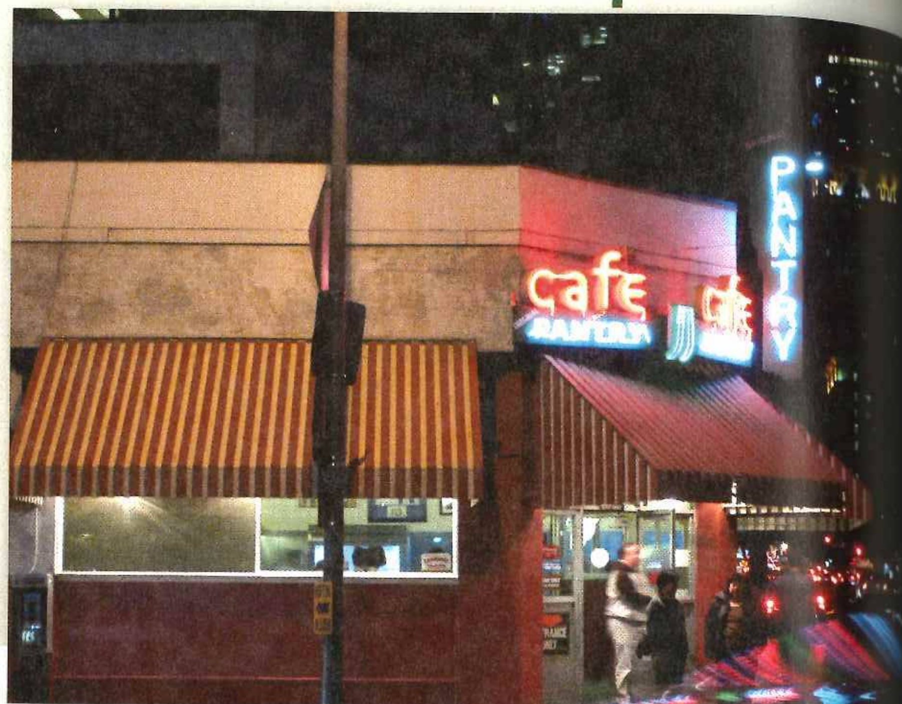
CHAPTER

14 Small Business, General Partnerships, and Limited Partnerships



RESTAURANT
Many restaurants are operated as small businesses by sole proprietors or by family partnerships or companies.

Learning Objectives

After studying this chapter, you should be able to:

1. Define *entrepreneurship* and describe the types of businesses that an entrepreneur can use to operate a business.
2. Define *sole proprietorship* and describe the liability of a sole proprietor.
3. Define *general partnership* and describe how general partnerships are formed and operated.
4. Define *limited partnership* and describe how limited partnerships are formed and operated.
5. Explain the tort and contract liability of general and limited partners.

Chapter Outline

"One of the most fruitful sources of ruin to a man of the world is the recklessness or want of principle of partners, and it is one of the perils to which every man exposes himself who enters into a partnership."

—Vice Chancellor Malins
Mackay v. Douglas, 14 Eq. 106 AT 118 (1872)

Introduction to Small Business, General Partnerships, and Limited Partnerships

A person who wants to start a business must decide whether the business should operate as one of the major forms of business organization—*sole proprietorship, general partnership, limited partnership, limited liability partnership, limited liability company,* and *corporation*—or under other available legal business forms. The selection depends on many factors, including the ease and cost of formation, the capital requirements of the business, the flexibility of management decisions, government restrictions, personal liability, tax considerations, and the like.

This chapter discusses small businesses, entrepreneurship, sole proprietorships, general partnerships, and limited partnerships.

The partner of my partner is not my partner.

Legal maxim

Entrepreneurship

An **entrepreneur** is a person who forms and operates a business. An entrepreneur may start a business by him- or herself or may cofound a business with others. Most businesses started by entrepreneurs are small, although some grow into substantial organizations.

entrepreneur
A person who forms and operates a new business either by him- or herself or with others.

Examples Bill Gates and Paul Allen started Microsoft Corporation, which grew into a giant software company. Mark Zuckerberg and others founded Facebook, Inc., an extremely successful social networking service. David Filo and Jerry Yang founded Yahoo!, which is a leader in providing Internet services. Jack Ma and others founded Alibaba Group, an online services and business to business platform in China. Jack Dorsey, Evan Williams, and others started Twitter, Inc., an online social networking and microblogging service. Jeremy Stoppelman and Russel Simmons founded Yelp, Inc., an online urban guide and business review site. Reid Hoffman and others started Linkedin Corporation, which operates a professional networking service.

Every day, entrepreneurs in this country and elsewhere around the world create new businesses that hire employees, provide new products and services, and contribute to the growth of economies of countries.

It is when merchants dispute about their own rules that they invoke the law.

Judge Brett
Robinson v. Mollett (1875)

Entrepreneurial Forms of Conducting Business

Entrepreneurs contemplating starting a business have many options when choosing the legal form in which to conduct the business. Each of these forms of business has advantages and disadvantages for the entrepreneurs. The major forms for conducting businesses and professions are as follows:

- Sole proprietorship
- General partnership
- Limited partnership
- Limited liability partnership
- Limited liability company
- Corporation

Certain requirements must be met to form and operate each of these forms of business. These requirements are discussed in this chapter and the other chapters in Part IV.

Sole Proprietorship

sole proprietorship
A form of business in which the owner is actually the business; the business is not a separate legal entity.

sole proprietor
The owner of a sole proprietorship.

A **sole proprietorship** is the simplest form of business organization. There is only one owner of the business, who is called the **sole proprietor**. There is no separate legal entity. Sole proprietorships are the most common form of business organization in the United States. Many small businesses—and a few large ones—operate in this way.

Operating a business as a sole proprietorship has several major advantages, including the following:

- Forming a sole proprietorship is easy and does not cost a lot.
- The owner has the right to make all management decisions concerning the business, including those involving hiring and firing employees.
- The sole proprietor owns all of the business and has the right to receive all of the business's profits.
- A sole proprietorship can be easily transferred or sold if and when the owner desires to do so; no other approval (e.g., from partners or shareholders) is necessary.

This business form has important disadvantages, too. For example, a sole proprietors' access to the capital is limited to personal funds plus any loans he or she can obtain, and a sole proprietor is legally responsible for the business's contracts and the torts he or she or any of his or her employees commit in the course of employment.

Creation of a Sole Proprietorship

d.b.a.
A designation for a business that is operating under a trade name; it means "doing business as."

fictitious business name statement
A document filed with the state that designates a trade name of a business, the name and address of the applicant, and the address of the business.

Creating a sole proprietorship is easy. There are no formalities, and no federal or state government approval is required. Some local governments require all businesses, including sole proprietorships, to obtain licenses to do business within the local jurisdiction. If no other form of business organization is chosen, the business is by default a sole proprietorship.

The following feature discusses the requirement for businesses to file for a trade name under certain circumstances.

Business Environment

d.b.a. Trade Name

A sole proprietorship can operate under the name of the sole proprietor or a **trade name**. For example, the author of this book can operate a sole proprietorship under the name "Henry R. Cheeseman" or under a trade name such as "The Big Cheese." Operating under a trade name is commonly designated as **d.b.a. (doing business as)** (e.g., Henry R. Cheeseman, doing business as "The Big Cheese").

Most states require all businesses—including sole proprietorships, general and limited partnerships, limited liability companies and limited liability partnerships, and corporations—that operate under a trade name to file a **fictitious business name statement** (or **certificate of trade name**) with the appropriate government agency. The statement must contain the name and address of the applicant, the trade name, and the address of the business. Most states also require notice of the trade name to be published in a newspaper of general circulation serving the area in which the applicant does business.

These requirements are intended to disclose the real owner's name to the public. Noncompliance can result in a fine. Some states prohibit violators from maintaining lawsuits in the state's courts.

Personal Liability of a Sole Proprietor

unlimited personal liability of a sole proprietor
The personal liability of a sole proprietor for all the debts and obligations of a sole proprietorship.

A sole proprietor bears the risk of loss of the business; that is, the owner will lose his or her entire capital contribution if the business fails. In addition, the sole proprietor has **unlimited personal liability** (see **Exhibit 14.1**). Therefore, creditors may recover claims against the business from the sole proprietors' personal assets (e.g., home, automobile, bank accounts).

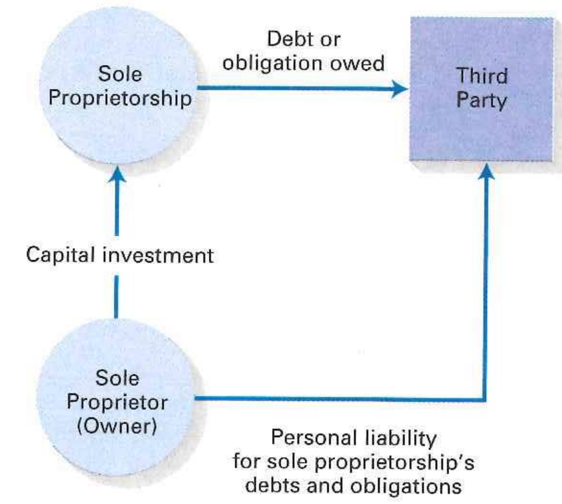


Exhibit 14.1 SOLE PROPRIETORSHIP

Example Nathan opens a clothing store called "The Clothing Store" and operates it as a sole proprietorship. Nathan files the proper statement and publishes the necessary notice of the use of the trade name. Nathan contributes $25,000 of his personal funds to the business and borrows $100,000 from a bank in the name of the business. After several months, Nathan closes the business because it is unsuccessful. At the time it is closed, the business has no assets, owes the bank $100,000, and owes other debts of $25,000. Nathan, the sole proprietor, is personally liable to pay the bank and all the debts of the sole proprietorship from his personal assets.

In the following case, the court had to decide the liability of a sole proprietor.

CASE 14.1 *STATE COURT CASE Sole Proprietorship*

Bank of America, N.A. v. Barr

9 A.3d 816, 2010 Me. Lexis 130 (2010)
Supreme Judicial Court of Maine

"An individual doing business as a sole proprietor, even when business is done under a different name, remains personally liable for all of the obligations of the sole proprietorship."

—Alexander, Judge

Facts

Constance Barr was the sole owner of The Stone Scone, a business operated as a sole proprietorship. Based on documents signed by Barr on behalf of The Stone Scone, Fleet Bank approved a $100,000 unsecured small business line of credit for The Stone Scone. Fleet Bank sent a letter addressed to Barr and The Stone Scone, which stated, "Dear Constance H Barr: Congratulations! Your company has been approved for a $100000 Small Business Credit Express Line of Credit." The bank sent account statements addressed to both The Stone Scone and Barr. For four years, Fleet Bank provided funds to The Stone Scone. After that time, however, The Stone Scone did not make any further payments on the loan,

(continued)

leaving $91,444 unpaid principal. Bank of America, N.A., which had acquired Fleet Bank, sued The Stone Scone and Barr to recover the unpaid principal and interest. Barr stipulated to a judgment against The Stone Scone, which she had converted to a limited liability company, but denied personal responsibility for the unpaid debt. The trial court found Barr personally liable for the debt. Barr appealed.

Issue

Is Barr, the sole owner of The Stone Scone, personally liable for the unpaid debt?

Language of the Court

The trial record contains sufficient evidence that Barr is personally liable for the debt owed to Bank of America. The evidence demonstrates that, at the time Barr acted on The Stone Scone's behalf to procure the small business line of credit, she was the owner of The Stone Scone and the sole proprietor of that business. An individual doing business as a sole proprietor, even when business is done under a different name, remains personally liable for all of the obligations of the sole proprietorship. As the sole proprietor of The Stone Scone when that sole proprietorship entered into the agreement for a line of credit with Fleet Bank, Barr became personally liable for the debts incurred on that line of credit account.

Decision

The supreme judicial court affirmed the trial court's judgment that held Barr personally liable, as the sole proprietor of The Stone Scone, for the sole proprietorship's unpaid debt owed to Bank of America.

Ethics Questions

Why are sole proprietors personally liable for the debts of their business? Did Barr act ethically in denying responsibility for The Stone Scone's debts?

Taxation of a Sole Proprietorship

Critical Legal Thinking

What are the benefits of being the owner of a sole proprietorship? What are the detriments?

A sole proprietorship is not a separate legal entity, so it does not pay taxes at the business level. Instead, the earnings and losses from a sole proprietorship are reported on each sole proprietor's personal income tax filing. A sole proprietorship business earns income and pays expenses during the course of operating the business. A sole proprietor has to file tax returns and pay taxes to state and federal governments. For federal income tax purposes, a sole proprietor must prepare a personal income tax **Form 1040 U.S. Individual Income Tax Return** and report the income or loss from the sole proprietorship on his or her personal income tax form. The income or loss from the sole proprietorship is reported on **Schedule C (Profit or Loss from Business)**, which must be attached to the taxpayer's Form 1040.

SMALL BUSINESS

This is the main street of Saint Ignace, Michigan. Small businesses serve local communities across the United States.

General Partnership

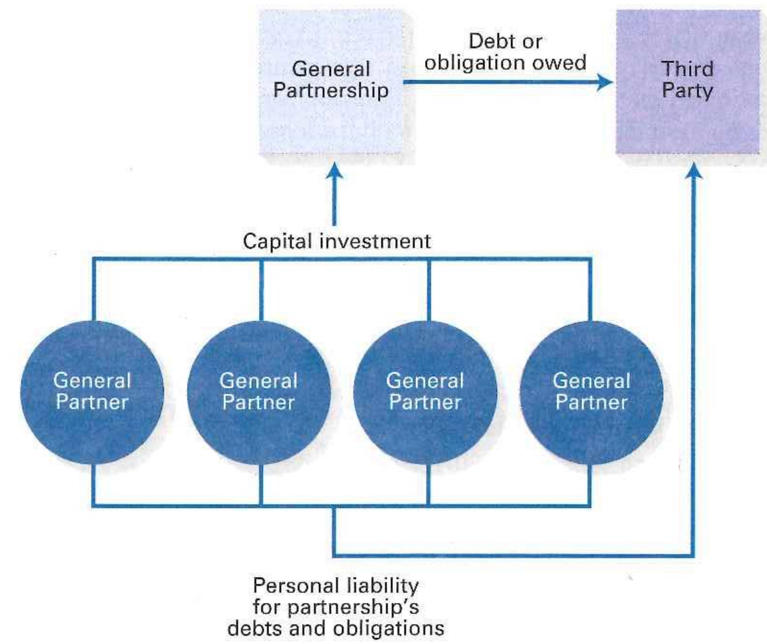
General partnership, or **ordinary partnership**, has been recognized since ancient times. The English common law of partnerships governed early U.S. partnerships. The individual states expanded the body of partnership law.

A general partnership, commonly referred to as a partnership, is a voluntary association of two or more persons for carrying on a business as co-owners for profit. The formation of a general partnership creates certain rights and duties among partners and between the partners and third parties. These rights and duties are established in the partnership agreement and by law. **General partners**, or **partners**, are personally liable for the debts and obligations of the partnership (see **Exhibit 14.2**).

general partnership (ordinary partnership)
An association of two or more persons to carry on as co-owners of a business for profit [UPA Section 6(1)].

general partners of a general partnership
Persons liable for the debts and obligations of a general partnership.

Exhibit 14.2 GENERAL PARTNERSHIP



Uniform Partnership Act

In 1914, the National Conference of Commissioners on Uniform State Laws, which is a group of lawyers, judges, and legal scholars, promulgated the **Uniform Partnership Act (UPA)**. The UPA is a model act that codifies general partnership law. Its goal was to establish consistent partnership law that was uniform throughout the United States. The UPA has been adopted in whole or in part by most states, the District of Columbia, Guam, and the Virgin Islands. A **Revised Uniform Partnership Act (RUPA)** has been issued by the National Conference of Commissioners on Uniform State Laws, but it has not been adopted by many states.

The UPA covers most problems that arise in the formation, operation, and dissolution of general partnerships. Other rules of law or equity govern if there is no applicable provision of the UPA [UPA Section 5]. The UPA forms the basis of the study of general partnerships in this chapter.

Uniform Partnership Act (UPA)
A model act that codifies partnership law. Most states have adopted the UPA in whole or in part.

Formation of a General Partnership

A business must meet four criteria to qualify as a general partnership under the UPA [UPA Section 6(1)]. It must be (1) an association of two or more persons (2) carrying on a business (3) as co-owners (4) for profit. A general partnership is a voluntary association of two or more persons. All partners must agree to the participation of each co-partner. A person cannot be forced to be a partner or to accept another person as a partner. The UPA's definition of *person* who may be a general partner includes natural persons, partnerships (including limited partnerships), corporations, and other associations. A business—a trade, an occupation, or a profession—must be carried on. The organization or venture must have a profit motive in order to qualify as a partnership, even though the business does not actually have to make a profit.

A general partnership may be formed with little or no formality. Co-ownership of a business is essential to create a partnership. The most important factor in determining co-ownership is whether the parties share the business's profits and management responsibility.

Receipt of a share of business profits is *prima facie* evidence of a general partnership because nonpartners usually are not given the right to share in a business's profits. No inference of the existence of a general partnership is drawn if profits are received in payment of (1) a debt owed to a creditor in installments or otherwise; (2) wages owed to an employee; (3) rent owed to a landlord; (4) an annuity owed to a widow, widower, or representative of a deceased partner; (5) interest owed on a loan; or (6) consideration for the sale of goodwill of a business [UPA Section 7]. An agreement to share losses of a business is strong evidence of a general partnership.

A lawyer with his briefcase can steal more than a hundred men with guns.

Mario Puzo
The Godfather

The right to participate in the management of a business is important evidence for determining the existence of a general partnership, but it is not conclusive evidence because the right to participate in management is sometimes given to employees, creditors, and others. It is compelling evidence of the existence of a general partnership if a person is given the right to share in profits, losses, and management of a business.

Name of the General Partnership

It is the privilege of a trader in a free country, in all matters not contrary to law, to regulate his own mode of carrying it on according to his own discretion and choice.

Baron Alderson
Hilton v. Eckersly (1855)

A general partnership can operate under the names of any one or more of the partners or under a fictitious business name. A general partnership must file a fictitious business name statement—d.b.a. (doing business as)—with the appropriate government agency to operate under a trade name. The general partnership usually must publish a notice of the use of the trade name in a newspaper of general circulation where the partnership does business. The name selected by the partnership cannot indicate that it is a corporation (e.g., it cannot contain the term *Inc.*) and cannot be similar to the name used by any existing business entity.

General Partnership Agreement

The agreement to form a general partnership may be oral, written, or implied from the conduct of the parties. It may even be created inadvertently. No formalities are necessary, although a few states require general partnerships to file certificates of partnership with an appropriate government agency. General partnerships that exist for more than one year or are authorized to deal in real estate must have their general partnership agreement in writing under the Statute of Frauds.

It is good practice for partners to put their partnership agreement in writing. A written document is important evidence of the terms of the agreement, particularly if a dispute arises among the partners.

A written agreement is called a **general partnership agreement**, or **articles of general partnership**, or **articles of partnership**. The parties can agree to almost any terms in their partnership agreement, except terms that are illegal. The articles of partnership can be short and simple or long and complex. If an agreement fails to provide for an essential term or contingency, the provisions of the UPA apply. Thus, the UPA acts as a gap-filling device to the partners' agreement.

general partnership agreement (articles of general partnership) (articles of partnership)
A written agreement that partners sign to form a general partnership.

Taxation of General Partnerships

The merchant has no country.

Thomas Jefferson
(1743–1826)

General partnerships do not pay federal income taxes. Instead, the income and losses of partnership flow onto and have to be reported on the individual partners' personal income tax returns. This is called **flow-through taxation**. A general partnership has to file an information return with the government, telling the government how much income was earned or the amount of losses incurred by the partnership. This way, the government tax authorities can trace whether partners are reporting their income or losses correctly.

Right to Participate in Management

In the absence of an agreement to the contrary, all general partners have an equal **right to participate in the management** of the general partnership business. In other words, each partner has one vote, regardless of the proportional size of his or her capital contribution or share in the partnership's profits. Under the UPA, a simple majority decides most ordinary partnership matters [UPA Section 18]. If the vote is tied, the action being voted on is considered to be defeated.

right to participate in management
A situation in which, unless otherwise agreed, each partner has a right to participate in the management of a partnership and has an equal vote on partnership matters.

Example Maude, George, Hillary, and Michael form a general partnership; $200,000 capital is contributed to the partnership in the following amounts: Maude, $60,000 (30 percent); George, $10,000 (5 percent); Hillary, $100,000 (50 percent); and Michael, $30,000 (15 percent). Although the capital contributions of the partners differ significantly, each of the four partners has an equal say in the business. The partners can, by agreement, modify the UPA's majority rule by delegating management responsibility to a committee of partners or to a managing partner.

Right to Share in Profits

Unless otherwise agreed, the UPA mandates that a general partner has the right to an equal share in the partnership's profits and losses [UPA Section 18(a)]. The **right to share in the profits** of the partnership is considered to be the right to share in the earnings from the investment of capital.

right to share in profits
Unless otherwise agreed, the UPA mandates that a general partner has the right to an equal share in the partnership's profits and losses.

Example Maude, George, Hillary, and Michael form a general partnership. Capital is contributed to the partnership in the following amounts: Maude, 30 percent; George, 5 percent; Hillary, 50 percent; and Michael, 15 percent. The partnership makes $100,000 profit for the year. Although the capital contributions of the partners differ significantly, each of the four partners share equally in the profits of the business—each receives $25,000.

Where a partnership agreement provides for the sharing of profits but is silent as to how losses are to be shared, losses are shared in the same proportion as profits. The reverse is not true, however. If a partnership agreement provides for the sharing of losses but is silent as to how profits are to be shared, profits are shared equally.

It has been uniformly laid down in this Court, as far back as we can remember, that good faith is the basis of all mercantile transactions.

Justice Buller
Salomons v. Nissen (1788)

Partnership agreements can provide that profits and losses are to be allocated in proportion to the partners' capital contributions or in any other manner.

Example Partners with high incomes from other sources can benefit the most by having the losses generated by a partnership allocated in a greater portion to them.

Right to an Accounting

General partners are not permitted to sue the partnership or other partners at law. Instead, they are given the right to bring an **action for an accounting** against other partners. An action for an accounting is a formal judicial proceeding in which the court is authorized to (1) review the partnership and the partners' transactions and (2) award each partner his or her share of the partnership assets

action for an accounting
A formal judicial proceeding in which the court is authorized to (1) review the partnership and the partners' transactions and (2) award each partner his or her share of the partnership assets.

[UPA Section 24]. An action results in a money judgment for or against partners, according to the balance struck.

Example If a partner suspects that another partner is committing fraud by stealing partnership assets, the partner can bring an action for an accounting.

Liability of General Partners of a General Partnership

General partners must deal with third parties in conducting partnership business. This often includes entering into contracts with third parties on behalf of the partnership. Partners, employees, and agents of the partnership sometimes injure third parties while conducting partnership business. Partners of a general partnership have **personal liability** for the contracts and torts of the partnership. Contract and tort liability of general partnerships and their partners are discussed in the following paragraphs.

Tort Liability of General Partners

While acting on partnership business, a partner or an employee of the general partnership may commit a tort that causes injury to a third person. This tort could be caused by a negligent act, a breach of trust (e.g., embezzlement from a customer's account), breach of fiduciary duty, defamation, fraud, or another intentional tort. The general partnership is liable if the act is committed while the person is acting within the ordinary course of partnership business or with the authority of his or her co-partners. General partners have **unlimited personal liability** for the debts and obligations of the partnership.

unlimited personal liability of a general partner
A general partner's personal liability for the debts and obligations of the general partnership.

Under the UPA, general partners have **joint and several liability** for torts and breaches of trust [UPA Section 15(a)]. This is so even if a partner did not participate in the commission of the act. This type of liability permits a third party to sue one or more of the general partners separately. Judgment can be collected only against the partners who are sued.

joint and several liability
Tort liability of partners together and individually. A plaintiff can sue one or more partners separately. If successful, the plaintiff can recover the entire amount of the judgment from any or all of the defendant-partners who have been found liable.

Example Nicole, Jim, and Maureen form a general partnership. Jim, while on partnership business, causes an automobile accident that injures Catherine, a pedestrian. Catherine suffers $100,000 in injuries. Catherine, at her option, can sue Nicole, Jim, or Maureen separately, or any two of them, or all of them.

The partnership and partners who are made to pay **tort liability** may seek indemnification from the partner who committed the wrongful act. A release of one partner does not discharge the liability of other partners.

Contract Liability of General Partners

As a legal entity, a general partnership must act through its agents—that is, its partners and employees. Contracts entered into with suppliers, customers, lenders, or others on the partnership's behalf are binding on the partnership. General partners have *unlimited personal liability* for contracts of the partnership.

Under the UPA, general partners have **joint liability** for the contracts and debts of the partnership [UPA Section 15(b)]. This means that a third party who sues to recover on a partnership contract or debt must name all the general partners in the lawsuit. If such a lawsuit is successful, the plaintiff can collect the entire amount of the judgment against any or all of the partners. If the third party's suit does not name all the general partners, the judgment cannot be collected against any of the partners or the partnership assets. Similarly, releasing any general partner from the lawsuit releases them all. Some states provide that general partners are *jointly and severally liable* for the contracts of the general partnership.

joint liability
Liability of partners for contracts and debts of the partnership. A plaintiff must name the partnership and all of the partners as defendants in a lawsuit.

A general partner who is made to pay more than his or her proportionate share of **contract liability** may seek indemnification from the partnership and from those partners who have not paid their share of the loss.

Liability of Incoming Partners

A new partner who is admitted to a general partnership is liable for the existing debts and obligations (**antecedent debts**) of the partnership only to the extent of his or her capital contribution. The **incoming partner** is personally liable for debts and obligations incurred by the general partnership after becoming a partner.

Critical Legal Thinking
Why are general partners liable for the obligations of the partnership? How do *joint and several liability* and *joint liability* differ?

Example Bubble.com is a general partnership with four partners. On May 1, Frederick is admitted as a new general partner by investing a $100,000 capital contribution. As of May 1, Bubble.com owes $800,000 of preexisting debt. After Frederick becomes a partner, the general partnership borrows $1 million of new debt. If the general partnership goes bankrupt and out of business still owing both debts, Frederick's capital contribution of $100,000 will go toward paying the $800,000 of existing debt owed by the partnership when he joined the partnership, but he is not personally liable for this debt. However, Frederick is personally liable for the $1 million of unpaid debt that the partnership borrowed after he became a partner.

Dissolution of a General Partnership

The duration of a partnership can be a fixed term (e.g., five years) or until a particular undertaking is accomplished (e.g., until a real estate development is completed), or it can be an unspecified term. A partnership with a fixed duration is called a **partnership for a term**. A partnership with no fixed duration is called a **partnership at will**.

The **dissolution of a general partnership** is "the change in the relation of the partners caused by any partner ceasing to be associated in the carrying on of the business" [UPA Section 29]. A partnership that is formed for a specific time (e.g., five years) or purpose (e.g., the completion of a real estate development) dissolves automatically on the expiration of the time or the accomplishment of the objective. Any partner of a partnership at will (i.e., one without a stated time or purpose) may rightfully withdraw and dissolve the partnership at any time.

dissolution of a general partnership
The change in the relationship of partners in a partnership caused by any partner ceasing to be associated in the carrying on of the business.

Unless a partnership is continued, the **winding up** of the partnership follows its dissolution. The process of winding up consists of the liquidation (sale) of partnership assets and the distribution of the proceeds to satisfy claims against the partnership. The surviving partners have the right to wind up the partnership. If a surviving partner performs the winding up, he or she is entitled to reasonable compensation for his or her services [UPA Section 18(f)].

winding up
The process of liquidating a partnership's assets and distributing the proceeds to satisfy claims against the partnership.

Wrongful Dissolution

A partner has the *power* to withdraw and dissolve the partnership at any time, whether it is a partnership at will or a partnership for a term. A partner who withdraws from a partnership at will has the *right* to do so and is therefore not liable for dissolving the partnership. A partner who withdraws from a partnership for a term prior to the expiration of the term does not have the right to dissolve the partnership. The partner's action causes a **wrongful dissolution** of the partnership. The partner is liable for damages caused by the wrongful dissolution of the partnership.

wrongful dissolution
A situation in which a partner withdraws from a partnership without having the right to do so at that time.

Example Ashley, Vivi, Qixia, and Tina form a general partnership called "Down-Scale Partnership" to operate an upscale men's clothing store. The partnership has a stated term of five years. After one year, Ashley decides to quit the partnership.

Because Ashley has the *power* to quit the partnership, the four-partner partnership dissolves when she does quit. Ashley does not have the *right* to quit the partnership, and her action causes the wrongful dissolution of the partnership. She is liable for any damages caused by her wrongful dissolution of the partnership.

Distribution of Assets On Dissolution

After partnership assets have been liquidated and reduced to cash, the proceeds are distributed to satisfy claims against the partnership. The debts are satisfied in the following order [UPA Section 40(b)]:

1. Creditors (except partners who are creditors)
2. Creditor-partners
3. Capital contributions
4. Profits

Fraud is infinite in variety; sometimes it is audacious and unblushing; sometimes it pays a sort of homage to virtue, and then it is modest and retiring; it would be honesty itself, if it could only afford it.

Lord MacNaghten
Reddaway v. Banham (1896)

The partners can agree to change the priority of distributions among themselves. If the partnership cannot satisfy its creditors' claims, the partners are personally liable for the partnership's debts and obligations [UPA Sections 40(d), 40(f)]. After the proceeds are distributed, the partnership automatically terminates. Termination ends the legal existence of the partnership [UPA Section 30].

Continuation of a General Partnership After Dissolution

The surviving, or remaining, partners have the right to continue a partnership after its dissolution. It is good practice for the partners of a partnership to enter into a **continuation agreement** that expressly sets forth the events that allow for continuation of the partnership, the amount to be paid outgoing partners, and other details.

When a partnership is continued, the old partnership is dissolved, and a new partnership is created. The new partnership is composed of the remaining partners and any new partners admitted to the partnership. The creditors of the old partnership become creditors of the new partnership and have equal status with the creditors of the new partnership [UPA Section 41].

The following feature discusses an important partnership issue: right of survivorship.

Business Environment

Right of Survivorship of General Partners

A general partner is a co-owner with the other partners of the specific partnership property as a **tenant in partnership**. This is a special legal status that exists in a general partnership. On the death of a general partner, the deceased partner's right in specific partnership property vests in the remaining partner or partners; it does not pass to his or her heirs or next of kin. This is called the **right of survivorship**. The *value* of the deceased general partner's interest in the partnership passes to his or her beneficiaries or heirs on his or her death, however. On the death of the last surviving partner, the rights in specific partnership property vest in the deceased partner's legal representative.

Example Jennifer, Harold, Shou-Ju, and Jesus form a general partnership to operate a new restaurant. After their first restaurant is successful, they expand until the partnership owns 100 restaurants. At that time, Jennifer dies. None of the partnership assets transfer to Jennifer's heirs. For example, her heirs do not get 25 of the restaurants. Instead, under the right of survivorship, they inherit Jennifer's **ownership interest**, and her heirs now have the right to receive Jennifer's one-quarter of the partnership's profits and other partnership distributions.

Liability of Outgoing Partners

The dissolution of a **general partnership** does not, of itself, discharge the liability of an **outgoing partner** for existing partnership debts and obligations. If a general partnership is dissolved, each general partner is personally liable for debts and obligations of the partnership that exist at the time of dissolution.

If a general partnership is dissolved because a general partner leaves the partnership and the partnership is continued by the remaining partners, the outgoing partner is personally liable for the debts and obligations of the partnership at the time of dissolution. The outgoing partner is not liable for any new debts and obligations incurred by the general partnership after the dissolution, as long as proper notification of his or her withdrawal from the partnership has been given to the creditor(s).

right of survivorship
A rule providing that, on the death of a general partner, the deceased partner's right in specific partnership property vests in the remaining partner or partners; the value of the deceased general partner's interest in the partnership passes to his or her beneficiaries or heirs.

LIMITED PARTNERSHIP
Many businesses operate as limited partnerships. Limited partnerships have both general partners and limited partners, whose rights, duties, and liabilities differ.

Limited Partnership

Today, all states have enacted statutes that provide for the creation of limited partnerships. In most states, these partnerships are called **limited partnerships** or **special partnerships**. Limited partnerships are used for business ventures such as investing in real estate, drilling oil and gas wells, movie productions, and the like.

A limited partnership, or special partnership, has two types of partners: (1) **general partners**, who invest capital, manage the business, and are personally liable for partnership debts, and (2) **limited partners**, who invest capital but do not participate in management and are not personally liable for partnership debts beyond their capital contributions (see **Exhibit 14.3**).

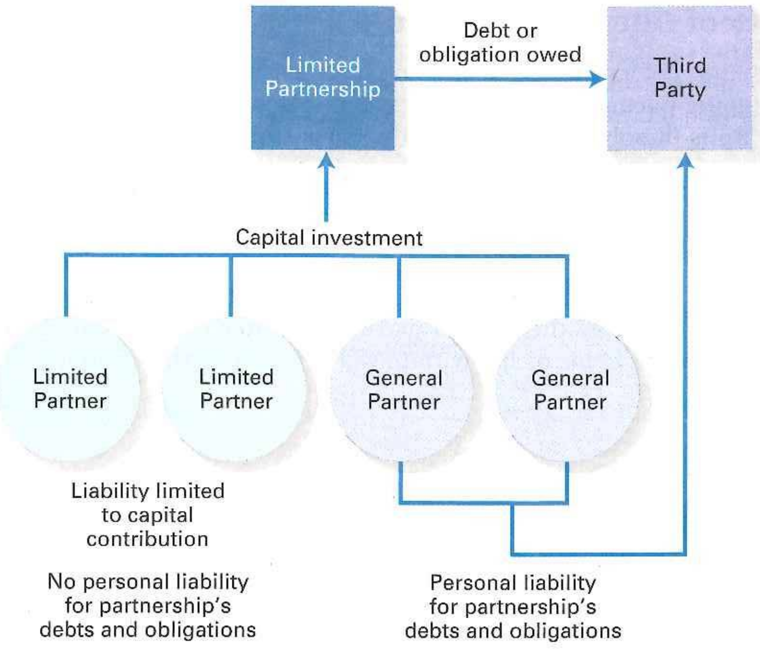
A limited partnership must have one or more general partners and one or more limited partners [RULPA Section 101(7)]. There are no upper limits on the number of general or limited partners allowed in a limited partnership. Any

limited partnership
A type of partnership that has two types of partners: (1) general partners and (2) limited partners.

general partners of a limited partnership
Partners in a limited partnership who invest capital, manage the business, and are personally liable for partnership debts.

limited partners
Partners in a limited partnership who invest capital but do not participate in management and are not personally liable for partnership debts beyond their capital contributions.

Exhibit 14.3 LIMITED PARTNERSHIP



person—including natural persons, partnerships, limited partnerships, trusts, estates, associations, and corporations—may be a general or limited partner. A person may be both a general partner and a limited partner in the same limited partnership.

Revised Uniform Limited Partnership Act

In 1916, the National Conference of Commissioners on Uniform State Laws (NCCUSL), a group of lawyers, judges, and legal scholars, promulgated the **Uniform Limited Partnership Act (ULPA)**. The ULPA contains a uniform set of provisions for the formation, operation, and dissolution of limited partnerships. Most states originally enacted this law.

In 1976, the National Conference of Commissioners on Uniform State Laws promulgated the **Revised Uniform Limited Partnership Act (RULPA)**, which provides a more modern, comprehensive law for the formation, operation, and dissolution of limited partnerships. This law supersedes the ULPA in the states that have adopted it. The RULPA provides the basic foundation for the discussion of limited partnership law in the following paragraphs. In 2001, certain amendments were made to the RULPA. The changes made by these amendments are discussed in this chapter.

Revised Uniform Limited Partnership Act (RULPA)
A revision of the ULPA that provides a comprehensive law for the formation, operation, and dissolution of limited partnerships.

Formation of a Limited Partnership

The creation of a limited partnership is formal and requires public disclosure. The entity must comply with the statutory requirements of the RULPA or other state statutes. Under the RULPA, two or more persons must execute and sign a **certificate of limited partnership** [RULPA Sections 201, 206]. The certificate must contain the following information:

- Name of the limited partnership.
- General character of the business.
- Address of the principal place of business and name and address of the agent to receive service of legal process.
- Name and business address of each general and limited partner.
- Latest date on which the limited partnership is to dissolve.

certificate of limited partnership
A document that two or more persons must execute and sign and that makes a limited partnership legal and binding.

- Amount of cash, property, or services (and description of property or services) contributed by each partner and any contributions of cash, property, or services promised to be made in the future.
- Any other matters that the general partners determine should be included.

The certificate of limited partnership must be filed with the secretary of state of the appropriate state and, if required by state law, with the county recorder in the county or counties in which the limited partnership carries on its business. The limited partnership is formed when the certificate of limited partnership is filed. The certificate of limited partnership may be amended to reflect the addition or withdrawal of a partner and other matters [RULPA Section 202(a)].

Under the RULPA, the law of the state in which the limited partnership is organized governs the partnership, its internal affairs, and the liability of its limited partners [RULPA Section 901].

Defective Formation

Defective formation occurs when (1) a certificate of limited partnership is not properly filed, (2) there are defects in a certificate that is filed, or (3) some other statutory requirement for the creation of a limited partnership is not met. If there is a substantial defect in the creation of a limited partnership, persons who thought they were limited partners can find themselves liable as general partners.

Partners who erroneously but in good faith believe they have become limited partners can escape liability as general partners by either (1) causing the appropriate certificate of limited partnership (or certificate of amendment) to be filed or (2) withdrawing from any future equity participation in the enterprise and causing a certificate showing this withdrawal to be filed. The limited partner remains liable to any third party who transacts business with the enterprise before either certificate is filed if the third person believed in good faith that the partner was a general partner at the time of the transaction [RULPA Section 304].

defective formation
Incorrect creation of a limited partnership that occurs when (1) a certificate of limited partnership is not properly filed, (2) there are defects in a certificate that is filed, or (3) some other statutory requirement for the creation of a limited partnership is not met.

Limited Partnership Agreement

Although not required by law, the partners of a limited partnership often draft and execute a **limited partnership agreement** (also called the **articles of limited partnership**) that sets forth the rights and duties of the general and limited partners; the terms and conditions regarding the operations, termination, and dissolution of the partnership; and so on. Where there is no such agreement, the certificate of limited partnership serves as the articles of limited partnership.

It is good practice to establish voting rights in a limited partnership agreement or certificate of limited partnership. The limited partnership agreement can state which transactions must be approved by which partners (i.e., general, limited, or both). General and limited partners may be given unequal voting rights.

A limited partnership agreement may specify how profits and losses from the limited partnership are to be allocated among the general and limited partners. If there is no such agreement, the RULPA provides that profits and losses from a limited partnership are shared on the basis of the value of each partner's capital contribution [RULPA Section 503].

limited partnership agreement (articles of limited partnership)
A document that sets forth the rights and duties of general and limited partners; the terms and conditions regarding the operation, termination, and dissolution of a partnership; and so on.

Example Four general partners each contribute $50,000 in capital to the limited partnership; four limited partners each contribute $200,000 capital. The total amount of contributed capital is $1 million. The limited partnership agreement does not stipulate how profits and losses are to be allocated. Assume that the limited partnership makes $3 million in profits. Under the RULPA, each general partner would receive $150,000 in profit, and each limited partner would receive $600,000 in profit.

Liability of General and Limited Partners of a Limited Partnership

It is the spirit and not the form of law that keeps justice alive.

Earl Warren
The Law and the Future (1955)

General partners and limited partners of a limited partnership have different degrees of liability, depending on the circumstances. The liability of general and limited partners is discussed in the following paragraphs.

Liability of General Partners

unlimited liability of general partners of a limited partnership
General partners are personally liable for the debts and obligations of a limited partnership.

The general partners of a limited partnership have **unlimited liability** for the debts and obligations of the limited partnerships. Thus, general partners have unlimited personal liability for the debts and obligations of the limited partnership. This liability extends to debts that cannot be satisfied with the existing capital of the limited partnership.

The RULPA permits a corporation or limited liability company to be a general partner or the sole general partner of a limited partnership. Where this is permissible, this type of general partner is liable for the debts and obligations of the limited partnership only to the extent of its capital contribution to the partnership.

Liability of Limited Partners

limited liability of limited partners of a limited partnership
Limited partners are liable only for the debts and obligations of a limited partnership up to their capital contribution; they are not personally liable for the debts and obligations of a limited partnership.

Generally, limited partners have **limited liability** for the debts and obligations of the limited partnership. Limited partners are liable only for the debts and obligations of the limited partnership up to their capital contributions, and they are not personally liable for the debts and obligations of the limited partnership.

Example Gertrude and Gerald are the general partners of a limited partnership called Real Estate Development, Ltd. They each invest $50,000 in the limited partnership. Lin, Leopold, Lonnie, and Lawrence are limited partners of the limited partnership and each invest $50,000 in the limited partnership. Real Estate Development, Ltd., borrows $2 million from City Bank. After two years, the limited partnership has spent all of its capital, has no assets, and goes bankrupt, still owing City Bank $2 million of unpaid debt. In this case, the four limited partners each lose their $50,000 capital investment but are not personally liable for the $2 million debt owed by the limited partnership to City Bank. The two general partners each lose their $50,000 investment and are each personally liable to City Bank for the limited partnership's unpaid $2 million loan to City Bank.

Liability on a Personal Guarantee

Four things belong to a judge: to hear courteously, to answer wisely, to consider soberly, and to decide impartially.

Socrates (470 BCE–399 BCE)

On some occasions, when limited partnerships apply for an extension of credit from a bank, a supplier, or another creditor, the creditor will not make the loan based on the limited partnership's credit history or ability to repay the credit. The creditor may require a limited partner to guarantee the repayment of the loan personally in order to extend credit to the limited partnership. If a limited partner personally guarantees a loan made by a creditor to the limited partnership and the limited partnership defaults on the loan, the creditor may enforce the **personal guarantee** and recover payment from the limited partner who personally guaranteed the repayment of the loan.

Management of a Limited Partnership

Critical Legal Thinking

What are the benefits of being a general partner of a limited partnership? What are the detriments?

Under partnership law, general partners have the right to manage the affairs of the limited partnership. On the other hand, as a trade-off for limited liability, limited partners give up their right to participate in the control and management of the limited partnership. This means, in part, that limited partners have no right to bind the partnership to contracts or other obligations.

Under the RULPA, a limited partner is liable as a general partner if his or her participation in the control of the business is substantially the same as that of a general partner, but the limited partner is liable only to persons who reasonably believed him or her to be a general partner [RULPA Section 303(a)]. This is called the **control rule**.

Critical Legal Thinking

What are the benefits of being a limited partner of a limited partnership? What are the detriments?

Example Laura is an investor and a limited partner in a limited partnership. At some time after she becomes a limited partner, Laura thinks that the general partners are not doing a very good job managing the affairs of the limited partnership, so she participates in the management of the limited partnership. While she is doing so, a bank loans $1 million to the limited partnership, believing that Laura is a general partner because of her involvement in the management of the limited partnership. If the limited partnership defaults on the $1 million loan owed to the bank, Laura will be treated as a general partner and will be held personally liable for the loan, along with the general partners of the limited partnership.

The RULPA permits a limited partner to engage in the management of the partnership's affairs without losing his or her limited liability if the limited partner has been formally hired by the partnership to be an executive of the partnership [RULPA Sections 303(b), 303(c)].

Example The general partners of the limited partnership vote to make Laura, a limited partner, president of the limited partnership. Laura therefore has two distinct relationships with the limited partnership: first as an investor and limited partner, and second as a manager (president) of the limited partnership. In this case, Laura can lawfully participate in the management of the limited partnership without losing the limited liability shield granted by her limited partner status.

The following feature discusses a modern rule of limited partnership.

Business Environment

Modern Rule Permits Limited Partners to Participate in Management

As mentioned previously, the general rule is that limited partners who take part in the management of the affairs of a limited partnership who have not been expressly elected to office to do so lose their limited liability shield and become general partners, and are personally liable for the debts and obligations of the limited partnership.

The 2001 amendments to the RULPA make an important change to the control rule. The new **Section 303 of the RULPA** eliminates this restriction and permits limited partners to participate in the management of a limited partnership without losing their limited liability shield.

The limited liability partnership agreement can permit certain or all limited partners a say in how the partnership's business should be run.

Section 303 places limited partners on par with shareholders of a corporation, members of a limited liability company (LLC), and the partners of a limited liability partnership (LLP) in terms of being able to participate in the management of the entity without becoming personally liable for the debts and obligations of the limited partnership.

States may adopt this change as part of their own limited liability partnership law.

Section 303 of the RULPA
A section that permits limited partners to participate in the management of a limited partnership without losing their limited liability shield.

Dissolution of a Limited Partnership

certificate of cancellation
A document filed with the secretary of state upon the dissolution of a limited partnership.

Just like a general partnership, a limited partnership may be *dissolved* and its affairs wound up. The RULPA establishes rules for the **dissolution of a limited partnership** and the winding up of the partnership. On the dissolution and the commencement of the winding up of a limited partnership, a **certificate of cancellation** must be filed by the limited partnership with the secretary of state of the state in which the limited partnership is organized [RULPA Section 203].

After the assets of a limited partnership have been liquidated, the proceeds must be distributed. The RULPA provides the following order of **distribution of assets of a limited partnership** on the winding up of the partnership [RULPA Section 804]:

1. *Creditors* of the limited partnership, including partners who are creditors (except for liabilities for distributions)
2. *Partners* with respect to:
   a. Unpaid distributions
   b. Capital contributions
   c. The remainder of the proceeds

The partners may provide in the limited partnership agreement for a different distribution among the partners, but the creditors must retain their first priority.

Key Terms and Concepts

Action for an accounting (317)
Antecedent debt (319)
Certificate of cancellation (325)
Certificate of limited partnership (322)
Continuation agreement (320)
Contract liability (319)
Control rule (325)
d.b.a. (doing business as) (312)
Defective formation (323)
Dissolution of a general partnership (319)
Dissolution of a limited partnership (325)
Distribution of assets of a general partnership (321)
Distribution of assets of a limited partnership (326)
Entrepreneur (311)
Fictitious business name statement (certificate of trade name) (312)
Flow-through taxation (317)
Form 1040 U.S. Individual Income Tax Return (314)
General partner of a general partnership (ordinary partner) (315)
General partner of a limited partnership (321)
General partnership (ordinary partnership) (315)
General partnership agreement (articles of general partnership) (articles of partnership) (316)
Incoming partner (319)
Joint and several liability (318)
Joint liability (318)
Limited liability of limited partners (324)
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Limited partnership (special partnership) (321)
Limited partnership agreement (articles of limited partnership) (323)
Outgoing partner (321)
Ownership interest (320)
Partnership at will (319)
Partnership for a term (319)
Personal guarantee (324)
Personal liability (318)
Revised Uniform Limited Partnership Act (RULPA) (322)
Revised Uniform Partnership Act (RUPA) (315)
Right of survivorship (320)
Right to participate in management (317)
Right to share in profits (317)
Schedule C (Profit or Loss from Business) (314)
Section 303 of the RULPA (325)
Sole proprietor (312)
Sole proprietorship (312)
Tenant in partnership (320)
Tort liability (318)
Trade name (312)
Uniform Limited Partnership Act (ULPA) (322)
Uniform Partnership Act (UPA) (315)
Unlimited personal liability (324)
Unlimited personal liability of a general partner (318)
Unlimited personal liability of a sole proprietor (313)
Winding up (319)
Wrongful dissolution (319)

Law Case with Answer

Edward A. Kemmler Memorial Foundation v. Mitchell

Facts Clifford W. Davis and Dr. William D. Mitchell formed a general partnership to purchase and operate rental properties for investment purposes. The general partnership purchased a parcel of real property from the Edward A. Kemmler Memorial Foundation (Foundation) on credit. Davis signed a $150,000 promissory note to the Foundation as "Cliff W. Davis, Partner." Prior to executing the note, Davis and Mitchell entered into an agreement between themselves that provided that only Davis, and not Mitchell, would be personally liable on the note to Foundation. They did not inform Foundation of this side agreement, however. When the partnership defaulted on the note, Foundation sued the partnership and both partners to recover on the note. Mitchell asserted in defense that the agreement with Davis relieved him of personal liability. Foundation argued that Mitchell, as a general partner, was personally liable on the note and that the Davis–Mitchell side agreement did not change Mitchell's personal liability to pay the note. Is Mitchell jointly liable on the note owed to Foundation?

Answer Yes, Mitchell is jointly liable—personally liable—on the partnership note owed to Foundation. Every general partner is an agent of a general partnership for the purpose of carrying on its business. The act of every partner, including the execution in the partnership name of any contract or instrument, binds the partnership, unless the partner so acting has in fact no authority to act for the partnership in the particular matter. Here, Davis had the authority as a general partner and bound the partnership when he signed a $150,000 promissory note to Foundation as "Cliff W. Davis, Partner."

If a promissory note is executed in the name of the partnership, the partnership is bound unless a contradictory agreement between the partners is known to the parties with whom they are dealing. The side agreement between Davis and Mitchell, the two general partners, which relieved Mitchell of any personal liability for the promissory note, was not effective against Foundation, which had not agreed to such restriction on Mitchell's liability. Because Foundation had no knowledge of the agreement between Davis and Mitchell regarding Mitchell's liability for the note, Mitchell cannot avoid personal liability as a general partner on the promissory note owed to Foundation. The partnership is liable to Foundation for the unpaid note, and the two general partners, Davis and Mitchell, are jointly liable—personally liable—on the note owed to Foundation. *Edward A. Kemmler Memorial Foundation v. Mitchell*, 584 N.E.2d 695, 1992 Ohio Lexis 205 (Supreme Court of Ohio)

Critical Legal Thinking Cases

14.1 Sole Proprietorship James Schuster was a sole proprietor doing business as (d.b.a.) "Diversity Heating and Plumbing" (Diversity Heating). Diversity Heating was in the business of selling, installing, and servicing heating and plumbing systems. George Vernon and others (Vernon) owned a building that needed a new boiler. Vernon hired Diversity Heating to install a new boiler in the building. Diversity Heating installed the boiler and gave a warranty that the boiler would not crack for 10 years. Four years later, James Schuster died. On that date, James's son, Jerry Schuster, inherited his father's business and thereafter ran the business as a sole proprietorship d.b.a. "Diversity Heating and Plumbing." One year later, the boiler installed in Vernon's building broke and could not be repaired. Vernon demanded that Jerry Schuster honor the warranty and replace the boiler. When Jerry Schuster refused to do so, Vernon had the boiler replaced at a cost of $8,203 and sued Jerry Schuster to recover this amount for breach of warranty. Jerry Schuster argued that he was a sole proprietor and as such he was not liable for the business obligations his father had incurred while operating his own sole proprietorship.

Is Jerry Schuster liable for the warranty made by his father? *Vernon v. Schuster, d/b/a/ Diversity Heating and Plumbing*, 688 N.E.2d 1172, 1997 Ill. Lexis 482 (Supreme Court of Illinois)

14.2 Liability of General Partners Jose Pena and Joseph Antenucci were medical doctors who were partners in a medical practice. Both doctors treated Elaine Zuckerman during her pregnancy. Her son, Daniel Zuckerman, was born with severe physical problems. Elaine, as Daniel's mother and natural guardian, brought a medical malpractice suit against both doctors. The jury found that Pena was guilty of medical malpractice but that Antenucci was not. The amount of the verdict totaled $4 million. The trial court entered judgment against Pena but not against Antenucci. Plaintiff Zuckerman made a post-trial motion for judgment against both defendants.

Is Antenucci jointly and severally liable for the medical malpractice of his partner, Pena? *Zuckerman v. Antenucci*, 478 N.Y.S.2d 578, 1984 N.Y. Misc. Lexis 3283 (Supreme Court of New York)

14.3 Tort Liability Thomas McGrath was a partner in the law firm Tarbenson, Thatcher, McGrath, Treadwell & Schoonmaker. One day, at approximately 4:30 P.M., McGrath went to a restaurant–cocktail establishment in Kirkland, Washington. From that time until about 11:00 P.M., he imbibed considerable alcohol while socializing and discussing personal and firm-related business. After 11:00 P.M., McGrath did not discuss firm business but continued to socialize and drink until approximately 1:45 A.M., when he and Fredrick Hayes, another bar patron, exchanged words. Shortly thereafter, the two encountered each other outside and, after another exchange, McGrath shot Hayes. Hayes sued McGrath and the law firm for damages.

Who is liable? *Hayes v. Tarbenson, Thatcher, McGrath, Treadwell & Schoonmaker*, 749 P.2d 178, Web 1988 Wash. App. Lexis 27 (Court of Appeals of Washington)

14.4 Liability of Limited Partners Virginia Partners, Ltd. (Virginia Partners), a limited partnership organized under the laws of Florida, conducted business in Kentucky but failed to register as a foreign limited partnership, as required by Kentucky law. Robert Day was tortiously injured in Garrard County, Kentucky, by a negligent act of Virginia Partners. At the time of the accident, Day was a bystander observing acid being injected into an abandoned oil well by Virginia Partners. The injury occurred when a polyvinyl chloride (PVC) valve failed, causing a hose to rupture from its fitting and spray nitric acid on Day, severely injuring him. Day sued Virginia Partners and its limited partners to recover damages.

Are the limited partners liable? *Virginia Partners, Ltd. v. Day*, 738 S.W.2d 837, 1987 Ky. App. Lexis 564 (Court of Appeals of Kentucky)

14.5 Liability of Partners Raugust-Mathwig, Inc., a corporation, was the sole general partner of a limited partnership. Calvin Raugust was the major shareholder of this corporation. The three limited partners were Cal-Lee Trust; W.J. Mathwig, Inc.; and W.J. Mathwig, Inc., and Associates. All three of the limited partners were valid corporate entities. Although the limited partnership agreement was never executed and a certificate of limited partnership was not filed with the state, the parties opened a bank account and began conducting business.

John Molander, an architect, entered into an agreement with the limited partnership to design a condominium complex and professional office building to be located in Spokane, Washington. The contract was signed on behalf of the limited partnership by its corporate general partner. Molander provided substantial architectural services to the partnership, but neither project was completed because of a lack of financing. Molander sued the limited partnership, its corporate general partner, the corporate limited partners, and Calvin Raugust individually to recover payments allegedly due him.

Against whom can Molander recover? *Molander v. Raugust-Mathwig, Inc.*, 722 P.2d 103, 1986 Wash. App. Lexis 2992 (Court of Appeals of Washington)

Ethical

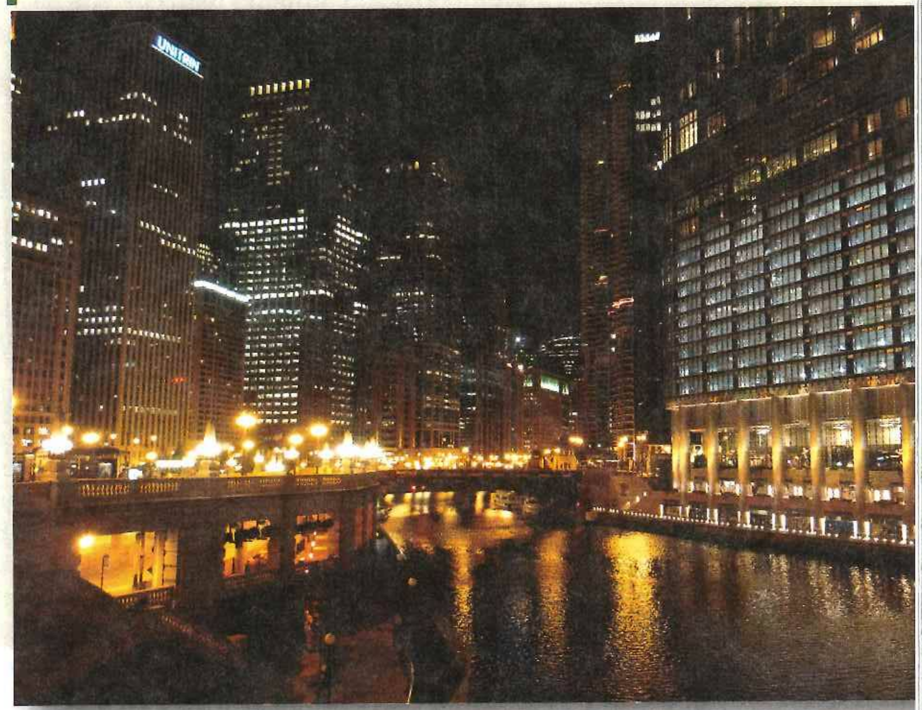
Ethics Case

14.6 Ethics Case Robert K. Powers and Lee M. Solomon were among other limited partners of the Cosmopolitan Chinook Hotel (Cosmopolitan), a limited partnership. Cosmopolitan entered into a contract to lease and purchase neon signs from Dwinell's Central Neon (Dwinell's). The contract identified Cosmopolitan as a "partnership" and was signed on behalf of the partnership, "R. Powers, President." At the time the contract was entered into, Cosmopolitan had taken no steps to file its certificate of limited partnership with the state, as required by limited partnership law. The certificate was not filed with the state until several months after the contract was signed. When Cosmopolitan defaulted on payments due under the contract, Dwinell's sued Cosmopolitan and its general and limited partners to recover damages. *Dwinell's Central Neon v. Cosmopolitan Chinook Hotel*, 587 P.2d 191, 1978 Wash. App. Lexis 2735 (Court of Appeals of Washington)

1. What is a defective formation of a limited partnership?
2. Did the limited partners act ethically in denying liability on the contract?
3. Are the limited partners liable?

CHAPTER 15

Limited Liability Companies, Limited Liability Partnerships, and Special Forms of Business



CHICAGO
Many businesses operate as limited liability companies (LLCs), and many professionals operate their businesses as limited liability partnerships (LLPs). These forms of business provide limited liability to their owners.

Learning Objectives

After studying this chapter, you should be able to:

1. Define *limited liability company (LLC)* and describe the benefits of an LLC.
2. Define *limited liability partnership (LLP)* and describe the benefits of an LLP.
3. Define *franchise* and describe the various forms of franchises.
4. Define *licensing* and describe how intellectual property and software are licensed.
5. Describe special forms of business, such as joint ventures and strategic alliances.

Chapter Outline

"Justice is the end of government. It is the end of civil society. It ever has been, and ever will be pursued, until it be obtained, or until liberty be lost in the pursuit."

—James Madison
The Federalist, No. 51 (1788)

Introduction to Limited Liability Companies, Limited Liability Partnerships, and Special Forms of Business

Owners may choose to operate a business as a *limited liability company (LLC)*. The use of LLCs as a form of conducting business in the United States is of rather recent origin. In 1977, Wyoming was the first state in the United States to enact legislation creating an LLC as a legal form for conducting business. The evolution of LLCs then grew at blinding speed, with all the states having enacted LLC statutes by 1998. Most LLC laws are quite similar, although some differences do exist among these state statutes.

Most states have enacted laws that permit certain types of professionals, such as accountants, lawyers, and doctors, to operate as *limited liability partnerships (LLPs)*. The owners of an LLP have limited liability for debts and obligations of the partnership.

Franchising is an important method for distributing goods and services to the public. Franchises—such as Coca-Cola, McDonald's, and KFC—operate domestically and around the world. *Licensing* permits one business to use another business's trademarks, service marks, trade names, and other intellectual property in selling goods, services, and software.

There shall be one law for the native and for the stranger who sojourns among you.

Moses
Exodus 12:49

Several forms of business are used to conduct global business. In particular, these include *international franchising*, *joint ventures*, and *strategic alliances*. Multinational corporations conduct business worldwide.

This chapter discusses LLCs, LLPs, franchises, licensing, joint ventures, and strategic alliances, which are used to conduct business domestically and globally.

Limited Liability Company

A *limited liability company (LLC)* is an unincorporated business entity that combines the most favorable attributes of general partnerships, limited partnerships, and corporations. An LLC may elect to be taxed as a partnership, the owners can manage the business, and the owners have limited liability for debts and obligations of the partnership. Many entrepreneurs who begin new businesses choose the LLC as their legal form for conducting business.

limited liability company (LLC)
An unincorporated business entity that combines the most favorable attributes of general partnerships, limited partnerships, and corporations.

member
An owner of an LLC.

Limited liability companies (LLCs) are creatures of state law, not federal law. An LLC can only be created pursuant to the laws of the state in which the LLC is being organized. These statutes, commonly referred to as **limited liability company codes**, regulate the formation, operation, and dissolution of LLCs. The owners of LLCs are usually called **members** (some states refer to owners of LLCs as *shareholders*).

An LLC is a separate *legal entity* (or legal person), distinct from its members [ULLCA Section 201]. LLCs are treated as artificial persons who can sue or be sued, enter into and enforce contracts, hold title to and transfer property, and be found civilly and criminally liable for violations of law.

Uniform Limited Liability Company Act

In 1996, the National Conference of Commissioners on Uniform State Laws (a group of lawyers, judges, and legal scholars) issued the **Uniform Limited Liability Company Act (ULLCA)**. The ULLCA codifies LLC law. Its goal is to establish comprehensive LLC law that is uniform throughout the United States. The ULLCA covers most problems that arise in the formation, operation, and termination of LLCs. The ULLCA is not law unless a state adopts it as its LLC statute. The ULLCA was revised in 2006, and this revision is called the **Revised Uniform Limited Liability Company Act (RULLCA)**. Many states have adopted all or part of the ULLCA or the RULLCA as their LLC law.

Uniform Limited Liability Company Act (ULLCA)
A model act that provides comprehensive and uniform laws for the formation, operation, and dissolution of LLCs.

Revised Uniform Limited Liability Company Act (RULLCA)
A revision of the ULLCA.

Taxation of LLCs

Under the Internal Revenue Code and regulations adopted by the Internal Revenue Service (IRS) for federal income tax purposes, an LLC is taxed as a partnership unless it elects to be taxed as a corporation. Thus, an LLC is not taxed at the entity level, but its income or losses flow through to the members' individual income tax returns in a process called **flow-through taxation**. This avoids double taxation. Most LLCs accept the default status of being taxed as a partnership instead of electing to be taxed as a corporation.

Formation of an LLC

Under the ULLCA, an LLC may be organized by one or more persons. Some states require at least two members to organize an LLC. In states where an LLC may be organized by only one member, sole proprietors can obtain the benefit of the limited liability shield of an LLC.

An LLC can be organized in only one state, even though it can conduct business in all other states. When choosing a state for organization, the members should consider the LLC codes of the states under consideration. For the sake of convenience, most LLCs, particularly small ones, choose as the state of organization the state in which the LLC will be doing most of its business.

The minute you read something that you can't understand, you can almost be sure that it was drawn up by a lawyer.

Will Rogers

When starting a new LLC, the organizers must choose a name for the entity. The name must contain the words *limited liability company* or *limited company* or the abbreviation *L.L.C.*, *LLC*, *L.C.*, or *LC*. *Limited* may be abbreviated as *Ltd.*, and *company* may be abbreviated as *Co.* [ULLCA Section 105(a)].

Articles of Organization

Because LLCs are creatures of statute, certain formalities must be taken and statutory requirements must be met to form an LLC.

An LLC is formed by delivering **articles of organization** to the office of the secretary of state of the state of organization for filing. If the articles are in proper form, the secretary of state will file the articles. The existence of an LLC begins when the articles of organization are filed. The filing of the articles of organization by the secretary of state is conclusive proof that the organizers have satisfied all the conditions necessary to create the LLC [ULLCA Section 202]. Under the ULLCA, the articles of organization of an LLC must set forth [ULLCA Section 203]:

articles of organization
The formal documents that must be filed at the secretary of state's office of the state of organization of an LLC to form the LLC.

WEB EXERCISE
Go to **http://form.sunbiz.org/pdf/cr2e047.pdf** and read the information and forms necessary to form a Florida limited liability company.

- The name of the LLC
- The address of the LLC's initial office
- The name and address of the initial agent for service of process
- The name and address of each organizer
- Whether the LLC is a term LLC and, if so, the term specified

- Whether the LLC is to be a manager-managed LLC and, if so, the name and address of each manager
- Whether one or more of the members of the LLC are to be personally liable for the LLC's debts and obligations

The articles of organization may set forth provisions from the members' operating agreement and any other matter not inconsistent with law. An LLC can amend its articles of organization at any time by filing **articles of amendment** with the secretary of state [ULLCA Section 204].

The LLC is a **domestic LLC** in the state in which it is organized. The LLC law of the state governs the operation of the LLC. An LLC may do business in other states, however. To do so, the LLC must register as a **foreign LLC** in any state in which it wants to conduct business.

Operating Agreement

operating agreement
An agreement entered into among members that governs the affairs and business of the LLC and the relations among members, managers, and the LLC.

Members of an LLC may enter into an **operating agreement** that regulates the affairs of the company and the conduct of its business, and governs relations among the members, managers, and company [ULLCA Section 103(a)]. The operating agreement may be amended by the approval of all members unless otherwise provided in the agreement. The operating agreement and amendments may be oral but are usually written.

certificate of interest
A document that demonstrates evidence of a member's ownership interest in an LLC.

An LLC's operating agreement may provide that a member's ownership interest may be evidenced by a **certificate of interest** issued by the LLC [ULLCA Section 501(c)]. The certificate of interest acts the same as a stock certificate issued by a corporation.

Unless otherwise agreed, the ULLCA mandates that a member has the right to an equal share in the LLC's profits [ULLCA Section 405(a)]. This is a default rule that the members can override by agreement and is usually a provision in their operating agreement.

Examples Lilly and Harrison form an LLC. Lilly contributes $75,000 capital, and Harrison contributes $25,000 capital. They do not have an agreement as to how profits are to be shared. If the LLC makes $100,000 in profits, under the ULLCA, Lilly and Harrison will share the profits equally—$50,000 each. To avoid this outcome, Lilly and Harrison should agree in their operating agreement how they want the profits to be divided.

Losses from an LLC are shared equally unless otherwise agreed. Profits and losses from an LLC do not have to be distributed in the same proportion.

Example A member who has the right to a 10 percent share of profits may be given in the operating agreement the right to receive 25 percent of the LLC's losses.

Distributional Interest

distributional interest
A member's ownership interest in an LLC that entitles the member to receive distributions of money and property from the LLC.

A member's ownership interest in an LLC is called a **distributional interest**. A member's distributional interest in an LLC is personal property and may be transferred in whole or in part [ULLCA Section 501(b)]. Unless otherwise provided in the operating agreement, a transfer of an interest in an LLC does not entitle the transferee to become a member of the LLC or to exercise any right of a member. A transfer entitles the transferee to receive only distributions from the LLC to which the transferor would have been entitled [ULLCA Section 502]. A transferee of a distributional interest becomes a member of the LLC if it is so provided in the operating agreement or if all the other members of the LLC consent [ULLCA Section 503(a)].

Limited Liability of Members of an LLC

The great can protect themselves, but the poor and humble require the arm and shield of the law.

Andrew Jackson (1767–1845)
Seventh President of the United States

In the course of conducting business, the agents and employees of an LLC may enter into contracts on behalf of the LLC. Sometimes, however, the LLC may not perform these contracts. In addition, the agents or employees of an LLC may be engaged in accidents or otherwise cause harm to third parties when acting on LLC business. These third parties—whether in contract disputes or tort disputes—will look to be compensated for their loss or injuries. The following paragraphs discuss the liability of the LLC, its members, and its managers.

Liability of an LLC

An LLC is liable for any loss or injury caused to anyone as a result of a wrongful act or omission by a member, a manager, an agent, or an employee of the LLC who commits the wrongful act while acting within the ordinary course of business of the LLC or with authority of the LLC [ULLCA Section 302].

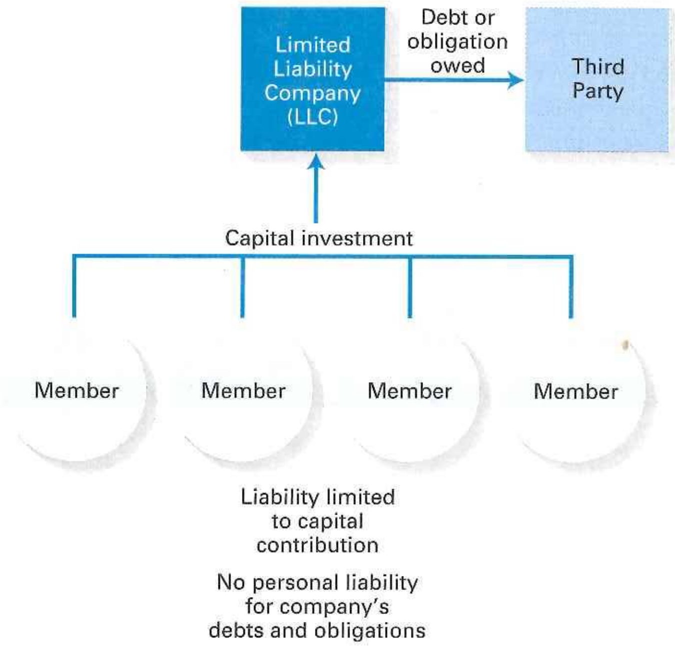
Example Sable, Silvia, and Samantha form SSS, LLC, to own and operate a business. Each member contributes $10,000 capital. While on LLC business, Sable drives her automobile and accidentally hits and injures Damon. Damon can recover damages for his injuries from Sable personally because she committed the negligent act. Damon can also recover damages from SSS, LLC, because Sable was acting within the scope of the ordinary business of the LLC when the accident occurred. Silvia and Samantha have limited liability only up to their capital contributions in SSS, LLC.

Members' Limited Liability

limited liability of members of LLCs
The liability of LLC members for the LLC's debts, obligations, and liabilities is limited to the extent of their capital contributions. Members of LLCs are not personally liable for the LLC's debts, obligations, and liabilities.

The general rule is that members of an LLC are not personally liable to third parties for the debts, obligations, and liabilities of an LLC beyond their capital contribution. Members have **limited liability** (see **Exhibit 15.1**). The debts, obligations, and liabilities of an LLC, whether arising from contracts, torts, or otherwise, are solely those of the LLC [ULLCA Section 303(a)].

Exhibit 15.1 LIMITED LIABILITY COMPANY (LLC)



Whatever the human law may be, neither an individual nor a nation can commit the least act of injustice against the obscurest individual without having to pay the penalty for it.

Henry David Thoreau (1817–1862)

Example Jasmin, Shou-Yi, and Vanessa form an LLC, and each contributes $25,000 in capital. The LLC operates for a period of time, during which it borrows money from banks and purchases goods on credit from suppliers. After some time, the LLC experiences financial difficulty and goes out of business. If the LLC fails with $500,000 in debts, each of the members will lose her capital contribution of $25,000 but will not be personally liable for the rest of the unpaid debts of the LLC.

In the following case, the court addressed the issue of the limited liability of a member of an LLC.

CASE 15.1 *STATE COURT CASE Limited Liability Company*

Siva v. 1138 LLC

2007 Ohio App. Lexis 4202 (2007)
Court of Appeals of Ohio

"Finally, the evidence did not show that Siva was misguided as to the fact he was dealing with a limited liability company."

—Brown, Judge

Facts

Five members—Richard Hess, Robert Haines, Lisa Hess, Nathan Hess, and Zack Shahin—formed a limited liability company called 1138 LLC. Ruthiran Siva owned a commercial building located at 1138 Bethel Road, Franklin County, Ohio. Siva entered into a written lease agreement with 1138 LLC whereby 1138 LLC leased premises in Siva's commercial building for a term of five years at a monthly rental of $4,000; 1138 LLC began operating a bar on the premises. Six months later, 1138 LLC was in default and breach of the lease agreement. Siva sued 1138 LLC and Richard Hess to recover damages. Siva received a default judgment against 1138 LLC, but there was no money in 1138 LLC to pay the judgment. Hess, who had been sued personally, defended, arguing that as a member-owner of the LLC, he was not personally liable for the debts of the LLC. The trial court found in favor of Hess and dismissed Siva's complaint against Hess. Siva appealed.

Issue

Is Richard Hess, a member-owner of 1138 LLC, personally liable for the debt owed by the LLC to Siva?

Language of the Court

Based upon the evidence presented, a reasonable trier of fact could have concluded that 1138 LLC became insolvent due to unprofitable operations. Moreover, even if the record suggests poor business judgment by Hess, it does not demonstrate that he formed 1138 LLC to defraud creditors. Finally, the evidence did not show that Siva was misguided as to the fact he was dealing with a limited liability company. Siva's counsel drafted the lease agreement and Siva acknowledged at trial he did not ask any of the owners of 1138 LLC to sign the lease in an individual capacity.

Decision

The court of appeals held that Hess, as a member-owner of 1138 LLC, was not personally liable for the debt that the LLC owed to Siva. The court of appeals affirmed the decision of the trial court that dismissed Siva's complaint against Hess.

Ethics Questions

Did Hess owe an ethical duty to pay the debt owed by 1138 LLC to Siva? Did Siva act ethically by suing Hess personally to recover the debt owed by the 1138 LLC?

Liability of Managers

Managers of LLCs are not personally liable for the debts, obligations, and liabilities of the LLC they manage [ULLCA Section 303(a)].

Example An LLC that is engaged in real estate development hires Sarah Goldstein, a nonmember, to be its president. Sarah, while acting within the scope of her LLC authority, signs a loan agreement whereby the LLC borrows

$1 million from a bank for the construction of an office building. If the LLC subsequently suffers financial difficulty and defaults on the bank loan, Sarah is not personally responsible for the loan. The LLC is liable for the loan, but Sarah is not because she was acting as the manager of the LLC.

Liability of Tortfeasors

A person who intentionally or unintentionally (negligently) causes injury or death to another person is called a **tortfeasor**. A tortfeasor is personally liable to persons he or she injures and to the heirs of persons who die because of his or her conduct. This rule applies to members and managers of LLCs. Thus, if a member or a manager of an LLC negligently causes injury or death to another person, he or she is personally liable to the injured person or the heirs of the deceased person.

tortfeasor
A person who intentionally or unintentionally (negligently) causes injury or death to another person. A person liable to persons he or she injures and to the heirs of persons who die because of his or her conduct.

Management of an LLC

An LLC can be either a *member-managed LLC* or a *manager-managed LLC*. An LLC is a member-managed LLC unless it is designated as a manager-managed LLC in its articles of organization [ULLCA Section 203(a) (b)]. The distinctions between these two are as follows:

- **Member-managed LLC.** In this type of LLC, the members of the LLC have the right to manage the LLC.
- **Manager-managed LLC.** In this type of LLC, the members designate a manager or managers to manage the LLC and, by doing so, they delegate their management rights to the manager or managers. Designated manager or managers have the authority to manage the LLC, and the members no longer have the right to manage the LLC.

A **manager of an LCC** may be a member of an LLC or a nonmember. Whether an LLC is a member-managed or manager-managed LLC has important consequences on the right to bind the LLC to contracts and on determining the fiduciary duties owed by members to the LLC. These important distinctions are discussed in the paragraphs that follow.

Member-Managed LLC

In a **member-managed LLC**, each member has equal rights in the management of the business of the LLC, regardless of the size of his or her capital contribution. Any matter relating to the business of the LLC is decided by a majority vote of the members [ULLCA Section 404(a)].

member-managed LLC
An LLC that has not been designated as a manager-managed LLC in its articles of organization. The LLC is managed by its members.

Example Allison, Jaeson, Stacy, Lan-Wei, and Ivy form North West.com, LLC. Allison contributes $100,000 capital, and the other four members each contribute $25,000 capital. When deciding whether to add another line of products to the business, Stacy, Lan-Wei, and Ivy vote to add the line, and Allison and Jaeson vote against it. The line of new products is added to the LLC's business because three members voted yes, while two members voted no. It does not matter that the two members who voted no contributed $125,000 in capital collectively versus $75,000 in capital contributed by the three members who voted yes.

Manager-Managed LLC

In a **manager-managed LLC**, the members and nonmembers who are designated managers control the management of the LLC. The members who are not managers have no rights to manage the LLC unless otherwise provided in the operating agreement. In a manager-managed LLC, each manager has equal rights in the management and conduct of the company's business. Any matter related to the business of the LLC may be exclusively decided by the managers by a majority vote of the

manager-managed LLC
An LLC that has designated in its articles of organization that it is a manager-managed LLC. Nonmanager members give their management rights over to designated managers, who manage the LLC.

managers [ULLCA Section 403(b)]. A manager must be appointed by a vote of a majority of the members; managers may also be removed by a vote of the majority of the members [ULLCA Section 404(b)(3)].

Certain actions cannot be delegated to managers but must be voted on by all members of the LLC. These actions include (1) amending the articles of organization; (2) amending the operating agreement; (3) admitting new members; (4) consenting to dissolve the LLC; (5) consenting to merge the LLC with another entity; and (6) selling, leasing, or disposing of all or substantially all of the LLC's property [ULLCA Section 404(c)].

Laws too gentle are seldom obeyed; too severe, seldom executed.

Benjamin Franklin
Poor Richard's Almanack (1756)

CONCEPT SUMMARY

MANAGEMENT OF AN LLC

Type of LLC	Description
Member-managed LLC	The members do not designate managers to manage the LLC. The LLC is managed by its members.
Manager-managed LLC	The members designate certain members or nonmembers to manage the LLC. The LLC is managed by the designated managers; nonmanager members have no right to manage the LLC.

Agency Authority to Bind an LLC to Contracts

The designation of an LLC as member-managed or manager-managed is important in determining who has authority to bind the LLC to contracts. The following rules apply:

- **Member-managed LLC.** In a member-managed LLC, all members have agency authority to bind the LLC to contracts.

  Example If Theresa, Artis, and Yolanda form a member-managed LLC, each one of them can bind the LLC to a contract with a third party such as a supplier, purchaser, or landlord.

- **Manager-managed LLC.** In a manager-managed LLC, the managers have authority to bind the LLC to contracts, but nonmanager members cannot bind the LLC to contracts.

  Example Alexis, Derek, Ashley, and Sadia form an LLC. They designate the LLC as a manager-managed LLC and name Alexis and Ashley as the managers. Alexis, a manager, enters into a contract to purchase goods from a supplier for the LLC. Derek, a nonmanager member, enters into a contract to lease equipment on behalf of the LLC. The LLC is bound to the contract entered into by Alexis, a manager, but it is not bound to the contract entered into by Derek, a nonmanager member.

An LLC is bound to contracts that members or managers have properly entered into on its behalf in the ordinary course of business [ULLCA Section 301].

CONCEPT SUMMARY

AGENCY AUTHORITY TO BIND AN LLC TO CONTRACTS

Type of LLC	Agency Authority
Member-managed LLC	All members have agency authority to bind the LLC to contracts.
Manager-managed LLC	The managers have authority to bind the LLC to contracts; the nonmanager members cannot bind the LLC to contracts.

Duty of Loyalty

A member of a member-managed LLC and a manager of a manager-managed LLC owe a *fiduciary* **duty of loyalty** to the LLC. This means that these parties must act honestly in their dealings with the LLC. The duty of loyalty includes the duty not to usurp the LLC's opportunities, make secret profits, deal with the LLC secretly, compete with the LLC secretly, or represent any interests adverse to those of the LLC [ULLCA Section 409(b)].

duty of loyalty
A duty owed by a member of a member-managed LLC and a manager of a manager-managed LLC to be honest in his or her dealings with the LLC and not to act adversely to the interests of the LLC.

Example Ester, Yi, Maria, and Enrique form the member-managed LLC Big .Business.com, LLC, which conducts online auctions over the Internet. Ester secretly starts a competing business to conduct online auctions over the Internet. Ester is liable for breaching her duty of loyalty to the LLC with Yi, Maria, and Enrique. Ester is liable for any secret profits she made, and her business will be shut down.

Example In the preceding example, suppose that Ester, Yi, Maria, and Enrique designated their LLC as a manager-managed LLC and named Ester and Yi managers. In this case, only the managers owe a duty of loyalty to the LLC, but nonmanager members do not. Therefore, Ester and Yi, the named managers, could not compete with the LLC; Maria and Enrique, nonmanager members, could compete with the LLC without any legal liability.

No Fiduciary Duty Owed

A member of a manager-managed LLC who is not a manager owes no fiduciary duty of loyalty or care to the LLC or its other members [ULLCA Section 409(h)(1)]. Basically, a nonmanager member of a manager-managed LLC is treated equally to a shareholder in a corporation.

Example Felicia is a member of a 30-person manager-managed LLC that is engaged in buying, developing, and selling real estate. Felicia is not a manager of the LLC but is just a member-owner. If a third party approaches Felicia with the opportunity to purchase a large and valuable piece of real estate that is ripe for development, and the price is below fair market value, Felicia owes no duty to offer the opportunity to the LLC. She may purchase the piece of real estate for herself without violating any duty to the LLC.

The following feature compares an LLC to other forms of business and highlights the advantages of an LLC over other forms of business.

Business Environment

Advantages of Operating a Business as an LLC

What are the advantages of operating a business as an LLC rather than a sole proprietorship, general partnership, limited partnership, C corporation, or S corporation? Some of the differences and advantages are as follows:

- An LLC can have any number of member-owners, whereas an S corporation can have only 100 shareholders.
- An LLC has flow-through taxation the same as general and limited partnerships and S corporations. Unlike an S corporation, an LLC does not have to file a form with the IRS to obtain flow-through taxation.
- S corporations cannot have shareholders other than estates, certain trusts, and individuals, whereas an LLC can have these and other types of shareholders such as general and limited partnerships, corporations, and other LLCs.
- An LLC can have nonresident alien member-owners, whereas an S corporation cannot have nonresident aliens as stockholders.
- An S corporation can have only one class of stock, whereas an LLC can have more than one class of interest, thereby permitting a more complex capital structure.

(continued)

- An S corporation may not own more than 80 percent of another corporation, whereas an LLC may own 100 percent of other businesses.
- An S corporation cannot be affiliated with other businesses, whereas an LLC can be part of an affiliated group of businesses.
- Members of LLCs can manage the LLC similarly to general partners, who can manage a general partnership or a limited partnership, whereas shareholders of an S corporation do not have rights to manage the corporation.
- Members of LLCs can manage the business and still have limited liability, whereas the general partners of a general or limited partnership can manage the business of the partnership but do not have limited liability.
- Members of an LLC have limited liability like limited partners of a limited partnership, but unlike limited partners, member-owners of an LLC have a say in management without losing their limited liability.
- A limited partnership must have at least one general partner who is personally liable for the obligations of the partnership. An LLC provides limited liability to all members.
- Similar to corporations having professional management, an LLC can choose to be a manager-managed LLC whereby designated managers manage the affairs of the business. Nonmanager members thereby do not have rights to manage the LLC's business affairs.
- An LLC can be owned by one owner in most states. Therefore, an owner obtains limited liability that is not available to a sole proprietor of a sole proprietorship.
- The formation of an LLC is no more complex than forming a corporation. The formation of an LLC is more complex and costly than forming a sole proprietorship and usually more complex and costly than forming a general partnership and limited partnership.

For these reasons LLCs have become a preferred form of operating businesses in the United States.

Limited Liability Partnership

Critical Legal Thinking

Describe the advantages of operating as an LLC versus operating as a (1) sole proprietorship, (2) general partnership, (3) limited partnership, (4) C corporation, and (5) S corporation.

limited liability partnership (LLP)
A special form of partnership in which all partners are limited partners, and there are no general partners.

Many states have enacted legislation to permit the creation of **limited liability partnerships (LLPs)**. In most states, the law restricts the use of LLPs to certain types of professionals, such as accountants, lawyers, and doctors. Nonprofessionals cannot use the LLP form of partnership.

LLPs are creatures of state law, not federal law. An LLP can only be created pursuant to the laws of the state in which the LLP is being organized. These statutes, commonly referred to as **limited liability partnership codes**, regulate the formation, operation, and dissolution of LLPs. The state legislature may amend its LLP statutes at any time. The courts interpret state LLP statutes to decide LLP and member disputes.

LLPs enjoy the *flow-through* tax benefit of other types of partnerships; that is, there is no tax paid at the partnership level, and all profits and losses are reported on the individual partners' income tax returns.

Critical Legal Thinking

How does an LLP differ from a general partnership? How does an LLP differ from a limited partnership?

Articles of Limited Liability Partnership

articles of limited liability partnership
The formal documents that must be filed at the secretary of state's office of the state of organization of an LLP to form the LLP.

An LLP is created formally by filing **articles of limited liability partnership** with the secretary of state of the state in which the LLP is organized. This is a public document. The LLP is a **domestic LLP** in the state in which it is organized. The LLP law of the state governs the operation of the LLP. An LLP may do business in other states, however. To do so, the LLP must register as a **foreign LLP** in any state in which it wants to conduct business.

Many state laws require LLPs to carry a minimum of $1 million of liability insurance that covers negligence, wrongful acts, and misconduct by partners or employees of the LLP. This requirement guarantees that injured third parties will have compensation to recover for their injuries and is a quid pro quo for permitting partners to have limited liability.

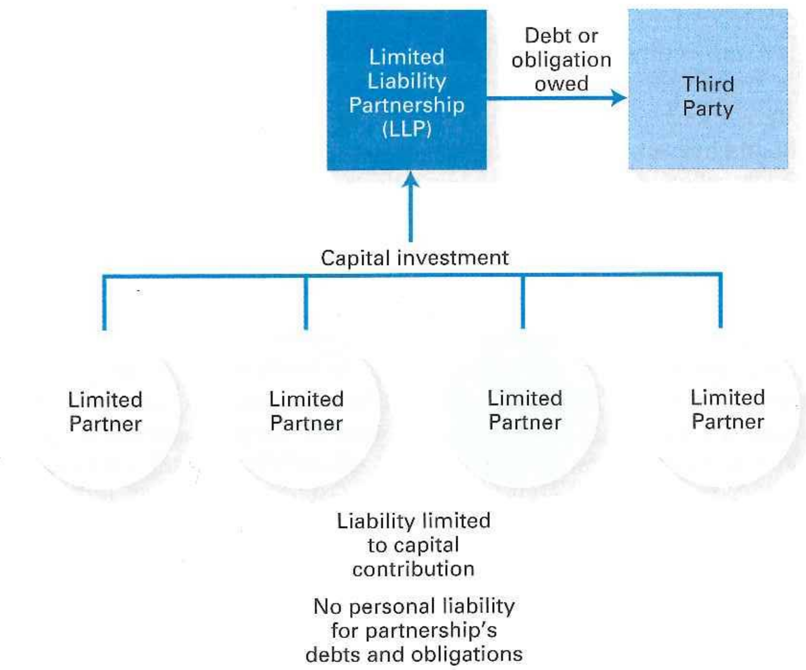
Limited Liability of Partners

limited liability of partners of LLPs
The liability of LLP partners for the LLP's debts, obligations, and liabilities is limited only to the extent of their capital contributions. Partners of LLPs are not personally liable for the LLPs' debts, obligations, and liabilities.

In an LLP, there does not have to be a general partner who is personally liable for the debts and obligations of the partnership. Instead, *all* partners are **limited partners** who have **limited liability** and stand to lose only their capital contribution if the partnership fails. None of the partners is personally liable for the debts

and obligations of the partnership beyond his or her capital contribution (see **Exhibit 15.2**).

Exhibit 15.2 LIMITED LIABILITY PARTNERSHIP (LLP)



Example Suppose Shou-Yi, Patricia, Ricardo, and Namira, all lawyers, form an LLP called Shou-Yi, Namira LLP to provide legal services. While providing legal services to the LLP's client Multi Motors, Inc., Patricia commits legal malpractice (negligence). This malpractice causes Multi Motors, Inc., a huge financial loss. In this case, Multi Motors, Inc., can sue and recover against Patricia, the negligent party, and against Shou-Yi, Namira LLP. Shou-Yi, Ricardo, and Namira can lose their capital contribution in Shou-Yi, Namira LLP but are not personally liable for the damages caused to Multi Motors, Inc. Patricia is personally liable to Multi Motors, Inc., because she was the negligent party.

The following feature discusses how important the LLP form of business is to accounting firms.

Business Environment

Accounting Firms Operate as LLPs

Prior to the advent of the limited liability partnership (LLP) form of doing business, accounting firms operated as general partnerships. As such, the general partners were personally liable for the debts and obligations of the general partnership. Many lawsuits were brought against accountants in conjunction with the failure of corporations, banks, and other firms that accountants had audited. Many of these firms failed because of fraud by their major owners and officers. The shareholders and creditors of these failed companies sued the auditors, alleging that the auditors had been negligent in not catching the fraud.

To address this issue, state legislatures created a new form of business, the LLP. This entity was particularly created for accountants, lawyers, and other professionals to offer their services under an umbrella of limited liability. The partners of an LLP have limited liability up to their capital contribution; the partners do not have personal liability for the debts and liabilities of the LLP, however.

Once LLPs were permitted by law, many accounting firms organized as LLPs. Many law firms operate as LLPs.

Franchise

franchise
An arrangement whereby one party (the *franchisor*) licenses another party (the *franchisee*) to use the franchisor's intellectual property and business model in the distribution of goods and services.

franchisor (licensor)
The party who grants the franchise and license to a franchisee in a franchise arrangement.

A **franchise** is established when one party (the **franchisor**, or **licensor**) licenses another party (the **franchisee**, or **licensee**) to use the franchisor's trade name, trademarks, commercial symbols, patents, copyrights, and business model in the distribution and selling of goods and services. Generally, the franchisor and the franchisee are established as separate corporations. The term *franchise* refers to both the agreement between the parties and the franchise outlet.

Franchising has several advantages. For example, the franchisor can reach lucrative new markets, the franchisee has access to the franchisor's knowledge and resources while running an independent business, and consumers are assured of uniform product quality.

A typical franchise arrangement is illustrated in **Exhibit 15.3**.

Exhibit 15.3 FRANCHISE ARRANGEMENT

Types of Franchises

franchisee (licensee)
The party who is granted the franchise and license by a franchisor in a franchise arrangement.

There are four basic forms of franchises: (1) *distributorship franchise*, (2) *processing plant franchise*, (3) *chain-style franchise*, and (4) *area franchise*. They are discussed in the following list.

distributorship franchise
A franchisor manufactures a product and licenses a franchisee to distribute the product to the public.

- **Distributorship franchise.** In a **distributorship franchise**, the franchisor manufactures a product and licenses a retail dealer to distribute a product to the public.

  Example Ford Motor Company manufactures automobiles and franchises independently owned automobile dealers (franchisees) to sell them to the public.

processing plant franchise
A franchisor provides a secret formula or process to the franchisee and the franchisee manufactures the product and distributes it to retail dealers.

- **Processing plant franchise.** In a **processing plant franchise**, the franchisor provides a secret formula, or the like, to the franchisee. The franchisee then manufactures the product at its own location and distributes it to retail dealers.

  Example The Coca-Cola Corporation, which owns the secret formulas for making Coca-Cola and other soft drinks, sells syrup concentrate to regional bottling companies, who add water and sweeteners and produce and distribute soft drinks under the Coca-Cola name and other brand names.

chain-style franchise
A franchisor licenses a franchisee to make and sell its products or distribute its services to the public from a retail outlet serving an exclusive territory.

- **Chain-style franchise.** In a **chain-style franchise**, the franchisor licenses the franchisee to make and sell its products or services to the public from a retail outlet serving an exclusive geographical territory. The product is made or the service is provided by the franchise. Most fast-food franchises use this form.

  Example The Pizza Hut Corporation franchises independently owned restaurant franchises to make and sell pizzas to the public under the Pizza Hut name.

area franchise
A franchisor authorizes a franchisee to negotiate and sell franchises on its behalf in designated areas. The area franchisee is called a *subfranchisor*.

- **Area franchise.** In an **area franchise**, the franchisor authorizes the franchisee to negotiate and sell franchises on behalf of the franchisor. The area franchisee is called a **subfranchisor**. An area franchise is granted for a certain designated geographical area, such as a state, a region, or another agreed-upon area. Area franchises are often used when a franchisor wants to enter a market in another country.

  Example If Starbucks wanted to enter a foreign country to operate its coffee shops, it could grant an area franchise to a foreign company operating in the foreign country, which would then choose the individual franchisees in that country.

Franchise Agreement

franchise agreement
An agreement that a franchisor and franchisee enter into that sets forth the terms and conditions of a franchise.

A prospective franchisee must apply to the franchisor for a franchise. The **franchise application** often includes detailed information about the applicant's previous employment, financial and educational history, and credit status. If an applicant is approved, the parties enter into a **franchise agreement** that sets forth the terms and conditions of the franchise. Franchise agreements do not usually have much room for negotiation. Generally, the agreement is a standard-form contract prepared by the franchisor. Most states require franchise agreements to be in writing.

A franchisor's ability to maintain the public's perception of the quality of the goods and services associated with its trade name, **trademarks**, and **service marks** is the essence of its success. Most franchisors license the use of their trade names, trademarks, and service marks to their franchisees.

Franchisors are often owners of **trade secrets**, including product formulas, business plans and models, and other ideas. Franchisors license and disclose many of their trade secrets to franchisees.

Example The formula for the Coca-Cola soft drink is a highly protected trade secret.

The following feature discusses international franchising.

Global Law

International Franchising

SEOUL, SOUTH KOREA
This is a franchise restaurant in Seoul, South Korea. The global market offers opportunities for U.S. franchisors to expand their businesses worldwide. Foreign franchisees have knowledge about the cultural and business traditions of their markets, as well as connections in the foreign country. International franchising also provides an opportunity for foreign franchisors to offer franchise opportunities in the United States and around the world.

WEB EXERCISE
Go to **www.aboutmcdonalds.com/mcd/franchising/international_franchising_information.html** and read about McDonald's international franchising opportunities. Select a country, click "Go," and find information about obtaining a McDonald's franchise in that country.

Liability of Franchisors and Franchisees

If a franchise is properly organized and operated, the franchisor and franchisee are separate legal entities. Therefore, the franchisor deals with the franchisee as an *independent contractor*. Franchisees are liable on their own contracts and are liable for their own torts (e.g., negligence). Franchisors are liable for their own contracts and torts. Generally, neither party is liable for the contracts or torts of the other.

Example Suppose that McDonald's Corporation, a fast-food restaurant franchisor, grants a restaurant franchise to Tina Corporation. Tina Corporation opens the franchise restaurant. One day, a customer at the franchise spills a chocolate shake on the floor. The employees at the franchise fail to clean up the spilled shake, and one hour later, another customer slips on the spilled shake and suffers severe injuries. The injured customer can recover damages from the franchisee, Tina Corporation, because it was negligent. It cannot recover damages from the franchisor, McDonald's Corporation.

Critical Legal Thinking
What is the public policy that supports the general rule that franchisors are not liable for the torts of a franchisee? Is this rule fair?

Example Suppose that, in the preceding example, McDonald's Corporation, the franchisor, grants a franchise to Gion Corporation, the franchisee. McDonald's Corporation enters into a loan agreement with City Bank, whereby it borrows $100 million. Gion Corporation, the franchisee, is not liable on the loan. McDonald's Corporation, the franchisor and debtor, is liable on the loan.

In the following case, the court had to decide whether a franchisor was liable for a franchisee's tort.

CASE 15.2 *STATE COURT CASE Franchise Liability*

Rainey v. Domino's Pizza, LLC

998 A.2d 342, 2010 Me. Lexis 56 (2010)
Supreme Judicial Court of Maine

"In evaluating the requisite level of control, courts commonly distinguish between control over a franchisee's day-to-day operations and controls designed primarily to insure uniformity and the standardization of products and services."

—Jabar, Judge

Facts

Domino's Pizza, LLC, is a franchisor that grants franchises to independent contractors who own and operate pizza restaurants under the Domino's Pizza name. Domino's granted a franchise to TDBO, Inc., to operate a franchise restaurant in Gorham, Maine. The relationship between Domino's Pizza and TDBO was governed by a franchise agreement. Under the agreement, Domino's established quality-control, marketing, and operational standards and had the right to receive royalty payments from TDBO. TDBO owned its own equipment, purchased supplies from sources licensed by Domino's, maintained its own records and bank accounts, hired and determined the wages of employees, and established the prices of its products. The agreement expressly stated that TDBO was an independent contractor and that Domino's was not liable for TDBO's debts and obligations.

Edward Langen was an employee of TDBO. Paul Rainey, while riding his motorcycle, was seriously injured in a collision with a car driven by Langen, who was delivering a pizza for his employer TDBO. Rainey sued Langen, TDBO, and Domino's, alleging negligence and vicarious liability. Domino's moved for summary judgment on the negligence and vicarious liability counts. The trial court granted Domino's motion for summary judgment, finding that Domino's was not vicariously liable for its franchisee's negligence. Rainey appealed this judgment.

Issue

Under the facts of this case, can Domino's be held vicariously liable for the alleged negligence of its franchisee TDBO?

Language of the Court

In distinguishing between employees and independent contractors, we consider several factors, the most important of which is the "right to control." In evaluating the requisite level of control, courts commonly distinguish between control over a franchisee's day-to-day operations and controls designed primarily to insure uniformity and the standardization of products and services.

We now turn to the instant case. Based on our review of the agreement, we conclude that, although the quality control requirements and minimum operational standards are numerous, these controls fall short of reserving control over the performance of TDBO's day-to-day operations. In the end, the quality, marketing, and operational standards present in the agreement do not establish the supervisory control or right of control necessary to impose vicarious liability.

Decision

The appellate court found that Domino's is not vicariously liable for the alleged negligence of its franchisee TDBO and affirmed the trial court's grant of summary judgment in favor of Domino's.

Ethics Questions

Did Domino's breach its duty of ethics by denying liability in this case? What would the consequences be if franchisors were held liable for the negligence of their franchisees?

Licensing

licensing
A business arrangement that occurs when the owner of intellectual property (the *licensor*) contracts to permit another party (the *licensee*) to use the intellectual property.

licensor
The party who grants a license.

licensee
The party to whom a license is granted.

Licensing is an important business arrangement in both domestic and international markets. **Licensing** occurs when one business or party that owns trademarks, service marks, trade names, and other intellectual property (the **licensor**) contracts to permit another business or party (the **licensee**) to use its trademarks, service marks, trade names, and other intellectual property in the distribution of goods, services, software, and digital information. This is called a **license**. A licensing arrangement is illustrated in **Exhibit 15.4**.

Exhibit 15.4 LICENSING ARRANGEMENT

Example The Walt Disney Company owns the merchandising rights to Winnie the Pooh stories and all the characters associated with the Winnie the Pooh stories. The Walt Disney Company enters into an agreement whereby it permits the Beijing Merchandising Company, a business formed under Chinese law, to manufacture and distribute a line of clothing, children's toys, and other items bearing the likeness of the Winnie the Pooh characters. This is a license. The Walt Disney Company is the licensor, and the Beijing Merchandising Company is the licensee.

Joint Venture

joint venture
An arrangement in which two or more business entities combine their resources to pursue a single project or transaction.

A **joint venture** is an arrangement in which two or more business entities combine their resources to pursue a single project or transaction. The parties to a joint venture are called **joint venturers**. Joint ventures resemble partnerships, except that partnerships are usually formed to pursue ongoing business operations rather than to focus on a single project or transaction. Unless otherwise agreed, joint venturers have equal rights to manage a joint venture. Joint venturers owe each other the fiduciary duties of loyalty and care. If a joint venturer violates these duties, it is liable for the damages the breach causes.

If a joint venture is operated as a *partnership*, then each joint venturer is considered a partner of the joint venture. This is called a **joint venture partnership**. In a joint venture partnership, each joint venturer is liable for the debts and obligations of the joint venture partnership.

joint venture corporation
A corporation owned by two or more joint venturers that is created to operate a joint venture.

In pursuing a joint venture, many joint venturers form a corporation to operate the joint venture. This is called a **joint venture corporation**. The joint venturers are shareholders of the joint venture corporation. The joint venture corporation is liable for its debts and obligations. The joint venturers are liable for the debts and obligations of the joint venture corporation only up to their capital contributions to the joint venture corporation.

If you have ten thousand regulations, you destroy all respect for the law.
Winston Churchill
(1874–1965)
Prime Minister of the United Kingdom

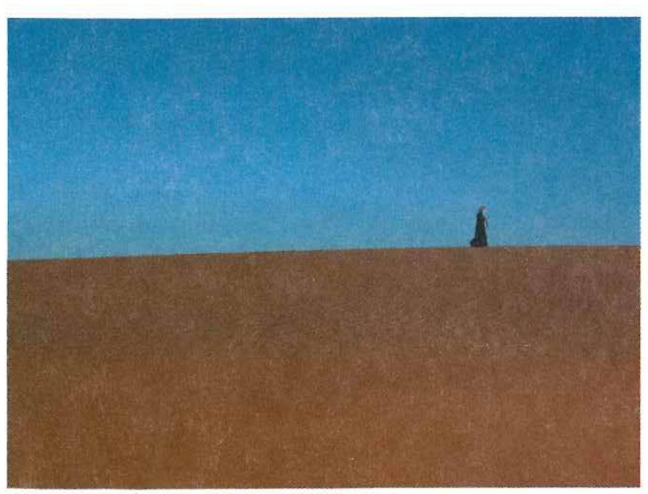
Example Suppose that ChevronTexaco Corporation and ConocoPhillips Corporation form a third corporation, called Canadian Imperial Corporation, to operate a joint venture. ChevronTexaco and ConocoPhillips each contribute \$100 million capital to Canadian Imperial Corporation, and each becomes a shareholder of Canadian Imperial Corporation. If the joint venture fails and Canadian Imperial Corporation owes \$1 billion to its creditors, which it cannot pay, ChevronTexaco and ConocoPhillips each lose their \$100 million capital contributions but are not liable for any further unpaid debts or obligations of Canadian Imperial Corporation.

strategic alliance
An arrangement between two or more companies whereby they agree to ally themselves and work together to accomplish a designated objective.

The following feature discusses international strategic alliances.

Global Law

International Strategic Alliances



SAUDI ARABIA
*A **strategic alliance** is an arrangement between two or more companies whereby they agree to ally themselves and work together to accomplish a designated objective. A strategic alliance allows the companies to reduce risks, share costs, combine technologies, and extend their markets. For example, companies often enter into strategic alliances when they decide to expand internationally into foreign countries. Strategic alliances are often used to conduct international business.*

Key Terms and Concepts

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Articles of amendment (332)
Articles of limited liability partnership (338)
Articles of organization (331)
Certificate of interest (332)
Chain-style franchise (340)
Distributional interest (332)
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Law Case with Answer

Creative Resource Management, Inc. v. Soskin

Facts Nashville Pro Hockey, LLC, was a limited liability company organized under the laws of Tennessee. The LLC owned and operated the Nashville Nighthawks, a minor league professional hockey team. Nashville Pro Hockey, LLC, contracted with Creative Resource Management, Inc. (CRM), whereby CRM, for fees and other consideration, would provide employee leasing services to Nashville Pro Hockey, LLC. The contract was signed by Barry Soskin, the president of Nashville Pro Hockey, LLC. A paragraph in the contract provided the following: "By affixing my hand and seal to this agreement, I personally guarantee any and all payments payable as represented and outlined in this agreement." Nashville Pro Hockey, LLC, failed while owing CRM \$29,626. CRM sued Nashville Pro Hockey, LLC, and Barry Soskin to recover the unpaid compensation. Soskin defended, alleging that his signature on the contract was in his representative capacity only and not in his individual capacity as a guarantor.

Did Soskin's signature on the contract constitute a personal guarantee for the payment of the debt of Nashville Pro Hockey, LLC, to CRM and thereby make Soskin personally liable to CRM for the debt?

Answer Yes, Soskin's signature on the contract constituted a personal guarantee for the payment of the debts of Nashville Pro Hockey, LLC, to CRM, thereby making Soskin personally liable to CRM for the debt. The contract contained personal guarantee language in the body of the contract. The words "I personally guarantee any and all payments payable as represented and outlined in this agreement" reflect indisputably a guarantee by Soskin. Soskin insists that he signed only as a representative of the limited liability company. CRM insists that his signature imposes personal liability upon him. The stark fact is that the words "I personally guarantee" are meaningless if applied to Nashville Pro Hockey, LLC, and not to Barry Soskin individually. Because the words "I personally guarantee" cannot refer to Nashville Pro Hockey, LLC, and retain any meaning at all in the context of this agreement, they must of necessity reflect the personal guarantee of Barry Soskin. Thus, Soskin was a guarantor, and he is personally liable to repay the money owed to CRM by Nashville Pro Hockey, LLC. *Creative Resource Management, Inc. v. Soskin*, 1998 Tenn. App. Lexis 788 (Court of Appeals of Tennessee)