite of its heavy transaction costs.

Finally, it is important for those contemplating a public issue to remember that expensive disclosure obligations do not come to an end with the issue itself. Generally, securities legislation has "continuous disclosure" requirements for issuers whose securities are held by members of the public.[159] In Ontario, continuous disclosure obligations include timely reports of material changes, annual and interim financial statements, forms of proxy, information circulars, annual reports and, importantly, insider reports for significant participants in the venture.[160]

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[154]The Ontario *Securities Act*, R.S.O. 1980, c. 466 [hereinafter *OSA*], *e.g.*, imposes three main requirements on financing arrangements designed to protect unwary investors: to trade, underwrite or advise on securities one must be registered with the Securities Commission (s. 24(1)); a prospectus must be filed for any distribution of securities (s. 52); and where a first trade, in any securities which have previously been acquired pursuant to an exemption, is made without meeting certain conditions, that trade will be considered a distribution requiring a prospectus (ss 71(4), 71(5) and 71(6)). See S.D.A. Clark, "Impact of the Securities Act on Financing a Corporation" in *Corporate and Commercial Law 1983-1984*, *supra*, note 30, 75 at 75-76.

[155]Defined in the *OSA*, *ibid.*, ss 1(1)(40), 1(1)(11) and 1(1)(42) respectively.

[156]Klein, *supra*, note 6 at 1554. The frustrating (and sometimes ineffective) transaction costs involved in government regulation are canvassed generally in O.E. Williamson, "Transaction-Cost Economics: The Governance of Contractual Relations" (1979) 22 J.L. & Econ. 233.

[157]See, *e.g.*, J.A. Kegley, "Watching for Securities" *The Blood-Horse* (1 September 1984) 6122 at 6122 where the author points out that limited partnership units are generally "investment contracts" and thus are securities subject to regulation.

[158]*OSA*, *supra*, note 154, s. 71(1)(d).

[159]In Ontario these obligations are imposed on "reporting issuers", a term defined in the *OSA*, *ibid.*, s. 1(1)(38).

[160]Part XVII (ss 74-82) of the *OSA*, *ibid.*, sets out the details of continuous disclosure requirements.

VI. Syndication

"Syndication", a term perhaps too loosely employed in the horse business for a lawyer's taste, is used variously to describe joint ventures of very different stripes.[161] Nonetheless, the longest standing form of equine syndication is generally agreed to be a vehicle for the co-ownership of a single thoroughbred horse either already standing at stud as a stallion or finishing its career at the track with bright breeding prospects.[162] The structure of this business enterprise is really quite simple. Typically, a stallion owner divides his interest into a fixed number of equal, undivided, fractional interests or "shares" and sells each share individually to as many as forty different purchasers. A stallion syndication is first and foremost a contract of sale between a single vendor and a group of unconnected purchasers. Mindful, however, that the contract of sale also establishes a business enterprise for the joint exploitation of a single asset, the participants set the terms of reference not only of the instant bargain but also of their business relationship over the longer term.

Generally, there are three parties to a syndication agreement: the owner-vendor of the stallion, the purchaser of the stallion share, and a "syndicate manager".[163] The syndicate manager plays a dual role — first as promoter of the deal,[164] and second as an active participant, since the business of breeding the stallion usually takes place at the syndicate manager's farm. Sometimes, the syndicate manager is himself the vendor of the stallion.

Coming to any sort of sophisticated understanding of the precise nature of this form of business organization is made difficult given that syndication agreements are private contracts agreed to among members of a close community who value confidentiality. Ironically, however, syndication agreements for different horses, different purposes and different jurisdictions bear remarkable similarity.[165] This can in part be attributed to the "boilerplate" syndrome but may also be explained by a lack of lawyer horse-sense. Since not all lawyers understand the peculiarities of the business, they sometimes

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[161]See J.J. Hickey Jr, *Equine Syndications* (Washington: American Horse Council, 1983) at 1, who notes that "syndications" in horse parlance can include joint ownership schemes, partnerships and limited partnerships for racing and breeding.

[162]R.B. Campbell, "Stallion Syndicates as Securities" (1982) 70 Ky L.J. 1031.

[163]See J.J. Hickey Jr, "Legal Characteristics" (Address to American Horse Council Syndication Panel, 9 June 1982).

[164]For Klein, *supra*, note 6 at 1527, the role of the promoter in itself is enough to make an individual a participant in a venture, given the crucial role he plays in the formation of the business organization.

[165]Syndication agreements from a wide range of jurisdictions were obtained by the author from commercial breeders on the understanding that their confidentiality would be respected.

have trouble expressing their clients' particular interests in the contractual language of the syndication agreement.

Enormous sums of money may be involved in the syndication of a single horse. In 1957, Kentucky horseman Leslie Combs II, as syndicate manager, formed the first million dollar stallion syndicate, and since then, many stallions have been syndicated for prices as high as U.S.$40 million.[166] Furthermore, there is a well-established secondary market for the sale of stallion shares, including at least two private equine "stock exchanges",[167] and single shares have been traded for as much as U.S.$3 million.[168] There is also a secondary market for the breeding rights which attach to each syndicate share.

The current legal and industry literature on syndications tends to focus narrowly on the positive law attributes of stallion syndications ignoring, to some extent, the economic context of the true bargain which a syndication agreement represents.

A. Control

Irrespective of the number of shares into which the stallion has been divided,[169] legal ownership vests in the shareholders. At law, the shareholders are tenants-in-common, enjoying undivided rights as co-owners.[170] In this instance, once again, ownership and control do not coincide. Standard practice in syndication is to confer control not on the owners, but on the syndicate manager.

The powers critical to the direction of a breeding venture are generally accorded to the syndicate manager in the agreement. Typically, parties agree

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[166]In 1957, the champion Nashua was retired to stud and syndicated for U.S.$1,251,200: Lohman & Kirkpatrick, *supra*, note 27 at 154. Recent examples include Devil's Bag at U.S.$36 million and El Gran Senor at U.S.$40 million in 1984, and Conquistador Cielo at U.S.$36 million in 1982.

[167]The Matchmaker Thoroughbred Breeders' Exchange opened for trading in July 1984: *The Blood-Horse* (23 June 1984) 4290-91 [advertisement]. The other major exchange is the International Share and Season Information Exchange.

[168]A Seattle Slew share was sold for an estimated U.S.$3 million in 1984: K.S. Herbert & D. Biles, "Stud News: Slew Share Sold" *The Blood-Horse* (9 June 1984) 4035 at 4035.

[169]Generally, stallions are syndicated into 40 shares, but there are exceptions, notably 32-share Northern Dancer, the leading sire of stakes winners in the modern history of the sport.

[170]Since syndication agreements include the expression "equal shares" as words of severance of the stallion interest, shareholders are tenants-in-common and as such enjoy a specific regime of rights in the property including, *e.g.*, the right to leave property at their death to someone other than their co-owners. See E.L.G. Tyler & N.E. Palmer, *Crossley Vaines' Personal Property*, 5th ed. (London: Butterworths, 1973) at 56.Historically, co-ownership of horses has generally been characterized as tenancy-in-common. See, *e.g.*, G.H.H. Oliphant, *The Law of Horses*, 6th ed. by C.E.L. Lloyd (Toronto: Carswell, 1908) at 8n.

that the stallion shall stand (*i.e.* reside) at the syndicate manager's farm under the latter's care, promotion and general management. The syndicate manager is granted "sole and complete discretion and control over all breeding activities".[171] Furthermore, the syndicate manager has the power to decide on any alteration to the "normal book" (*i.e.* number of mares that can be bred to the stallion during one breeding season). Generally, one breeding right attaches to each share and four breeding rights are accorded to the stallion manager as compensation for services rendered. Since these breeding rights, or "nominations", can be traded independently of the shares to which they attach, the power to set the supply (and, accordingly, to influence price) is enormous. Since many stallions can accommodate more than forty-four mares in a season,[172] this power is even more substantial. Furthermore, the syndicate manager sets the stud fee for each additional nomination which inevitably has an influence on the value and marketability of the shareholders' own nominations. The ownership and control of the stallion breeding venture are thus in different hands.

It is arguable that through their collective right to dismiss the syndicate manager, the shareholders retain ultimate control over the venture. Typically, clauses providing for the replacement of the syndicate manager require something more than a majority vote of shareholders.[173] Though in law this might be perceived as the basis of owner-control, functionally it puts very little restraint on the syndicate manager's absolute authority. Economists argue that an owner's power of control over his manager is only as good as the owner's ability to monitor the manager's conduct.[174] Just as the rules of agency provided no guarantee for sole proprietors' control, neither will agency rules necessarily be of help where ownership is divided forty ways. Arguably, forty individuals will have even greater difficulty coordinating their monitoring efforts. The control problem is in some measure alleviated by giving the syndicate manager a profit stake in his own performance.

The influence of the syndicate manager on the decisions of the shareholders is not to be underestimated. An interesting example of this phenomenon occurred in 1982 when the shareholders of Northern Dancer, the

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[171]The language of this clause may differ but complete control is invariably granted to the syndicate manager: see "Syndication Guidelines" *New York Thoroughbred Breeder* (Fall 1981) 33 at 35.

[172]Lohman & Kirkpatrick, *supra*, note 27 at 119.

[173]See, *e.g.*, "Syndication Guidelines", *supra*, note 171 at 34. Since such a change would be so fundamental to the organization, one can draw an analogy with provisions in company law statutes requiring special majorities of shareholders for, *e.g.*, an amendment to the company charter. Removing a syndicate manager is arguably a more fundamental change than removing a director which, under s. 104(1) of the *Canada Business Corporations Act*, S.C. 1974-75-76, c. 33 [hereinafter *CBCA*] only requires an ordinary resolution of shareholders.

[174]See, *e.g.*, Fama, *supra*, note 34 at 60; and Jensen & Meckling, *supra*, note 5 at 40.

then leading active sire, were offered the unheard-of price of U.S.$40 million in a sort of equine take-over bid by a foreign investor. Windfields Farm was a minority shareholder in the horse and, more importantly, had been stallion manager of the horse since its initial syndication. When the stallion manager balked at the offer the deal fell through, in part because of the faith the shareholders placed in their stallion manager's judgment.[175]

B. Return

Measuring return on investment in a stallion syndicate is difficult given the volatile nature of the breeding market. Each shareholder, as we have observed, is entitled to one nomination per year, which can either be used by him for one of his own mares or sold separately to a third party.[176] The price of a nomination, like the price of the share to which it is attached, can vary widely from year to year depending on the success of the stallion.[177]

The syndicate manager generally receives compensation in two forms under a syndication agreement. He receives a fixed salary for standing the horse at his farm and, in addition, he "earns" up to four breeding rights annually for his participation in the venture.[178] This gives him an immediate stake in the success of the business — a device which, economists have argued, may prove to be an incentive for effective performance.[179] Thus, the syndication business structure allows the syndicate manager to participate directly while retaining the security of a guaranteed return for his services rendered. It is arguable that this participation means that, at least in economic terms, he is a joint venturer.

Cost should also be a key factor in evaluating the syndication form's appropriateness. Generally, shareholders assume a *pro rata* responsibility

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[175]P. Gzowski, *An Unbroken Line* (Toronto: McClelland & Stewart, 1983) at 158-62.

[176]A shareholder will sell his unwanted nomination under a "stallion service contract" generally at whatever the competitive secondary market will bear. By industry convention, the nomination carries with it a guarantee: the money will be refunded to the purchaser if the mare fails to produce a live foal that can stand and nurse without assistance. Demand for top stallions, sueh as Seattle Slew and Northern Dancer, is sueh that nomination holders can command over U.S.$1 million per nomination on the open market without offering guarantees: Lohman & Kirkpatrick, *supra*, note 27 at 120.

[177]The shares and breeding rights in the young stallion Danzig, *e.g.*, appreciated ten-fold after the sire's first crop turned in stakes winners including the 1984 two-year-old champion (and unsuccessful 1985 Triple Crown favourite) Chief's Crown. Canadian breeder Robert Anderson, a shareholder in the Danzig syndicate, sold a yearling by the young sire for U.S.$2.5 million at a public auction in Saratoga Springs, New York in August 1985: N.A. Campbell, "Breeder Achieves Success" *The [Toronto] Globe and Mail* (10 August 1985) S5.

[178]See Hickey, *supra*, note 161 at 3.

[179]O.E. Williamson, "Managerial Discretion and Business Behavior" in Posner & Scott, *supra*, note 5, 20 at 21.

for the costs of the venture. What is of perhaps more significance is the tax treatment of syndicate shares. Whereas in the United States, stallion shares are considered depreciable capital property,[180] under Canada's *Income Tax Act* animals are specifically excluded from all classes of depreciable property and consequently shareholders do not enjoy a deduction for capital cost allowance in this respect.[181] This disincentive may explain why certain great Canadian-bred stallions stand at farms in the United States.[182]

C. *Risk*

While ownership and control may be quite separate in stallion syndications, ownership and risk do coincide. Syndication agreements generally provide that title and all risks attaching thereto pass to the purchaser of the share upon execution of the agreement.[183] Indeed, transferring the risks in an inherently risky business, or at least sharing them with others, is the principal motivation to syndicate a stallion.[184] Most stallions are syndicated as untried sires, their value set on the sometimes questionable genetic assumption that horses' track performances and those of their parents and grandparents govern stallions' prospects at stud. It is precisely owing to this lack of a scientific standard for predicting success that breeders seek to dilute risk.[185]

As substantial a risk as the death of a stallion, given the purpose of the venture, is the possibility that the stallion will prove to be infertile. Often a horse will be syndicated before its fertility is established, as was the case when Devil's Bag was syndicated as a two-year-old racehorse (but unproven sire) for $U.S.36 million in 1984. Under the law of the sale of goods, an unallocated risk would likely fall to the vendor since contracts for the sale

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[180]See Trower, Davis & Geske, *supra*, note 91; and Lohman & Kirkpatrick, *supra*, note 27 at 145.

[181]*Income Tax Regulations*, C.R.C. 1978, c. 945, as am., Schedule II: Capital Cost Allowances, Class 8, s. (*i*)(ii).

[182]Sunny's Halo, the 1983 Canadian-bred Kentucky Derby winner, stands at Domino Stud in Kentucky. Northern Dancer, the 1964 Kentucky Derby winner bred in Canada by E.P. Taylor, stands at Windfields Farm in Maryland.

[183]Hickey, *supra*, note 161 at 1.

[184]I.J. Weiner, "Stallion Syndications: Part IV" *The Florida Horse* (March 1983) 262 at 262. Note that risks will vary according to the purpose of the venture. A horse syndicated before the end of its racing career is obviously a much more risky investment than a stallion already standing at stud.

[185]Examples of failed prospects are enough to make any informed investor risk-averse. For example, Triple Crown Winner Secretariat was syndicated in 1973 for U.S.$6.08 million and has subsequently proved to be something of a disappointment at stud. There are also examples of stallions with ignominious histories at the track, or no history at all, which nevertheless went on to be successful sires. Vice Regent, Canada's leading sire, had track earnings of only $6,125 in five starts and now commands a $50,000 stud fee.

of goods include an implied condition that the goods sold be reasonably fit for the purpose for which they were intended.[186] Virtually every modern-day syndication agreement, however, includes specific provisions pertaining to fertility. Industry tradition obliges the vendor to provide a guarantee of fertility for the stallion's first season at stud. The contract of sale will set down a procedure for establishing the stallion's fertility — usually based on a sixty per cent in-foal performance during the stallion's first year. If the fertility test is not fulfilled then the contract terminates and title to all shares reverts to the buyer. Once the initial fertility of the stallion has been established, the risk of infertility passes to the shareholders.[187] As the shareholders of the young stallion El Gran Senor have recently found out, bearing the risk of fertility can be a very expensive matter.[188]

The boilerplate stallion syndication invariably includes a provision designed to preclude the venture from being characterized as a partnership.[189] Though in law a partnership will not exist based on the mere fact of joint ownership of property,[190] participants are well aware that courts may characterize their bargain as such and thereby hold each of them responsible for the venture under the rules of that regime. Canadian courts have had occasion to consider whether joint ownership implies "a relation which subsists between persons carrying on a business in common with a view to profit" and have given strong authority for the position that a syndication is not a partnership. In *Porter*, where co-ownership of land was at issue, Mr Justice Duff of the Supreme Court of Canada noted that

> [a] common intention that each [co-owner] should be at liberty to deal with his undivided interest in the land as his own would obviously be incompatible with an intention that both should be bound to treat the corpus as the joint property, the property of a partnership.[191]

[186]See, *e.g.*, the *Sale of Goods Act*, R.S.O. 1980, c. 462, s. 15. The breach of such a term would give a right of rescission and damages to the purchaser. Implied terms as to the stallion's fertility can, of course, be excluded by private agreement (s. 53) and as a rule often are. For a fascinating though very dated consideration of warranties and conditions and the sale of horses, see Oliphant, *supra*, note 170 at 116ff.

[187]I.J. Weiner, "Stallion Syndications: Part V" *The Florida Horse* (April 1983) 456. Not surprisingly, the fear of assuming the risk of infertility has been a boon to the equine insurance industry.

[188]El Gran Senor was syndicated in 1984 for a reported U.S.$40 million. After his first breeding season, it appears that the young stallion is technically infertile. This is cause for justifiable panic among the shareholders, or more particularly, for their insurance company: N.A. Campbell, "El Gran's Fertility Remains Doubtful" *The [Toronto] Globe and Mail* (16 April 1985) 53.

[189]"Syndication Guidelines", *supra*, note 171 at 36.

[190]See, *e.g.*, *OPA*, *supra*, note 71, s. 3(1).

[191]*Supra*, note 79 at 330. Duff J.'s reasoning was recently applied in *A.E. Lepage Ltd* v. *Kamex Developments Ltd* (1977), 16 O.R. (2d) 193, 78 D.L.R. (3d) 223 (C.A.), aff'd without additional reasons (1979), [1979] 2 S.C.R. 155, 105 D.L.R. (3d) 84.

Reasoning by analogy from land to personal property (which always has its dangers) I suggest that a shareholder's right to deal independently with his undivided interest precludes the bargain from being characterized as a partnership.

D. *Duration*

The duration of the relationship between the participants can be the determining factor in transforming a simple contract into a complex bargain constituting a veritable business organization. Economist Ronald Coase suggests that "a firm is likely ... to emerge in those cases where a very short contract would be unsatisfactory".[192] The on-going relationship between the syndicate manager and the co-owners, and among the co-owners themselves, transforms the equine syndication agreement into a business enterprise rather than simply a contract for the sale of a specific good.

The venture has a natural life-span. When the stallion is no longer fit for breeding purposes, the enterprise necessarily comes to an end.[193] The significant power to decide when such a time has come rests with the syndicate manager (though generally this decision will not be a discretionary one).

The right to transfer a share in the stallion without bringing an end to the bargain is a distinctive characteristic of this joint venture. Generally, each fractional interest is independently transferable in accordance with a right of first refusal set down in the agreement. When a shareholder receives an acceptable offer from some third party to buy his share, he must submit the terms of that offer to the remaining shareholders, any of whom may acquire the share by matching the third party's offer.[194]

Thus it is possible for an investor to withdraw from the venture without necessarily threatening its very existence. If participants have differing objectives for investing in the firm, this might be very useful. While in partnership, withdrawal by a participant may bring the venture to a close (unless the parties agree otherwise), the syndication form is more flexible and may, accordingly, be more appropriate to independent-minded investors.

[192]"The Nature of the Firm" in Posner & Scott, *supra*, note 5, 3 at 5. Klein, *supra*, note 6 at 1546, notes that the longer the term, the more complex the bargains over the other elements become, and the more the relationship begins to resemble a firm.

[193]The active life of a sire varies enormously, but it can run as long as twenty-five years, which certainly gives the contract the quality of what economists call "firmishness".

[194]"Syndication Guidelines", *supra*, note 171 at 35.

E. Constraints

Constraints inhibiting the effectiveness of syndication include conflicts of interest and government regulation. As to conflicts of interest, the joint ownership of a stallion is subject to the variety of competing interests which plague all indivisible property jointly owned by unconnected participants. The scope and seriousness of such conflicts, however, are minimized by the structure of the decision-making process.

As between shareholders, the effects of conflicts are reduced by the nature of each participant's stake in the bargain. Each shareholder can effectively exploit his interest without treading on toes. His decision as to how and when to use his nomination (*i.e.* breeding right) is exercised independently of his co-owners. Accordingly, the terms of the agreement operate as a check on conflict of interest.[195] Each participant clearly has an interest in how his fellow shareholders use their nominations since, in the long run, all shareholders benefit when the highest quality mares are bred to the stallion. Consequently, many syndication agreements stipulate that nominations may only be used for stakes-winning or stakes-producing mares. Conflicts which arise between the syndicate manager and the shareholders may have serious repercussions for the shareholders, given the absolute nature of the manager's control. A syndicate manager may have a number of stallions under his charge and shareholders may not feel he is giving adequate attention to their investment. Furthermore, the syndicate manager's interests in other stallions may place him in a genuine position of conflict of interest. He may, for example, choose mares to complete an undersubscribed stallion's book to fit with his other breeding interests on the farm. Owners can bargain for restrictions on a manager's discretion as a means of reducing conflicts of interest.[196] This is one way to characterize two checks which serve to lessen the seriousness of this conflict in a syndication agreement. First, since the syndicate manager's compensation includes breeding rights, he presumably has the same interest in their effective exploitation as any of the shareholders. (Arguably he will be even more attentive, since his four nominations may outnumber those of any one shareholder.) Second, he is ultimately answerable to the shareholders by virtue of their ability to dismiss him.

Government regulation — specifically securities law disclosure requirements — poses an enormous potential barrier to stallion syndications. Indeed, Klein describes securities law regulations as "the most significant sets

[195] Anderson, *supra*, note 45 at 762. Imagine the difficulty of trying to get forty co-owners to agree on each mare to which the stallion would be bred.

[196] Anderson, *ibid.* at 771.

of rules affecting business associations".[197] For stallion syndications, the question arises as to whether the sale of the fractional interests in the horse amounts to a distribution of securities for which disclosure and registration requirements must be met.

David Johnston explains the purpose of this type of regulation: "The traditional goal of securities regulation has been the protection of the investor."[198] In fact, the law's preoccupation with protecting a purchaser of an interest in horses is a long-standing one. The source of concern was explained in 1908 in the Introduction to Oliphant's *The Law of Horses*:

> The frequent rascality in horse-dealing transactions arises from parties making improper use of [their] superior knowledge which experience alone can supply.[199]

The same concern might be said to justify state intervention requiring the vendor of shares to register and declare the nature of the transaction under a stallion syndication. As we have noted, the Ontario *Securities Act* imposes registration, prospectus and resale requirements on the distribution of certain securities.[200] The application of the provisions of the *Act* to syndications turns on whether a stallion share is a "security" and whether a syndication amounts to a "distribution". The sanction for not meeting the *Act*'s requirements is substantial. Where these rules are not met, the issuer can be held both criminally and civilly liable.[201]

A stallion share does not fall neatly under any of the sixteen branches of the definition of a "security" set out in paragraph 1(1)(40) of the Ontario *Securities Act*.[202] Two branches of this definition give cause for concern: first, subparagraph (ii) which includes "any document constituting evidence of title to or interest in ... property ... of any person or company"; and second, subparagraph (xiv) which includes certain "investment contracts".

As to the first, there is case law which would include evidence of a part interest in animals under this definition of a security. In *R. ex rel. Swain* v. *Boughner*, the Ontario High Court held that a bill of sale and certificate evidencing a half-interest in a pair of chinchillas, accompanied by a management and profit-sharing plan, constituted trading in a "security".[203] A

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[197] *Supra*, note 6 at 1554.

[198] *Canadian Securities Regulation* (Toronto: Butterworths, 1977) at 1.

[199] Oliphant, *supra*, note 170 at xliii-xliv.

[200] *Supra*, note 154 and accompanying text.

[201] *OSA*, *supra*, note 154, s. 118ff. and s. 126ff.

[202] As to the definition of "security" generally, see F. Iacobucci, "The Definition of Security for Purposes of a Securities Act" in Canada, *Proposals for a Securities Market Law for Canada*, vol. 3 by P. Anisman *et al.* (Ottawa: Supply & Services Canada, 1979); and L.F. Orbe, "A Security: The Quest for a Definition" (1984) 12 Sec. Reg. L.J. 220.

[203] (1948), [1948] O.W.N. 141 [hereinafter *Swain*].

stallion syndicate bears resemblance to the arrangement in *Swain*, but the power of control resting with the stallion shareholders distinguishes their situation from that of the chinchilla investors. Although the stallion manager does have significant powers to influence the venture, the critical right to decide which mares are to be bred to the stallion rests with the shareholders.[204] Furthermore, since stallion shares are not documents of title which are bought and sold simply for the purposes of investment, but rather the shares have a value in use, they likely fall outside this branch of the definition.[205] Moreover, as Victor Alboini notes, subparagraph (ii) is rarely relied upon alone in ascertaining whether or not a security exists.[206] The more pertinent question is whether a syndication represents an investment contract under the *Act*.

The inclusion of "investment contracts" in the definition of securities in the Ontario *Securities Act* is of American inspiration,[207] and Canadian courts have expressed a willingness to interpret the *Act* in light of American jurisprudence on investment contracts.[208] The American test introduced in *Securities and Exchange Commission* v. *W.J. Howey Co.*, now applied in Canada, requires four elements for an arrangement to constitute an investment contract: (1) the investment of money, (2) in a common enterprise, (3) with the expectation of profit, (4) solely from the efforts of others.[209] It is this latter aspect which precludes stallion syndications from being properly characterized as securities.[210]

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[204]This is not to diminish the very real authority that a syndicate manager may have, particularly with respect to unused or excess stallion seasons which he has the responsibility to book.

[205]*Re Ontario Securities Comm'n and Brigadoon Scotch Distributors (Canada) Ltd* (1970), [1970] 3 O.R. 714 at 716, 14 D.L.R. (3d) 38 (H.C.). See also the discussion in V.P. Alboini, *Securities Law and Practice*, vol. 1 (Toronto: Carswell, 1984) at 0-29.

[206]Alboini, *ibid.* at 0-32.

[207]*Ibid.* at 0-39ff.

[208]See *Pacific Coast Coin Exchange of Canada* v. *Ontario Securities Comm'n* (1977), [1978] 2 S.C.R. 112 at 126ff., 80 D.L.R. (3d) 529, de Grandpré J. [hereinafter *Pacific Coast Coin Exchange* cited to S.C.R.].

[209]328 U.S. 293 (1946) [hereinafter *Howey*]. The alternative "risk-capital" test developed in *State Commissioner of Securities* v. *Hawaii Market Center Inc.*, 485 P.2d 105 (Hawaii S.C. 1971) requires *inter alia* that the invested capital be subject to the risks of the enterprise without the investor enjoying any real right of control over managerial decisions. While a stallion shareholder does share in the risks of the venture, he can exploit (or control) the rights attached to his portion of the enterprise independently of other shareholders. The risk-capital test would therefore exclude stallion shares as "investment contracts".

[210]Not all breeding schemes are spared. Recently the Ninth Circuit Court of Appeal took a dimmer view of an arrangement to breed earthworms: *Smith* v. *Gross*, 604 F.2d 639 (1979).

The key question is to determine whether the syndicate manager's activities on behalf of the shareholders mean their expectations of profits arise "solely" from his efforts.[211]

Equine lawyers, well aware of the relevance of the syndicate manager's duties for securities law purposes, have noted that "as the role of the syndicate manager increases, it is more likely that the fourth element of *Howey* is present" and that consequently the shares will be viewed as investment contracts.[212] They tend to argue that the shareholders' profits do not derive from the syndicate manager's efforts, but rather from the disposition of the foal, the birth and caring of which is the shareholders' responsibility.[213] Furthermore, care is taken to draft syndication agreements so that they will fall outside the investment contract category. Excess nominations are distributed rather than pooled to avoid the view that the investment is a "common enterprise".[214] The owners' right to dismiss the syndicate manager is clearly set out, and effort is made to circumscribe the latter's discretion since, as Campbell notes, "attorneys become more nervous as the syndicate manager's role increases in significance".[215]

After a 1976 lower court decision holding a sale of a fractional interest in a racehorse to be an "investment contract" under Oregon securities legislation,[216] worried horsemen began approaching the Securities and Exchange Commission (SEC) to obtain "no-action" rulings before syndicating stallions. On 18 August 1977, the SEC published a no-action letter recommending that no enforcement action be taken under applicable securities legislation in connection with a syndication proposed by John R. Gaines and Gainesway Farm Inc. of Kentucky.[217] The Commission set down a

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[211]The "solely" test has recently been attenuated in the United States; see *Securities and Exchange Comm'n* v. *Glenn W. Turner Enterprises*, 474 F.2d 476 (9th Cir. 1973). This less stringent view was adopted in Canada in *Pacific Coast Coin Exchange*, *supra*, note 208 at 129 and turns on whether the third party's efforts are essential managerial efforts which affect the failure or success of the enterprise.

[212]Campbell, *supra*, note 162 at 1137.

[213]See, *e.g.*, Kegley, *supra*, note 157 at 6123; D. Sturgill, "Keeping Buyer, Seller, and Uncle Sam Happy" *The Thoroughbred of California* (December 1980) 146. Another argument sometimes raised is that the shareholder, in choosing the mare, is arranging the match which gives rise to the expected profit.

[214]See I.J. Weiner, "Pooling Excess Stallion Seasons" *The Florida Horse* (August 1983) 742. Inevitably in practice some nominations are pooled and the benefits spread *pro rata* among shareholders.

[215]Campbell, *supra*, note 162 at 1148.

[216]*Marshall* v. *Harris*, 555 P.2d 756 (Or. S.C. 1976). This case involved not a stallion syndication but rather a contract whereby the plaintiff sold an interest in two racehorses and their earnings in return for the defendant's undertaking to pay the horses' expenses.

[217]SEC, J.R. Gaines No-Action Letter (18 August 1977) reprinted in the *CCH Federal Securites Law Reporter* (Chicago: Commerce Clearing House, 1977) at para. 81,311.

series of conditions which, if adhered to in the syndication agreement, would not result in the shares constituting investment contracts. Though the letter imposes eight conditions on the SEC's undertaking not to take enforcement action, the essence of the ruling was that a syndicate manager could do no more than care for the horse and perform certain administrative functions for the shareholder.[218]

The Gainesway Farm no-action letter was the first in a series of about fifty such letters issued by the SEC.[219] Moreover, the conditions set by the Commission became the basis of what has now become the stallion syndication boilerplate. While the large number of no-action letter requests have produced some slight modifications to the standard form, [220] the rules for an acceptable syndication have not changed substantially since 1977. Furthermore, changes in the traditional manner of syndicating a stallion tend to be very respectful of SEC prejudices.[221]

Since traditional stallion syndications are not securities under most securities legislation, participants in this form of business venture are spared the enormous costs of complying with statutory registration and disclosure requirements. Nonetheless, the syndicate manager's power of control over the venture is the key to its success and he is generally granted substantial authority. Should this authority be viewed as giving the syndication the quality of an investment contract, the resulting costs would undermine the effectiveness of this form of business enterprise.

VII. Limited Companies

As profit takes on increasing importance in horse racing and breeding, more and more horsemen choose to do business through limited companies.[222] The trend away from sole proprietorships and partnerships observed generally within the Canadian business community[223] has also affected the

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[218]*Ibid.* Other conditions include requirements that shares only be sold to breeders for use in their business, that there be no pooling of income among the shareholders and that sale of shares be subject to a right of first refusal.

[219]Campbell, *supra*, note 162 at 1146 n. 64 lists the citations of the letters.

[220]See, *e.g.*, "SEC Expands Syndicate Guidelines" *American Horse Council Newsletter* (March 1980) regarding a no-action letter permitting the stallion manager to acquire mortality insurance on behalf of the shareholders.

[221]In August 1984, fifteen lifetime breeding rights in the successful stallion Alydar were sold by Calumet Farm of Kentucky for U.S.$2.5 million each. Though different in form from the usual share-ownership syndication, the Alydar arrangement puts limits on the stallion manager's ultimate control over the horse. Kegley, *supra*, note 157 at 6124, suggests that the securities considerations are not markedly different than for the usual syndicate.

[222]Kropp, Flanagan & Kahle, *supra*, note 3 at 996.

[223]Hadden, Forbes & Simmonds, *supra*, note 84 at 129.

horse industry: family farmers and sole owners frequently operate racing and breeding ventures as closely-held corporations.

Recently, however, existing closely-held corporations have solicited new equity capital from the public to finance company growth in this growing industry.[224] It has been suggested that the recent spate of public issues has been brought on by owners and breeders "anxious to raise the capital they need to remain competitive in an escalating bloodstock market".[225] Another explanation is that the owners want to share the risk of loss in this volatile industry. Though horsemen may not agree as to the appropriateness of opening up the industry to the wider investment community,[226] publicly-held companies are becoming an increasing reality. "Going public" results in a wholly new style of bargain being struck between participants.

The purpose of incorporating is no different in the horse business than in any other: participants seek limited liability and perpetual existence for their ventures as well as the security of a tried and true set of rules for doing business.[227] Nor are the reasons for going public unique in the horse business: an existing company seeks additional capital and a wider allocation of risk among participants. Rather than enumerate the positive law characteristics of closely-held and public companies, it is more useful to canvass briefly the functional elements of these business forms in order to understand how they might be appropriate for a particular equine investment.[228] Though publie and private companies are often lumped together by lawyers as "corporations", analysis of the control, risk, return and duration elements of each reveals very different economic bargains.

A. Control

As is the case with the other forms of business organization considered to this point, it is not helpful to view control for limited companies as resting wholly with the owners of the business. Lawyers are comfortable with the notion that a corporation is a separate entity with legal personality

[224]Public issues have occurred mostly in the United States: shares in Blue Grass Breeders Inc., Sovereign Thoroughbred Inc. and Kentucky Horse Center Inc. currently trade on the over-the-counter stock market, while Spendthrift Farm, Inc. and International Thoroughbred Breeders Inc. trade on the American Stock Exchange: "For the Record: Wall Street Report" *The Thoroughbred Record* (7 September 1985) 4423 at 4423.

[225]*Supra*, note 26 at 256.

[226]The "pro" and "con" of public companies were argued by R. Brennan & R. Fierro, "Multiple Ownership Viewpoints" *The Blood-Horse* (23 June 1984) 4281.

[227]Cameron, *supra*, note 1 at 2.

[228]In *Donahue* v. *Rodd Electrotype Co. of New England*, 328 N.E.2d 505 at 512 (Mass. S. Jud. Ct 1975), Tauro C.J. explained that shareholders' participation means that "the close corporation bears striking resemblance to a partnership."

distinct from those who own it[229] and consequently recognize more readily that persons other than shareholders take part in its control.[230] Company law statutes divide up control: directors manage, or supervise the management of, the affairs of the corporation;[231] officers, appointed by directors, can be delegated certain managerial powers;[232] and shareholders with voting rights have the right to elect and remove directors from office giving them, at least from a legal standpoint, the ultimate power to control the firm.[233]

It is the influence of the shareholder over the on-going activities of the firm which distinguishes the bargains represented by closely-held and publicly-held companies. Typically, closely-held companies have a small number of shareholders[234] with a high personal stake in the business and, consequently, a strong inclination to participate in the activities of the firm. Thus, in a closely-held equine breeding company, for example, majority shareholders will most likely run the business of the firm, especially since many of the operations are family farms. This means that, as a general rule, there is a high correlation between ownership and control in closely-held equine corporations, or at least as high a correlation as was observed for organizations such as partnerships.

When a closely-held equine corporation goes public, however, control exercised by the various participants to the bargain changes. There is a wide body of legal and economic literature explaining that the ownership of a small block of shares in a widely-held company represents an inadequate incentive for a shareholder to exercise his legal right of control.[235] This may give a seemingly disproportionate authority to managers:

> The essence of the problem is that large numbers of dispersed shareholders can rarely exercise effective control or supervision over the management of "their" companies, and are often uninterested in doing so. The directors and executives of such companies are in practice a self-perpetuating body and are

[229]See *Salomon* v. *Salomon & Co.* (1896), [1897] A.C. 22, [1895-99] All E.R. Rep. 33 (H.L.).

[230]See D.C. Ross, "Directors, Officers and Shareholders of a Corporation" in *Corporate and Commercial Law 1983-1984*, *supra*, note 30, 91 at 91: "[D]irectors, officers and shareholders each have their own spheres of activity. Control of a corporation is divided among them."

[231]See, *e.g.*, *CBCA*, *supra*, note 173, s. 97(1).

[232]*Ibid.*, s. 110(1). The powers which directors are prohibited from delegating are set out at s. 110(3).

[233]*Ibid.*, ss 101(3) and 104(1).

[234]The definition of "private company" at s. 1(1)(31) of the *OSA*, *supra*, note 154, which governs whether a closely-held company will or will not be subjeet to expensive and cumbersome securities regulation, stipulates that, *inter alia*, the private company must have no more than 50 shareholders.

[235]The leading work is A. Berle & G. Means, *The Modern Corporation and Private Property*, rev'd ed. (New York: Harcourt, Brace & World, 1968) at 64-65 where the authors recognize "control" as separate from ownership where stoek ownership is widely dispersed. The Berle-Means thesis is re-evaluated in Posner & Scott, *supra*, note 5 at 10ff.

in a position to dictate the way in which the affairs of "their" companies are to be conducted.[236]

Managers of the venture are likely to have their own views of the company's best interest and, if shareholdings are sufficiently widespread, their decision is likely to go unquestioned.[237] Functionally it is management's company and, as economists Armen Alchian and Harold Demsetz suggest, it is more useful to view shareholders as investors rather than as owners.[238]

It is of course possible for major shareholders to retain enough stock in a company that has gone public to hold on to their position of influence within the firm. This was the case, for example, when Spendthrift Farm, Inc., a venerable family-run Kentucky breeding operation, sold a large block of common stock to the public in November 1983. After the public offering, Chairman of the Board Leslie Combs II and his son Brownell Combs II together retained well over 50 per cent of the shares outstanding. They continued thereafter as officers and directors of the company. A well-planned public issue need not compromise existing owner-control.[239]

B. *Risk*

The importance of shareholders' immunity from liability for the debt of the company beyond their contribution to share capital should not be underestimated in contemplating the advantages of the corporate form. Indeed in the risky thoroughbred industry, limited liability takes on special importance. Yet the advantages should not be overstated, particularly with respect to small equine ventures, since generally lenders require the controlling shareholder of a closely-held company to give a personal guarantee for loans to the company.[240] This is all the more likely to be true where, as in the horse business, banks tend to feel less comfortable with the business risk involved.

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[236]Hadden, Forbes & Simmonds, *supra*, note 84 at 74.

[237]Company law imposes a fiduciary duty on directors to act in the "best interests of the corporation" (as opposed to the shareholders): *CBCA*, *supra*, note 173, s. 117(1)(a). It is unlikely that a minority shareholder would expend great energy in monitoring the director's adherence to this duty.

[238]"Production, Information Costs, and Economic Organization" in Posner & Scott, *supra*, note 5, 12 at 18 n. 14.

[239]See Spendthrift Farm, Inc., Preliminary Prospectus (17 November 1983) [hereinafter Spendthrift Prospectus] filed as a public document with the SEC. The Combs family plans to divest itself completely of Spendthrift stock. S. Crist, "Movement on Spendthrift Sale" *The New York Times* (29 August 1985) B-12, reported that the family was to sell its 63.7 per cent of the farm's stock for U.S.$57.2 million.

[240]See, generally, Hadden, Forbes & Simmonds, *supra*, note 84 at 142.

Even when shareholders have not given personal guarantees for company obligations, they may be held responsible in spite of the principle of limited liability. Klein points out that courts will not hesitate to "pierce the corporate veil" and hold shareholders liable where, for example, the corporation has been used for fraudulent purposes.[241]

Limited liability, especially in a business where participants are risk-conscious, may afford shareholders some peace of mind. However, an owner has at best only shifted the risk of the business's failure onto creditors of the corporation and, as Richard Posner points out, "[c]reditors must be paid to bear this risk."[242] The bargain among the participants in the firm is adjusted accordingly by way of special security in loans or inflated interest rates.

Where horsemen are disinclined to pay the high price of risk-sharing required by lenders or are unable to obtain debt financing at any price, they have the option of selling part of their business, either privately or publicly. Soliciting of equity capital from the public is more than a financing device — it is also a means whereby existing owners can share the risk of loss with others. That risk-sharing is generally achieved through the issue of the highest risk claims — common stock — rather than by way of debt financing makes this plain. Lenders to a corporation are, of course, participants in the firm, but since their claims rank ahead of those of the shareholders, the risk they have taken is less substantial. The bargain struck by a debenture holder is not the same as that of a shareholder. Though equine public issues tend to be for equity capital, there have been some public debenture offerings in the industry.[243]

C. Return

Return, at least theoretically, should not be affected by the corporate form. Income earned by a corporation, once dividends are declared, is income earned by its shareholders. This is reflected by the theory of integration on which the Canadian income tax system is said to be founded: "[I]ntegration means that the total tax paid by a corporation and its shareholders should be equal to the amount that would have been paid by the individual shareholders themselves had they carried on the economic activity themselves

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[241]Klein, *supra*, note 2 at 123. Canadian courts often show little hesitation in tearing away the veil of limited liability where they feel that the shareholder has in some way acted improperly. See, *e.g.*, I.R. Feltham, "Lifting the Corporate Veil" [1968] L.S.U.C. Spec. Lect. 305; and J.W. Durnford, "The Corporate Veil in Tax Law" (1979) 27 Can. Tax J. 282.

[242]*Economic Analysis of Law*, 2d ed. (Boston: Little, Brown, 1977) at 292.

[243]R. Fierro, "Horsemen's Methods and Regulation's Fishbowl" *The Blood-Horse* (23 June 1984) 4281.

directly, and not through the intermediary of a corporation."[244] The *Income Tax Act* contains certain devices to preclude the double taxation of corporate and shareholder income,[245] but it is generally agreed that the system falls short of perfect integration.[246] Consequently, clear-thinking tax planners can organize an equine business venture as a corporation (or not) to make the most of the shortcomings in the *Income Tax Act*'s attempt to integrate corporate and individual income taxes.[247] Indeed, in an industry where annual returns can fluctuate as significantly as they do in the horse business, judicious income deferral through retained corporate earnings and selective dividend declaration (both easier said than done) can change the complexion of return within the firm. Because of the erratic income streams of equine corporations, shareholders' profits are often more likely to be capital gains from the appreciation of the value of shares rather than dividend income.[248] Nonetheless, the corporate vehicle remains a potentially useful tool in maximizing return.

The returns of manager-participants are a further important aspect of the corporate bargain. In a closely-held corporation, since the shareholders will probably either monitor managers carefully or actually manage themselves,[249] management and ownership are likely to have similar objectives with respect to return. The separation of ownership and control in a publicly-held company is likely to give rise to differing approaches to return.[250] Yet the corporate structure provides a remedy to this problem: by giving a manager an ownership interest in the firm, his behaviour can be made to coincide with the wishes of the shareholders.[251] Where shareholders are not

[244]D.P. Jones, "Corporations, Double Taxation and the Theory of Integration" (1979) 27 Can. Tax J. 405 at 405.

[245]The obvious example is the dividend gross-up and tax credit which benefit individual shareholders and compensate for the fact that the Canadian corporation has already paid tax on the income being distributed as dividends: see *Income Tax Act*, *supra*, note 21, para. 82(1)(b) and s. 121.

[246]Jones, *supra*, note 244 at 427.

[247]*Ibid.*

[248]See, *e.g.*, Spendthrift Prospectus, *supra*, note 239 at 9, which discloses: "The Company has never paid cash dividends and does not expect to pay cash dividends in the foreseeable future."

[249]By putting themselves on a corporate payroll as managers, shareholders can ensure a more regular return in an industry in which returns on equity are so unpredictable. The Spendthrift Prospectus, *ibid.* at 23, disclosed that Brownell Combs II, then a principal stockholder, also had an employment agreement with the company for an annual salary of U.S.$500,000.

[250]Jensen & Meckling, *supra*, note 5 at 43, suggest that the reduced value of the firm caused by the manager's consumption of perquisites is an example of conflicting approaches to return.

[251]Economist Miron Stano, "Executive Ownership Interests and Corporate Performance" in Posner & Scott, *supra*, note 5, 38 at 38, found "[a]n unmistakeable positive relationship between profit rates among the largest U.S. corporations and executive stock interest".

themselves expert horsemen, this device may be less expensive and more practical than trying to monitor managerial behaviour.

D. Duration

The "desirability of perpetual existence" is often referred to by lawyers as a consideration for choosing the corporation over any other business form. It is argued that where the venture is an on-going business, it is preferable to avoid using sole proprietorship or partnership which both depend for their existence on the survival of the owners.[252]

From a functional point of view, however, it is plain that the duration of the venture has little to do with the fact of incorporation. This "firmishness" of the venture among participants turns not on the form but rather on the substance of the bargain. Furthermore, where a venture is in large measure the result of the efforts of one or two individuals, the fact that they incorporate as a closely-held company will not necessarily have any bearing on the duration of the bargain. When one shareholder dies or pulls out of the business, the venture is likely to terminate in spite of the immortality of the corporate minute book. As horseman Robert Fierro argued in speaking out against publicly-held equine corporations, this is particularly likely in

> [t]he horse industry [which] is an intensely personal business with certain ways of operating that are not always conducive to the world of the public corporation.[253]

Long term bargains, such as those completed when a company goes public, may be inappropriate to an industry so reliant on the skills of individual specialists.

E. Constraints

Many of the constraints which affect other business forms also affect closely-held and public corporations. The potential for conflict of interest between managers and shareholders in the horse business should not be exaggerated. Investment in any equine venture is, of course, somewhat exotic and consequently investors are likely to come from the close community of industry enthusiasts. Certainly for closely-held companies there are few uninformed or inattentive shareholders — especially since companies often begin as family operations. The separation between ownership and control for public corporations is nevertheless more likely to give rise to conflict-of-interest situations. It is arguable that even casual portfolio investors are likely to be interested enough in this specialized industry to have the ability

[252]Ross, *supra*, note 30 at 12-13; Cameron, *supra*, note 1 at 2.
[253]Fierro, *supra*, note 243 at 4281.

to monitor manager behaviour, but only shareholders whose investments make up a major portion of their portfolio will have the incentive to follow carefully the day-to-day workings of the firm. Horsemen recognize the potential problems caused by managers who have important industry investments outside the firm.[254] Yet just as shareholder reliance on manager expertise may give the manager an opportunity to cheat, conflicts are a necessary evil in the horse business where "[t]he flipside is likely to be a useful contact in the industry."[255]

Government and industry regulation represent further constraints on doing business as a limited company. Closely-held companies must abide by certain company, tax and administrative law rules, but these are likely to deter only the most marginal businesses from incorporating.[256] More substantial equine companies face heavy transaction costs if and when they solicit equity capital from the public. The important constraint imposed by securities law regulation in connection with a public issue and the on-going disclosure requirements asked of a reporting issuer will preclude closely-held equine companies from going public except after the most careful cost-benefit analyses. Major borrowing and private placement of equity capital represent workable alternatives.

The licensing requirements under the rules of racing represent an annoying constraint on corporate horseracing ventures. In Ontario, for example, participants must be licensed by the Racing Commission as owners before the company's horses can enter a race.[257] Since the rules in all jurisdictions have not been amended to accommodate the realities of corporate ownership and management, bringing a horse to a new racetrack for a single stakes race could theoretically require legions of shareholders and officers getting fingerprinted and photographed and the company paying for dozens of licences.[258]

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[254]Heckerman, *supra*, note 148 at 474.

[255]*Ibid.*

[256]Given that the likelihood for profit in the smallest firms is so dismal, as noted in the *ORC Report*, *supra*, note 10 at 18, any additional cost of doing business can amount to an important constraint.

[257]Ontario Rules, *supra*, note 63, Rule 32. The language of the Rules is somewhat ambiguous. Rule 32.09(b) states that a major shareholder is to be designated as the owner responsible for the horse and that only three other "major shareholders" may enjoy the owner's full privileges at the track, though "all other persons sharing in the ... corporation ... must be licensed". Rule 32.12 specifically regulates horses owned by limited companies and requires both the disclosure of the names of officers, directors and major shareholders, and that they be eligible for licensing. Rule 32.12(c) requires that the officers of the company be licensed but makes no specific mention of the shareholders and directors.

[258]Most racing commissions have the discretionary authority to waive licensing rules in situations in which the rules would not serve any worthwhile purpose: see, *e.g.*, Ontario Rules, *ibid.*, Rule 32.

VII. Conclusion

In our study of the thoroughbred racing and breeding industries, we have observed the use of all manners of business organization. Sole proprietorships and general partnerships still dominate the industry, but in recent years limited partnerships and stallion syndications have become increasingly prevalent. Equine ventures have also been organized as closely-held companies and, of late, as public corporations.

The task has fallen in large measure to lawyers to advise as to the appropriate equine business form. Unfortunately, lawyers have tended to focus their attention on the abstract legal rules associated with each category of venture instead of on the true economic relationships which the participants wish to create. Rather than viewing the equine business organization as a bargain between participants they have explained each legal form to clients as airtight compartments of inflexible rules.

This is not helpful to investors. A better approach isolates the elements of the bargain that the form represents and allows horsemen to understand the relative importance of control, risk, return and duration of the venture to the realization of their investment goals. Then, mindful of the constraints placed on their ability to bargain, they may organize their business accordingly. Often rules of positive law fail adequately to account for the dynamics of racing and breeding "bargains". The simple rule of unlimited liability in sole proprietorships, for example, ignores the risks taken by non-equity participants. Sometimes, as in the case of the legal right of ownership and the right to managerial control for public companies, the rule actually obscures the business bargain underlying the enterprise.

By resorting to the traditional business law classification to structure the argument of this essay, the author risks falling into the same trap. However, as a tool of analysis, the legal language of business associations is useful. Calling the bargain a "partnership" or a "limited company" does not obscure the reality of the bargain's functional make-up. In using familiar name-tags, lawyers need not fall back on an unrealistic view of business organizations as fixed legal entities rather than as the product of (at times) thoughtful bargaining between the participants.[259]

Investing in the horse business need not be more risky than it already is. Given the different objectives of participants in any equine venture, there is no universal formula for determining the appropriate business form. What

[259]Klein, *supra*, note 6 at 1525 explains: "The concept of the corporation (or partnership, cooperative, bank or government agency) as a separate entity should be used only as a convenient, perhaps even necessary, shorthand device for communication, but such a device can be . . . misleading."

horsemen should do is isolate the "deal points" important to them for the venture on which they are about to embark and negotiate among themselves accordingly. If horsemen make an effort to think of business organizations as bargains rather than as rigid sets of legal rules, investment in the horse industry will be a far safer bet.