|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  | | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | | |  |  | | --- | --- | |  | **LEARNING OBJECTIVES** |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  | | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | |  | After reading this chapter, you will be able to answer the following questions:   |  |  |  |  | | --- | --- | --- | --- | |  | [**1**](http://highered.mheducation.com/sites/0077339177/student_view0/ebook/chapter35/chbody1/major_forms_of_business_organization.htm#lo1) |  | What are the major forms of business organization, and what are the differences among them? | |  | [**2**](http://highered.mheducation.com/sites/0077339177/student_view0/ebook/chapter35/chbody1/specialized_forms_of_business_organization.htm#lo2) |  | What are the specialized forms of business organization? | |  | [**3**](http://highered.mheducation.com/sites/0077339177/student_view0/ebook/chapter35/chbody1/specialized_forms_of_business_organization.htm#lo3) |  | What is a franchise? | | |  |  |  |  | | --- | --- | --- | |  | **CASE OPENER** **The Dunkin’ Donuts Franchise Agreement** |  |  |  |  |  |  |  |  |  |  | | --- | --- | --- | --- | --- | --- | --- | --- | |  | Dunkin’s Donuts Corporation operates numerous restaurants worldwide, organizing many of them as franchises. Dunkin’ Donuts has the exclusive license to use and to license others to use its trademarks, service marks, and trade name. These marks and trade name have been used continuously since 1960 to identify Dunkin’s doughnut shops as well as the doughnuts, pastries, coffee, and other products associated with those shops. Dipak N. Bhayani operated two Dunkin’ Donuts franchises in Illinois for many years. Dunkin’ Donuts later notified Bhayani that his two franchises had been violating parts of the franchise license agreement. After repeated incidents and failure to cure the violations over a substantial period of time, Dunkin’ Donuts (the franchisor) demanded termination of both of Bhayani's franchises.   |  |  |  | | --- | --- | --- | | 1. |  | Did Dunkin' Donuts lawfully revoke Bhayani's franchises? | | 2. |  | What are some potential problems that a franchisor and a franchisee might experience in their relationship? |   The Wrap-Up at the end of the chapter will answer these questions. | |

p. 771

Suppose you come up with an idea to produce a novel product you think could lead to enormous profits. But what is the best way to produce this product? Should you do it yourself by creating your own business? Do you have enough money to create your own business? What are the legal ramifications if your business is not successful? What legal responsibilities do you have with respect to your business?

   Perhaps you share your idea with your best friend, who suggests that the two of you become partners in the production and sale of this product. What are the benefits associated with forming a partnership? What are the disadvantages? Are there other forms of business you should consider?

   Choosing the form of business to create is one of the most important decisions an enterprise makes. The extent of liability and control the owner will have depends on the form of the business. The business world is not static, however, and businesses can and do change form over time, so this chapter relates not only to new businesses but also to existing ones. The first section introduces the major types of business organizations, describing how these forms are both created and ended. The second section considers several types of business organizations that are less well known, but important nevertheless.

Major Forms of Business Organization

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| |  |  |  |  |  |  |  | | --- | --- | --- | --- | --- | --- | --- | | **SOLE PROPRIETORSHIP**  If you decide to go into business on your own, you are creating a **sole proprietorship*A business in which one person (sole proprietor) controls the management and profits.*,** a business organization in which you, as the **sole proprietor*The single person at the head of a sole proprietorship.*,** are in sole control of the management and the profits. Thus, if you wanted to open a lawn-mowing business or a sewing shop, you would likely be creating a sole proprietorship.     Why might an entrepreneur choose to create a sole proprietorship over other forms of business organization? First, opening a sole proprietorship requires very few legal formalities. Second, a sole proprietor has complete control of the management of the organization, with freedom to hire employees, determine business hours, and expand or change the nature of the business. Third, the sole proprietor keeps all the profits from the business. These profits are taxed as the personal income of the sole proprietor. |  | |  |  | | --- | --- | |  |  | | What are the major forms of business organization, and what are the differences among them? |  | |      However, sole proprietorships have disadvantages too. Suppose you are the sole proprietor of a restaurant in which a customer is injured and she sues your business. You are personally liable for any losses or obligations associated with the business. If you accrue large debts because of your business, you might have to sell your home to cover them. Moreover, because the sole proprietorship is not considered a separate legal entity, you, as the owner and sole proprietor, can be personally sued. Sole proprietorships are terminated automatically when the sole proprietor dies.     Funding for your business is limited to your personal funds and any loans you might be able to obtain. Thus, sole proprietorships often struggle in the initial stages because they have large start-up costs relative to the profits they make.  [Exhibit 35-1](http://highered.mheducation.com/sites/0077339177/student_view0/ebook/chapter35/chbody1/major_forms_of_business_organization.htm#id_0073377678_001_020980) summarizes the advantages and disadvantages of the sole proprietorship. Sole proprietorships are by far the most popular form of business organization in the United States. As the [Comparing the Law of Other Countries](http://highered.mheducation.com/sites/0077339177/student_view0/ebook/chapter35/chbody1/major_forms_of_business_organization.htm#id_0073377678_001_021013) box illustrates, they are popular in Germany too, although Germans call them “sole traders.”     An alternative form of business organization that retains many advantages of the sole proprietorship but addresses its funding drawback is the partnership.  p. 772  **Exhibit 35-1** Advantages and Disadvantages of the Sole Proprietorship    **PARTNERSHIP**  Suppose you and your best friend from college decide to create a business to buy and sell used books and CDs online. Both of you agree to share control of the business and split the profits equally. According to the Uniform Partnership Act (UPA), you and your friend have created a **partnership*A voluntary association between two or more people who co-own a business for profit.*,** a voluntary association between two or more persons who co-own a business for profit. Except in a few cases, a partnership is not considered a separate legal entity and is dissolved when any partner dies. The Uniform Partnership Act governs partnerships in most states in the absence of an express agreement.     What are the advantages of a partnership? First, formation is easy. The partners, each considered an agent of the partnership, are generally not required to create an official or even a written agreement to establish it. Second, because in most cases the partnership is not considered a separate legal entity, income from the business is taxed as individual income for each partner. For that reason, partners can also deduct business losses from their taxable income.     The major disadvantage of partnerships is that partners are personally liable for the firm's debts. If you are in a partnership with your best friend, who embezzles $50,000 through the business, you will likely be held personally liable for that $50,000. [Exhibit 35-2](http://highered.mheducation.com/sites/0077339177/student_view0/ebook/chapter35/chbody1/major_forms_of_business_organization.htm#id_0073377678_001_020991) summarizes the advantages and disadvantages of a partnership.     There are several types of partnerships (see [Exhibit 35-3](http://highered.mheducation.com/sites/0077339177/student_view0/ebook/chapter35/chbody1/major_forms_of_business_organization.htm#id_0073377678_001_020997)). In a **general partnership*A partnership in which the partners divide profits and management responsibility and share unlimited personal liability for the partnership’s debts.*** the partners divide the profits (usually equally) and the management responsibilities and share unlimited personal liability for the firm's debts. Thus, in our Internet business example, you and your best friend form a general partnership by agreeing to share management responsibilities and profits as well as assuming unlimited personal liability.  p. 773   |  |  |  |  |  |  |  | | --- | --- | --- | --- | --- | --- | --- | | |  | | --- | |  |  |  |  | | --- | --- | |  | **COMPARING THE LAW OF OTHER COUNTRIES** | |  |  |  |  |  |  |  | | --- | --- | --- | |  | **Sole Traders in Germany**  Germany's equivalent to the U.S. sole proprietor is the sole trader, which, while not recognized as a separate business organization, is defined quite broadly to include “anyone carrying out business under his or her own name.” Sole traders are limited companies that can employ a staff but may not have partners or shareholders.  *Major traders* are those operating a large-scale organization. Because the organizations are large, major traders must register their companies. A sole trader who manufactures goods, trades securities, or buys and sells large quantities of goods also must register.  *Minor traders* who wish to elevate their status to major trader must first submit company records to the registrar. The registrar must be satisfied that elements such as the number of employees and the amount of bank credit are large enough. While being a major trader does mean being governed by more extensive regulations, for many organizations it also presents opportunities for growth and expansion.     Because by definition a sole trader must operate under his or her own name, German companies at one time had to change names when a sole trader sold the firm. Changing names presented a problem to those who wished to keep the name because of its familiarity to customers. Eventually, a stipulation was added to German law permitting the “trading name” to be included in the sale of the company. |  |        Now imagine that your parents want to invest in your Internet business, sharing in its profits but not assuming management responsibilities or personal liability for its debts. Your parents can join your business as limited partners, and your partnership will become a **limited partnership (LP)*A partnership consisting of at least one general partner and at least one limited partner in which the general partners assume all liability for the partnerships’s debts and the limited partners assume no responsibility beyond their originally invested capital.*,** an agreement between at least one general partner and at least one limited partner. The general partners, you and your best friend, assume unlimited personal liability for the partnership's debts, but your parents, the limited partners, assume no liability beyond the capital they have invested in it and no part in its management. However, as limited partners, they pay taxes on their share of the profit.     If a limited partner dies, the limited partnership is usually unaffected. If a general partner dies, however, the limited partnership is usually dissolved.     A limited partnership must meet certain requirements not expected of general partnerships. First, it must use the word *limited* in its title. Second, the parties must file a certificate of partnership with a state office to create it; otherwise, it exists as a general partnership, and all parties are personally liable for all its debts.  **Exhibit 35-2** Advantages and Disadvantages of the Partnership  p. 774  **Exhibit 35-3** Types of Partnerships   |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  | | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | |  | |  | | --- | |  | | General partnership |  | A partnership in which the partners equally divide the profits and management responsibilities and share unlimited personal liability for the partnership’s debts | | Limited partnership (LP) |  | A partnership consisting of one general partner and at least one limited partner who does not have any part in the management of the business | | Limited liability partnership (LLP) |  | A partnership in which all partners are liable only to the extent of the partnership's assets | | Cooperative |  | A business organization consisting of individuals who join together to gain an advantage in the market that mutually benefits all members; can be incorporated or unincorporated | | Joint venture |  | A relationship between two or more persons or corporations that is created for a specific business undertaking | | Franchise |  | A business organization in which a franchisee, through a contractual agreement, sells a good or service that is trademarked by a franchisor | | Business trust |  | A business organization controlled by a group of trustees who operate the trust, according to a written agreement, for the beneficiaries; the trustees and the beneficiaries have limited liability | |        Suppose you are an attorney and a partner in a law firm with 30 other partners. One of your partners is sued because he was negligent in his duties as an attorney. This partner has unlimited liability for professional malpractice. But will you and the other partners also be held liable?     If the partners have created a **limited liability partnership (LLP)*A partnership in which all the partners assume liability for any partner’s professional malpractice to the extent of the partnership’s assets.*,** all the partners assume liability for one partner’s professional malpractice, but only to the extent of the partnership’s assets; the other partners’ personal assets cannot be taken. Moreover, each partner is liable for her own negligence and the negligence of those that she supervises. This distinctive feature of the LLP is the reason many professionals who do business together adopt it instead of the LP form.  **Legal Principle:** **Every partner in a limited liability partnership has liability limited to the partnership's assets.**     LLPs are fairly new; in 1991, Texas became the first state to enact a statute permitting their creation. Almost all states now have similar statutes. Like the limited partnership, the LLP has several special requirements. First, the business name must include the phrase *Limited Liability Partnership* or an abbreviation of the phrase. Second, the parties must file a form with the secretary of the state to create the LLP.     The LLP is not considered a separate legal entity. Each partner pays taxes on his or her share of the income of the business. An alternative form of business organization, the corporation, separates business ownership from business control.  **CORPORATION**  When you hear the word *business,* you probably think of firms like Walmart, Kmart, McDonald's, and Nike. Perhaps the most dominant form of business organization is the **corporation*A legal entity formed by issuing stock to investors, who are the owners of the corporation.*,** a legal entity formed by selling shares of stock to investors, who then become **shareholders*An investor who holds stock in a corporation, and thus is an owner of the corporation.*** and the owners of the company. These shareholders elect a board of directors, which is responsible for managing the business. The board of directors, in turn, hires officers to run the day-to-day business.  p. 775     None of the other forms of business we have discussed are separate legal entities. How does a corporation become a separate legal entity? It must be created according to state law. ([Chapter 38](http://highered.mheducation.com/sites/0077339177/student_view0/ebook/chapter38/chapter_opener.htm) discusses the laws governing the creation and functioning of the corporation.)     What are the consequences of being a separate legal entity? First, while the corporation can be sued and can be held liable for its debts, shareholders cannot. Their liability is usually limited to the amount they have invested in their share purchases, which supplies the company with capital. Second, the corporation is not dissolved when shareholders die. Third, the corporation must pay taxes on its profits, *and* its shareholders must pay taxes on the dividends (distributions of those profits) they receive from it. [Exhibit 35-4](http://highered.mheducation.com/sites/0077339177/student_view0/ebook/chapter35/chbody1/major_forms_of_business_organization.htm#id_0073377678_001_021043) summarizes the advantages and disadvantages of the corporate form of business.     One way to avoid the double taxation is by forming an **S corporation*A corporation that enjoys the tax status of a partnership.*,** which is a corporation under federal tax law but is taxed like a partnership as long as it follows certain regulations. For example, the S corporation cannot have more than 100 shareholders. Its income is taxed only when distributed to the shareholders, who must report the income on their personal income tax forms. S corporations are often, though not always, formed under federal law. Alternatively, other forms of corporation are created under state law.  **Legal Principle:** **A corporation is a separate legal entity and can be sued.**  **Exhibit 35-4** Advantages and Disadvantages of the Corporation  p. 776  **LIMITED LIABILITY COMPANY**  One of the newest forms of business organization in the United States is the **limited liability company (LLC)*An unincorporated business that is taxed like a partnership, with the members paying personal income taxes, but has the limited liability of a corporation.*,** an unincorporated form of business organization that many people see as combining the most advantageous features of partnerships and corporations. It combines the tax advantages and management flexibility of a partnership with the limited liability of a corporation.     First recognized in the United States in 1977 in Wyoming, the LLC is now recognized in every state, although the rules on LLCs have not evolved uniformly. To bring some uniformity to this area of law, the National Conference of Commissioners on Uniform State Laws drafted the Uniform Limited Liability Company Act (ULLCA) in 1995. In 2006, the commissioners revised the ULLCA. This act provides a model for states to follow, but it has not been uniformly adopted, so it is always necessary to check the specific requirements in the state in which you wish to create your LLC.  **Key Reasons for the Rapid Acceptance of Limited Liability Companies.**   As previously mentioned, the LLC offers its owners (referred to as **members*Owners of a limited liability company.***) the same limited liability for business debts as that offered by the corporation. But unlike the corporation, the LLC is not required to allocate profits and losses in proportion to ownership interests; nor is it required to hold an annual meeting and draft meeting minutes, so record keeping is simpler and more flexible. Unlike the case with limited partnerships, to obtain limited liability, an LLC member does not have to give up his or her right to participate in management of the LLC. In fact, an additional advantage of the LLC is the flexibility it offers members in terms of alternative ways to structure its management.     The most frequently cited advantage of the LLC is that the IRS generally treats it like a partnership or sole proprietorship. This means that members report their share of the profits and losses of the LLC on their personal tax returns. Consequently, no separate tax is assessed on the company itself, thereby allowing its members to avoid double taxation. In contrast, members of a corporation are subjected to double taxation. However, if the LLC members prefer, they may elect to have the entity taxed like a corporation. In a situation where most of the profits are going to be reinvested in the business, this option allows the profits to be taxed at the lower corporate rate. So, while we think of the opportunity to avoid double taxation as a key benefit of the LLC, more important perhaps is the fact that the members have the choice of how they wish to be taxed.     In our global environment, an increasingly important advantage of LLCs is that members need not be citizens or permanent residents of the United States. Other organizational forms, such as the subchapter S corporation, are available only when all the owners are U.S. citizens. Finally, as with a corporation, ordinary business expenses such as salaries paid to owners can be deducted from the profits of an LLC before the LLC's income is allocated to its owners for tax purposes.  **Formation and Management of Limited Liability Companies.**   A limited liability company is formed by filing articles of organization in the state in which members want to establish their LLC. While precise requirements vary by state, typically the articles include the name of the business, which must include the words *Limited Liability Company* or the initials *LLC,* its principal business address, the name and address of a registered agent for service, the names of the owners, and information about how the company's management will be structured.     LLCs typically want to do business in more states than just the state where they are formed, and they usually need to register in every additional state in which they intend to operate, a process referred to as *qualification.* Qualification simply entails filing a certificate of authority or some similar document, and getting a business license, in each additional state in which the business plans to operate. The LLC is usually referred to as a *foreign company* in the additional states, and under most state statutes the LLC is governed by the rules of the state where it was created, regardless of where it is transacting business.  p. 777     For purposes of jurisdiction, however, an LLC is considered a citizen of every state in which its members reside. Remember that one of the reasons a party can be sued in federal court when a matter involves more than $75,000, is the existence of diversity of citizenship—no plaintiff and defendant are residents of the same state. For determining whether diversity exists, a corporation is considered a resident of the state in which it is incorporated and the state that is its primary place of business. However, this rule does not apply to LLCs, as their citizenship is determined by the residences of their members. Consequently, if parties want to increase their likelihood of having access to the federal courts, they may want to consider either limiting LLC membership to individuals of only one or a few states or using a different form of business organization.     When members form an LLC, they typically draft an operating agreement, which is the foundational contract among the entity's owners. It spells out such matters as how the company is to be managed, how the profits and losses will be allocated, how interests may be transferred, and how and when the LLC may be dissolved. Any matter not covered in the operating agreement will be resolved in accordance with the state LLC statute; if a matter is not covered by the relevant statute, the principles of partnership law are generally followed.     While there is no requirement for an LLC to have a detailed, written operating agreement, in order to ensure the smooth functioning of the company, it is a good idea to have one. Failure to have such an agreement may result in a court imposing standards on the LLC that may be very different from what the members had in mind when they formed the company.   |  |  | | --- | --- | | [Exhibit 35-5](http://highered.mheducation.com/sites/0077339177/student_view0/ebook/chapter35/chbody1/specialized_forms_of_business_organization.htm#id_0073377678_001_021071) compares the standard forms of business organization discussed above.  **Legal Principle:** **As a general rule, an LLC is formed by filing articles of organization in the state in which members want to establish their LLC. Precise requirements for formation vary by state. Moreover, an LLC needs to register in every additional state in which it will do business.** |  | |

Specialized Forms of Business Organization

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| |  |  |  |  |  |  |  | | --- | --- | --- | --- | --- | --- | --- | | In addition to the traditional forms of business organization we've mentioned above, some specialized forms have become important: cooperatives, joint stock companies, business trusts, syndicates, joint ventures, and franchises.  **COOPERATIVE**  A **cooperative*An organization formed by individuals to market new products. Individuals in a cooperative pool their resources together to gain an advantage in the market.***  is an organization formed by individuals who usually pool their resources to gain an advantage in the market. Farmers might pool their yields of certain crops to ensure a high market price. Usually, members of the cooperative receive dividends in proportion to how many times per year they engage in business with the cooperative. |  | |  |  | | --- | --- | |  |  | | What are the specialized forms of business organization? |  | |   p. 778  **Exhibit 35-5** Traditional Forms of Business Organizations   |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  | | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | | Cooperatives may be incorporated or unincorporated. Unincorporated cooperatives are treated like partnerships, meaning members share joint liability for the cooperative's actions. Members of incorporated cooperatives, on the other hand, enjoy limited liability just as do the shareholders of a corporation.  p. 779   |  |  |  |  |  |  |  | | --- | --- | --- | --- | --- | --- | --- | | |  | | --- | |  |  |  |  | | --- | --- | |  | **COMPARING THE LAW OF OTHER COUNTRIES** | |  |  |  |  |  |  |  | | --- | --- | --- | |  | **Limited Liability Companies in Mexico**  A limited liability company in Mexico is “an association of individuals who are exempt from individual responsibility to third parties, yet who own the stock separately from the owner.” Limited liability companies are identifiable because their name must be followed by the phrase *Sociedad de Responsibilidad Limitada.* Without this phrase, courts assume that a partnership exists.     The LLC's important distinguishing factor is that members are an entity separate from the owners. Members, from 2 to 25 in number and referred to as *share/stockholders,* invest capital in the company. While they do not have any individual responsibility, collectively they must give their consent before the company can sell shares to new members. The decision must be unanimous; generally, members have one vote for every 100-peso share.     Mexico adopted the limited liability company model from Germany, where such companies are enormously popular, in hopes of attracting more investors to small companies by limiting their responsibilities. |  |     **JOINT STOCK COMPANY**  A **joint stock company*A partnership agreement in which company members hold transferable shares while all the goods of the company are held in the names of the partners.*** is a partnership agreement in which company members hold transferable shares while all the goods of the company are held in the names of the partners. Thus, the joint stock company is a mix of corporation and partnership. As in the corporation, members who hold shares of stock own the joint stock company. As in the partnership, these shareholders have personal liability, and in most cases the company is not a separate legal entity.  **BUSINESS TRUST**  A **business trust*A business organization governed by a group of trustees who operate the trust for beneficiaries.*** is a business organization governed by a group of **trustees*(1) In bankruptcy proceeding, an individual who takes over administration of a debtor’s estate. (2) A person who operates a business trust for beneficiaries.*,** who operate the trust for the **beneficiaries*(1) A person who can expect to benefit from a relationship. (2) A person who receives, or will receive, the proceeds from an insurance policy or a will.*.** A written trust agreement establishes the duties and powers of the trustees and the interests of the beneficiaries. As in a corporation, the trustees and beneficiaries enjoy limited liability, and in most states business trusts are taxed like corporations.  **SYNDICATE**  An investment group that comes together for the explicit purpose of financing a specific large project is a **syndicate*An investment group that comes together for the explicit purpose of financing a specific large project.*.** Syndicates are often used to purchase professional sports teams and are quite useful for their ability to raise large amounts of money in a short time. They are usually considered a type of joint venture; thus they are almost always governed by partnership law.  **JOINT VENTURE**  A **joint venture*An association between two or more parties wherein the parties share profits and management responsibilities with respect to a specific project.*** is a relationship between two or more persons or corporations created for a specific business undertaking. This relationship may entail financing, producing, and selling goods, securities, or commodities. Participants in the joint venture usually share the profits and losses equally.     Joint ventures can be agreements between small or very large businesses. For example, Penske Truck Leasing Co., L.P., is a joint venture among Penske Corporation, Penske Automotive Group, and General Electric with annual revenues of more than $4 billion. This joint venture operates more than 225,000 vehicles in North America, South America, Europe, and Asia. From a legal standpoint, partnerships and joint ventures are virtually the same. Thus, courts frequently apply partnership law to joint ventures. Joint ventures differ from partnerships, however, because they are usually created for making and selling a single product, while a partnership creates an ongoing full business. The joint venture is usually terminated when all the stock has been sold or at the discretion of the members.  p. 780   |  |  |  |  |  |  |  | | --- | --- | --- | --- | --- | --- | --- | | |  | | --- | |  |  |  |  | | --- | --- | |  | **E-COMMERCE AND THE LAW** | |  |  |  |  |  |  |  | | --- | --- | --- | |  | **Exploring Forms of Business Organization on the Internet**  If you are considering starting a business, the Internet can provide much information to help you decide which form you should create. At Business Tools (<http://smallbiz.findlaw.com/book>), you can read more about sole proprietorships, partnerships, and corporations. You can also search online for laws that affect the forms of business within your state. At Texas Business Forms ([www.sos.state.tx.us/corp/forms.shtml](http://www.sos.state.tx.us/)), you can read about and download the forms required to create various types of business in Texas. Thus, the Internet can make it easier to create your business by increasing the information available to you. |  |      |  |  |  |  |  |  |  | | --- | --- | --- | --- | --- | --- | --- | | |  | | --- | |  |  |  |  | | --- | --- | |  | **COMPARING THE LAW OF OTHER COUNTRIES** | |  |  |  |  |  |  |  | | --- | --- | --- | |  | **Types of Business Organization in China**  The concept of *legal persons* is at the root of all Chinese business law. The Civil Code of China defines a legal person as “an organization which possesses civil legal capacity for civil acts and which, according to the law, independently enjoys civil rights and assumes civil obligations.” The definition goes on to describe two types of legal persons.     The first is the *enterprise legal person,* any privately, collectively, or state-owned registered enterprise that meets four criteria: (1) existence of an outlined organizational structure, (2) an organization title, (3) articles governing the structure, and (4) the necessary funds and property. A foreign-owned or foreign joint venture may also acquire enterprise legal person status by applying for approval and registration.     The second type of legal persons is *other legal persons.* These include government agencies, institutions, and associations. Government agencies need not apply for registration because they are given legal-person status on their establishment. Other institutions and associations must meet the criteria above and may also be subject to approval and registration based on State Council rules specified in 1998. |  |        Also unlike a partnership, the joint venture is not automatically terminated when one of the members dies. Members of a joint venture also have less authority than general partners because they are not agents of the other members.     Joint-venture partners usually share equal management of the task for which they have come together, but they can agree to give one party greater management responsibilities. Both (or all) parties usually assume liability for the project, and each can be held responsible for the liability of the other(s).     Like a partnership, a joint venture may be formed without drawing up a formal agreement.  [Case 35-1](http://highered.mheducation.com/sites/0077339177/student_view0/ebook/chapter35/chbody1/specialized_forms_of_business_organization.htm#id_0073377678_001_021182) provides a judicial discussion of the elements necessary for the establishment of a joint venture.  p. 781   |  |  |  |  | | --- | --- | --- | --- | |  | **CASE**   **35-1** |  | **MMK GROUP, LLC v. THE SHESHELLS COMPANY, LLC, ET AL.** **U.S. DISTRICT COURT FOR THE NORTHERN DISTRICT OF OHIO 591 F. Supp. 2d 944 (2008)** |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  | | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | |  | *In 2002, Tina Bruce invented Lilypadz breast shields, a device that prevents breast milk leakage from nursing mothers. To refine and commercialize this idea, Ms. Bruce joined with Charles Pawloski, her uncle, to form Me & My Kidz, L.L.C. (M&MK), an Ohio limited liability company. To produce the breast shields, M&MK contacted Thermodyn and entered into a nondisclosure agreement. This nondisclosure agreement prohibited Thermodyn and its employees from disclosing M&MK's trade secret information and from competing with M&MK. M&MK argued that despite the nondisclosure agreement, Thomas Hass (a Thermodyn employee) used M&MK's confidential information to begin launching a competing product, SheShells Breast Coverlets.*  *Meanwhile, James MacMillan, the president of Thermodyn, claimed the relationship between Thermodyn and M&MK was a joint venture. Because he believed the relationship was a joint venture, Mr. MacMillan threatened to stop production unless M&MK provided increased financial benefits, provided Thermodyn with all of the patent information, and indemnified Thermodyn from any lawsuits. M&MK complied with the requests until Thermodyn met all of the outstanding production orders for breast shields and then notified Thermodyn of its intention to terminate their relationship.*  *After the relationship was terminated, Thomas Haas began selling the knock-off SheShells Breast Coverlets in violation of the trade-secrets agreement. M&MK filed suit against Mr. Haas, his company SheShells Co., LLC, and Thermodyn. The Thermodyn defendants filed counterclaims against M&MK, claiming a breach of an alleged joint venture. M&MK disagreed, claiming the two businesses did not have a joint venture and subsequently motioned to dismiss the breach of joint venture claim.*  **JUDGE KATZ:** Under Ohio law, a joint venture is a partnership established for the purposes of a single business enterprise. The essential elements of a partnership are as follows:   |  |  |  | | --- | --- | --- | | (1) |  | an express or implied partnership contract between the parties; | | (2) |  | the sharing of profits and losses; | | (3) |  | mutuality of agency; | | (4) |  | mutuality of control; and | | (5) |  | the co-ownership of the business and of the property used for partnership purposes or acquired with partnership funds. |   The essential elements of a joint venture partnership are similar:   |  |  |  | | --- | --- | --- | | (1) |  | a joint contract; | | (2) |  | an intention to associate as joint venturers; | | (3) |  | community of interest and control, including contributions to the joint venture; | | (4) |  | the mutual right to direct and control the purpose of the joint venture; and | | (5) |  | an agreement for the division of profits and losses jointly, not severally. |      A joint venture is distinguished from a partnership because the former relates to a single enterprise and the latter to a continuing business.     M&MK argues that Thermodyn alleges insufficient facts to establish the existence of a joint venture. The Court disagrees. Under the first element of a joint venture, Thermodyn must allege a set of facts in support of the existence of “a joint contract.” M&MK argues that the November 8, 2002, letter from Pawloski to the marketing director of Thermodyn and the “Thermodyn & M&MK Relationship” document cannot be construed as a joint contract because they do not satisfy the requirements of a contract under Ohio law. However, it is not necessary for Thermodyn to submit a single written contract or document to establish a joint contract. To establish an implied contract under Ohio law, a plaintiff must prove each of the elements of a contract, i.e. an agreement, based on a meeting of the parties' minds and mutual assent, to which the parties intended to be bound. A plaintiff need not show that the parties formally exchanged promises. Instead, a “contract implied in fact may be proved by showing that the circumstances surrounding the parties' transactions make it reasonably certain that an agreement was intended.”     Here, Thermodyn has alleged facts necessary to support a claim that the various documents submitted to the Court as well as the conduct of the parties establish a “joint contract.” A letter from Pawloski to the marketing director of Thermodyn described Thermodyn as a “long-term strategic partner and supplier of our LilyPadz product … we want to see both … benefit from this venture.” The letter goes on to set the target cost “of $3.75 per finished unit and for Thermodyn to have at least a 40% manufacturing margin.” The “Thermodyn & M&MK Relationship” document states that M&MK and Thermodyn intend to have a “transparent” relationship and explains the roles of each company: which will maintain the raw materials, how inventory shall be calculated, and how profit margins shall be calculated. Furthermore, the conduct of the parties is notable. Neither party disagrees that Thermodyn did in fact manufacture Lilypadz for several years, and Thermodyn Defendants allege that over “several years” Thermodyn invested $160,000 in equipment and staffing for the project.  p. 782     Under the second element of a joint venture, Thermodyn must allege a set of facts in support of “an intention to associate as joint ventures.” M&MK argues that the November 8, 2002, letter does not explicitly state M&MK's intention to associate as a joint venture. However, the letter from Pawloski states a desire for M&MK and Thermodyn to both benefit from “this venture,” and the Thermodyn & M&MK Relationship document delegates the duties and responsibilities that relate to the single enterprise of manufacturing and selling Lilypadz. Furthermore, some kind of business relationship existed between the companies that distributed the delegation of duties consistent with the above mentioned documents: M&MK marketed, distributed, and sold Lilypadz, while Thermodyn manufactured them.     For the Third and Fourth elements, Thermodyn must allege a set of facts in support of a “community of interest and control, including contributions to the joint venture” and “the mutual right to direct and control the purpose of the joint venture.” Thermodyn alleges that Thermodyn “came up with numerous modifications to the product … to assist in the development of the Lilypadz project.” Also, the Thermodyn and M&MK Relationship document states that “M&MK can work with Thermodyn during this startup and Thermodyn can be asked to sit in on sales meetings with major Lilypadz customers.” Furthermore, one of the reasons that Thermodyn has brought this Counterclaim is because M&MK “invested no funds in the project” and Thermodyn does not believe it was sufficiently compensated for its contributions.     Fifth, Thermodyn must allege a set of facts in support of “an agreement for the division of profits and losses—jointly, not severally.” Thermodyn has satisfied this element with allegations evidenced by the Thermodyn and M&MK Relationship document which states that “[b]oth companies should expect to share in the costs as well as the success of the Lilypadz product.” Thus, M&MK's motion to dismiss the breach of joint venture claim is denied. | | | |  | **DENIED.** | | | |  | | | | | |  | |  | | --- | | **CRITICAL THINKING** |   The process of critical thinking requires that we ask critical questions about whatever reasoning we encounter, even if, as in this case, the reasoning appears very convincing. Of the five criteria Judge Katz uses to claim that the companies were in a joint venture, which do you think he provides the weakest argument and least justification for? |  | |  | | --- | | **ETHICAL DECISION MAKING** |  |  | | --- | | Essentially, the court ruled in favor of Thermodyn and did not punish Thomas Haas for selling knock-off breast shields he created through stealing trade secrets. What theory or theories of ethical decision making might instead punish Haas for his actions violating the nondisclosure agreement? Explain. | |  |     **FRANCHISE**   |  |  |  |  |  |  |  | | --- | --- | --- | --- | --- | --- | --- | | When you go into McDonald's to eat lunch, what type of business are you patronizing? You are likely eating at a **franchise*A business arrangement between an owner of a trade name or trademark and a person who sells goods or services under the trade name or trademark.*.** This form of business organization is a business that exists because of an arrangement between the **franchisor*The owner of the trade name or trademark in a franchise.*,** an owner of a trade name or trademark, and the **franchisee*The seller of goods or services under a trade name or trademark in a franchise.*,** a person who sells goods or services under the trade name or trademark. [Exhibit 35-6](http://highered.mheducation.com/sites/0077339177/student_view0/ebook/chapter35/chbody1/specialized_forms_of_business_organization.htm#id_0073377678_001_021246) summarize the advantages and disadvantages of a franchise for the franchisor. |  | |  |  | | --- | --- | |  |  | | What is a franchise? |  | |      Generally, franchises fall into one of three categories. In a **chain-style business operation*A type of franchise in which the franchise operates under the franchisor’s business name and is required to follow the franchisor’s standards and methods of business operation.*,** such as McDonald's and Burger King, the franchise operates under the franchisor's business name and is required to follow the franchisor's standards and methods of business operation.  p. 783  **Exhibit 35-6** Starting a Franchise: Advantages and Disadvantages for the Franchisor     In the second category, **distributorships*A type of franchise in which the franchisor manufactures a product and licenses a dealer to sell the product in an exclusive territory.*,** the franchisor manufactures a product and licenses a dealer to sell it in an exclusive territory. A car dealership is an example of a distributorship.     Finally, the third category is the **manufacturing arrangement*A type of franchise in which the franchisor provides the franchisee with a formula or ingredient that is necessary to manufacture a product.*,** in which the franchisor provides the franchisee with the formula or necessary ingredient to manufacture a product. Soft-drink companies, for example, provide the syrup used to produce the final product, and then sell it, according to the franchisor's standards.   |  | | --- | | Franchising is one way to spread your business across the world. |     [Exhibit 35-7](http://highered.mheducation.com/sites/0077339177/student_view0/ebook/chapter35/chbody1/specialized_forms_of_business_organization.htm#id_0073377678_001_021261) indicates how important franchises are for the market economy.     Look at [Case 35-2](http://highered.mheducation.com/sites/0077339177/student_view0/ebook/chapter35/chbody1/specialized_forms_of_business_organization.htm#id_0073377678_001_021275) to see how the supreme court of Arkansas determined whether a franchise agreement existed between Mary Kay Cosmetics and Janet Isbell.  **Exhibit 35-7** The Top 10 Global Franchises, 2009   |  | | --- | | 1.   Subway (worldwide sales of more than $12 billion) | | 2.   McDonald’s | | 3.   Liberty Tax Service | | 4.   Sonic Drive In Restaurants | | 5.   Intercontinental Hotels Group | | 6.   Ace Hardware Corp. | | 7.   Pizza Hut | | 8.   UPS Store | | 9.   Circle K | | 10.   Papa John’s International. Inc. |   Source: Ranked by *Entrepreneur Magazine* on the basis of financial strength and stability, growth rate, and size of the system; [www.entrepreneur.com/franchise500/index.html](http://www.entrepreneur.com/franchise500/index.html). |   p. 784   |  |  |  |  | | --- | --- | --- | --- | |  | **CASE**   **35-2** |  | **MARY KAY, INC., A/K/A MARY KAY COSMETICS, INC. v. JANET ISBELL** **SUPREME COURT OF ARKANSAS 338 ARK. 556; 999 S.W. 2D 669; 1999 ARK. LEXIS 443** |  |  |  |  |  |  |  |  | | --- | --- | --- | --- | --- | --- | --- | |  | *In 1980, Janet Isbell signed an agreement to become a beauty consultant for Mary Kay. This agreement established that Isbell would sell products to customers at home demonstration parties, but she was prohibited from selling in retail establishments. In September 1981, Isbell signed her first agreement to become a unit sales director. She signed her second agreement in July 1991. In addition to serving as a beauty consultant, Isbell recruited other beauty consultants. She earned compensation in the form of commission on her sales as well as on the sales of the consultants she recruited. In 1994, she rented a space in a shopping mall to serve as a training center. In April 1994, Mary Kay's legal coordinator contacted Isbell, stating that the store space was not to be used to sell Mary Kay products. According to the agreement, Isbell's office could not look like a Mary Kay store. Furthermore, Isbell was told to cease all photo sessions of potential customers and to stop advertising “glamour tips.”*  *In September 1995, the vice president of sales development notified Isbell that Mary Kay was terminating its agreements with her. Isbell filed suit against Mary Kay, claiming she was a franchise under Arkansas' Franchise Practices Act. She argued that Mary Kay violated the Franchise Practices Act by refusing to comply with the FPA provisions for termination of a franchise. In August 1997, the trial court granted summary judgment to Isbell, but it did not explain why Isbell's relationships with Mary Kay could be considered a franchise. The trial court ruled as a matter of law that Mary Kay's termination of Isbell had violated the Act, and a jury awarded Isbell $110,583.33.*  **JUDGE GLAZE:** The threshold issue to be decided is whether the Arkansas Franchise Practices Act applies, because if it does, Isbell would be entitled to the designation of franchisee and permitted to invoke the protections and benefits of that Act.     To determine whether the Arkansas Franchise Practices Act applies to this case depends upon our interpretation and construction of the pertinent provisions of the Act. In this view, we turn first to Ark. Code Ann. §4-72-202 (1) (Supp. 1997), which in relevant part defines “franchise” to mean the following:   |  |  |  | | --- | --- | --- | |  | [A] written or oral agreement for a definite or indefinite period, in which a person grants to another a license to use a trade name, trademark, service mark, or related characteristic within an exclusive or nonexclusive territory, or to sell or distribute goods or services within an exclusive or nonexclusive territory, at wholesale, retail, by lease agreement, or otherwise. |  |      While the Act's definition of franchise is helpful, that definition alone is not dispositive of the issue as to whether Isbell, under the parties' agreement, is or is not a franchisee. The answer, however, can be found in §§ 4-72-203 and 4-72-202 (6) of the Act. Section 4-72-203 clearly provides the Act applies only to a franchise that contemplates or requires the franchise to establish or maintain a place of business in the state. Next, § 4-72-202 (6) defines “place of business” under the Act as meaning “a fixed geographical location at which the franchisee [1] displays for sale and sells the franchisor's goods or [2] offers for sale and sells the franchisor's services.”     We first should note that Isbell concedes that, as a sales director, her agreements with Mary Kay provided that she could not display for sale or sell Mary Kay products from an office, whether that office was located in her home or her training center. In fact, Isbell testified that she never displayed or sold Mary Kay products from her training center, and to have done so would have been a violation of her agreement with Mary Kay.     While conceding that the parties' agreements never contemplated that Isbell would or could sell the franchisor's goods from a fixed location, she argues no such prohibition prevented her from selling Mary Kay services from her home or training center. Specifically, Isbell suggests the facial makeovers and “Glamour Shots” photo sessions that were a part of Mary Kay's demonstration and training program constituted services that the parties contemplated could be sold by Isbell from her center.     Mary Kay's Director's Guide, which was made a part of the parties' agreements, very clearly provided that a sales director's office, albeit it her home or training center, could only be used to interview potential recruits and hold unit meetings and other training events. The Guide further provided that the office or center should not give the appearance of a cosmetic studio, facial salon or retail establishment, or give the appearance of being a “Mary Kay” store. Thus, nowhere in the parties' Guide or agreements can it be fairly said that the parties ever contemplated that Isbell could use her office or center as a fixed location to display or sell Mary Kay products or services.  p. 785     Even if we could agree with Isbell's contention that she was not prohibited from selling (or was otherwise authorized to sell) Mary Kay services, her argument must fail for another reason. Isbell simply never showed she sold Mary Kay services. She claims that because her contract requires her to provide motivational, counseling, and training services, such services should be considered part of the sale and commission when the product is actually sold. Isbell offered no proof as to what part of the commission, if any, was attributable to services. Neither Isbell nor Mary Kay was shown to have received any separate compensation for services provided to potential customers, but, to the contrary, evidence was presented showing these services, like the photographs taken at makeover sessions, were provided at cost with only the photographer receiving payment.     Finally, Isbell argues that her home constituted a place of business under the Act because as a consultant she occasionally displayed and sold products there. This argument, however, is not supported by the parties' agreement, since it never contemplated a fixed location for the display and sale of products. As previously stated, a Mary Kay consultant's location for selling products is her home or those of her potential customers.     In sum, we conclude that the agreements between Janet Isbell and Mary Kay did not contemplate the establishment of a fixed place of business as that term is defined in Ark. Code Ann. § 4-72-202 (6). As such, the business relationship entered into by Isbell and Mary Kay was not a franchise within the protection of the Arkansas Franchise Practices Act, and the court below erred in so holding. | | | |  | **REVERSED and DISMISSED.** | | | |  | | | | | |  | |  | | --- | | **CRITICAL THINKING** |     Outline the judge's reasoning in this case. What evidence does he use to support this reasoning?  What missing information would you call for when considering the facts of this case?  Would you interpret the Arkansas Franchise Practices Act and apply it to the facts of the case differently than Judge Glaze does? Why or why not? |  | |  | | --- | | **ETHICAL DECISION MAKING** |  |  | | --- | |  | | Consider the WPH framework. What values is Isbell promoting? What values are in conflict? Was the court fair in assessing her actions in light of these values? | |  |     **Franchise Law.**   Because franchisors are usually larger than franchisees and have more resources, they often have the upper hand in franchise relationships. However, federal and state laws have been established to protect the franchisee.     A franchise is a contractual relationship between the franchisor and the franchisee. Thus, contract law, and the Uniform Commercial Code in particular, apply. If the terms of the contract are not met, either side can sue for breach of contract.  **Creation of the Franchise.**   In the franchise relationship, the parties make a **franchise agreement*A contract whereby a company (the franchisor) grants permission (a license) to another entity (the franchisee) to use the franchisor’s name, trademark, or copyright in the operation of a business and associated sale of goods in return for payment.*** regarding payment to the franchisor, location of the franchise, restrictions the franchisee must follow, and method of termination of the franchise.     The franchise agreement usually sets out what the franchisee pays the franchisor (a large sum) for use of the trade name or trademark and what percentage of sales income will go to the franchisor. If the franchise requires a building, the agreement will specify who pays for buying or renting it or for building it if it must be constructed.     The franchisor usually includes in the agreement business practices that are forbidden and business standards, such as for cleanliness, that must be met. The franchisor can also set sales quotas and record-keeping requirements. The franchisee might be required to purchase certain supplies from the franchisor at a set price, but the franchisor cannot establish the price at which the franchisee sells the goods.  p. 786     The disagreement in the opening scenario for this chapter arose because of the third factor in franchise agreements. Because many Dunkin' Donuts restaurants are owned by franchisees, Dunkin' Donuts established guidelines and policies that promote business practices that enhance the quality of food and services at each restaurant. Dunkin' Donuts also has quality, safety, and cleanliness standards for each of its franchises. The franchise agreement stipulated that Dunkin' Donuts could inspect Bhayani's restaurant at any reasonable time.     Although the franchisor has the legal authority to ensure that the franchisee maintains the quality of goods and services associated with the franchise, it must be cautious. If it exercises too much authority in the day-to-day affairs of the business, the franchisor could be held liable for the torts of the franchisee's employees.  **Termination of the Franchise.**   Much of the litigation associated with franchises regards wrongful termination of a franchise. The franchise agreement establishes how the franchise will be terminated. The business is usually established for a trial period, such as a year. If the franchisee does not meet the requirements in the agreement, the franchisor can terminate it but must give sufficient notice. The termination also usually must have cause. For example, good cause exists if the franchisee repeatedly violates the franchise agreement. Additionally, the franchisor needs to have documented the warnings sent to the franchisee regarding the violations. The typical agreement gives the franchisor broad authority to terminate; in recent years, however, many states have been giving the franchisee greater termination protection.  **Legal Principle:** **When a franchisee does not uphold the franchise agreement, the franchisor can terminate the relationship with sufficient notice.**     The courts usually rely heavily on the written agreement when determining whether a franchise was wrongfully terminated. Look at [Case 35-3](http://highered.mheducation.com/sites/0077339177/student_view0/ebook/chapter35/chbody1/specialized_forms_of_business_organization.htm#id_0073377678_001_000558), which illustrates the agreement's importance.     |  |  |  |  | | --- | --- | --- | --- | |  | **CASE**   **35-3** |  | **COUSINS SUBS SYSTEMS, INC. v. MICHAEL R. McKINNEY** **U.S. DISTRICT COURT FOR THE EASTERN DISTRICT OF WISCONSIN 59 F. SUPP. 2D 816 (1999)** |  |  |  |  |  |  |  |  | | --- | --- | --- | --- | --- | --- | --- | |  | *Cousins Subs Systems entered into an agreement with Michael McKinney, whose company operates a chain of gas stations, to operate several Cousins submarine sandwich shops placed in the gas stations.*  *In April 1998, McKinney became disillusioned with the agreement and terminated it. He claimed Cousins had guaranteed him annual sales of $250,000 to $500,000 at each of his franchises and promised to provide advertising. McKinney also claimed Cousins guaranteed it would provide assistance in recruiting other franchises. Finally, McKinney argued Cousins enforced unrealistically high prices of subs. McKinney alleges he terminated the agreement because Cousins failed to uphold its promises.*  *In June 1998, Cousins filed suit against McKinney for wrongfully terminating the agreement with Cousins. Later in 1998, McKinney filed a counterclaim against Cousins. Cousins filed a motion to dismiss the counterclaim.*  **JUDGE ADELMAN:** McKinney first contends that Cousins violated Minn. Stat. § 80C.13, subd. 2, which provides:   |  |  |  | | --- | --- | --- | |  | No person may offer or sell a franchise in this state by means of any written or oral communication which includes an untrue statement of a material fact or which omits to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading. |  |   p. 787     McKinney does not clearly delineate his theory as to how this statute was violated. He appears to assert that Cousins violated this statute by making untrue oral representations to him about how much money he would make and about how much advertising and recruitment assistance it would provide. The main problem with this claim and, for that matter, with all of McKinney's claims is that the oral promises allegedly made by Cousins are directly contradicted by the written terms of the agreements that he signed and attached as exhibits to his pleadings. Where the allegations of a complaint are inconsistent with the terms of a written contract attached as an exhibit, the terms of the contract prevail over the averments differing therefrom. Unfortunately for McKinney, every oral representation that he alleges was made by Cousins is inconsistent with the written contracts he signed or the written circular he received.     McKinney alleges first that Cousins … orally guaranteed that annual sales at McKinney's franchises would be between $250,000 and $500,000, and that this level of sales was not realized. However, the Area Development Agreement states that McKinney “has not received any warranty or guaranty, express or implied, as to the potential volume, profits, or success of the business venture.” The Franchise Agreement contains virtually identical language. Thus, McKinney's claim of guaranteed profits is directly contradicted by the written contracts. McKinney also claims that Cousins promised to provide “advertising … in excess of the amount paid by McKinney,” and that Cousins failed to do so. But the Uniform Franchise Offering Circular states that “Cousins is not obligated to spend any specific amounts on advertising in the area where a particular franchisee is located. …” Thus, this claim too is directly contradicted by the written language of an exhibit. McKinney next alleges that Cousins “expressly guaranteed and promised to provide extensive assistance in recruitment of other franchisees in the development area,” but that such assistance was not forthcoming. The Area Development Agreement, however, states, with respect to the recruitment issue, “AREA DEVELOPER shall be responsible for advertising for, recruiting and screening prospects for SHOPS within the Exclusive Area.” Thus, every single oral promise that McKinney asserts was made by Cousins is inconsistent with the documents appended to his complaint. Under Seventh Circuit case law the language of the exhibits prevails.     McKinney's claims are further undermined by other language in the agreements. The area development and franchise agreements each contain integration clauses which expressly disavow any promises not included in the written agreements between the parties. The Area Development Agreement, for example, states that “this Agreement … constitutes the entire agreement of the parties, and there are no other oral or written understandings or agreements … relating to the subject matter of this agreement.”     McKinney cannot prevail on his claim under the Minnesota statute unless, in offering him a franchise, Cousins made an untrue statement of material fact. Cousins offered the franchises to McKinney through the written franchise documents, not through the alleged oral promises that are inconsistent with the exhibits. And the written documents do not contain untrue statements of material fact or omissions of material facts, nor does McKinney claim that they do. Therefore, McKinney's claim that the Minnesota Franchise Act was violated fails.     In sum, McKinney is an experienced businessman who made a deal which turned out to be less favorable than he anticipated. McKinney expressly acknowledged in detailed written agreements negotiated with the assistance of counsel that his purchase of a franchise was not a risk-free endeavor. He now makes allegations that are directly contrary to the agreements he signed. For the reasons stated, his claim under the Minnesota statute fails. | | | |  | **DISMISSED.** | | | |  | | | | | |  | |  | | --- | | **CRITICAL THINKING** |     What are the primary facts of this case? How would you word the issue of the case in your own words?  Judge Adelman repeatedly says the written terms of the contract between Cousins and McKinney are inconsistent with any alleged oral agreements they made. Do you agree that written contracts should overrule oral agreements in most instances? Why or why not? |  | |  | | --- | | **ETHICAL DECISION MAKING** |  |  | | --- | | Who are the primary stakeholders affected by the court's ruling for Cousins?     The decisions of a court have implications for business ethics. While [Chapter 2](http://highered.mheducation.com/sites/0077339177/student_view0/ebook/chapter2/chapter_opener.htm) distinguishes between what the law requires of a manager and what ethics requires, the relationship between the law and ethics is reciprocal. While ethical judgments lie behind various laws, law does have impacts on business ethics. In this case, the court's decision reminds us that business ethics must pay attention to the various stakeholders who feel the impacts of any business agreement. | |  |  |  |  |  |  |  |  |  |  | | --- | --- | --- | --- | --- | --- | --- | --- | |  | |  |  |  | | --- | --- | --- | |  | p. 788  **CASE OPENER**  **WRAP-UP** |  |  |  |  |  | | --- | --- | --- | |  | **Dunkin’ Donuts**  Bhayani's Dunkin' Donuts franchises violated the license agreement on multiple levels. Financially, under the franchise agreements, Bhayani agreed to pay a franchise fee of 4.9 percent of gross sales to Dunkin' Donuts and an advertising fee of 5 percent of gross sales to the Franchise Owners Advertising and Sales promotion fund. However, Bhayani fell behind on both financial payments on numerous occasions. By the time Dunkin' Donuts sent notice of termination, Bhayani owed $33,189.38 in delinquent fees and failed to cure the financial default.     Furthermore, Bhayani's franchises were also in violation of health and safety standards from the license agreement. During its routine health inspections, Dunkin' Donuts found multiple health and sanitation violations such as pests and evidence of pests; improper storage, refrigeration, and cooking temperatures; improper food and chemical storage; unsanitized utensils; faulty faucets; unclean floors, walls, countertops, toilets, and sinks; insufficient employee hygiene; ill-kept trash areas; and various documentation deficiencies. While some of these were cured by the time of the next inspection, most were not. After each substandard inspection, Dunkin' Donuts sent a notice of default and notice to cure. On the basis of the perceived failure to cure these violations over a substantial period of time, Dunkin' Donuts sent Bhayani a supplemental notice of termination.     As a franchisor, Dunkin' Donuts Corporation is permitted to establish certain standards for franchisees. With regard to Bhayani's restaurants, Dunkin' Donuts established standards for cleanliness and also negotiated financial rates. In accordance with the provisions in the license agreement, Dunkin' Donuts terminated the franchises. Bhayani claimed that any breaches of the agreement by him—either financial breaches or health, sanitation, and safety violations—were directly caused by the bad-faith actions of Dunkin' Donuts. He argued that Dunkin' Donuts targeted him for his franchisee activism by classifying him as a “C” franchise and blocking his attempt to open another franchise. However, the court found that Bhayani did not show that his franchises were exceptional or that they were terminated on the basis of some sort of “pretext” of Dunkin' Donuts. Thus, Dunkin' Donuts was well within its legal rights to terminate the franchise agreement.     Disagreements regarding payments or health standards of franchises are examples of what could go wrong with a franchising agreement. Another example of potential problems between franchisors and franchisees is disagreement over the termination of the franchise. All of these problems exist in the Dunkin' Donuts case. Both parties probably would have benefited from a greater understanding of the responsibilities of the franchisor and franchisee. |  | | |

## hapter36: Partnerships: Nature, Formation, and Operation

# Chapter Opener

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| p. 793   |  |  |  |  | | --- | --- | --- | --- | |  | | | | |  | PART 7 |  | Business Organizations |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  | | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | |  | |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  | | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | | |  |  | | --- | --- | |  | **LEARNING OBJECTIVES** |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  | | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | |  | After reading this chapter, you will be able to answer the following questions:   |  |  |  |  | | --- | --- | --- | --- | |  | [**1**](http://highered.mheducation.com/sites/0077339177/student_view0/ebook/chapter36/chbody1/nature_of_the_partnership.htm#lo1) |  | What is a partnership? | |  | [**2**](http://highered.mheducation.com/sites/0077339177/student_view0/ebook/chapter36/chbody1/formation_of_the_partnership.htm#lo2) |  | What are the different ways in which a partnership can be formed? | |  | [**3**](http://highered.mheducation.com/sites/0077339177/student_view0/ebook/chapter36/chbody1/interactions_between_partners.htm#lo3) |  | What are the rights of partners as they interact with each other? | |  | [**4**](http://highered.mheducation.com/sites/0077339177/student_view0/ebook/chapter36/chbody1/interactions_between_partners_and_third_parties.htm#lo4) |  | Are all members of a partnership liable for interactions with third parties? | | |  |  |  |  | | --- | --- | --- | |  | **CASE OPENER** **Jax Restaurant Partnership** |  |  |  |  |  |  |  |  |  |  | | --- | --- | --- | --- | --- | --- | --- | --- | |  | One afternoon in October 2000 Nicole Moren completed her day shift at Jax Restaurant at 4 p.m. and left to pick up her two-year-old son from day care. Moren was a partner in the restaurant. At about 5:30, Moren returned to the restaurant with her son after learning that her sister and partner, Amy Benedetti, needed help. Moren then called her husband to pick up their child. Because Moren did not want her son running around the restaurant, she brought him into the kitchen with her and put him on top of the counter until his ride arrived. While she was making pizzas, her son reached his hand into the dough-pressing machine. Unfortunately, his hand was crushed, resulting in permanent damages.     As a result of his son's debilitating accident, the child's father commenced a negligence action against the partnership. Therefore, the partnership served a third-party complaint on Nicole Moren, arguing that if the restaurant was obligated to compensate her son, the partnership was entitled to indemnity (reimbursement) from Moren for her own negligence. In other words, the partnership argued that it should not be held financially liable for the damages because the accident was Moren's own fault since she let her son enter the kitchen and play near the dough press.   |  |  |  | | --- | --- | --- | | p. 794  1. |  | Is the partnership as a whole liable even though it was primarily Moren's negligence that caused her son's injury? | | 2. |  | What could Jax Restaurant have done to avoid this suit? |   The Wrap-Up at the end of the chapter will answer these questions. | |        In the Jax Restaurant case, the court had to consider the laws of partnership in determining whether to find the partnership as a whole liable. The Uniform Partnership Act (UPA) is the main statute governing partnership law. If there is no express partnership agreement, UPA establishes the rules for the partnership.     This chapter discusses the creation and operation of the partnership, and the following chapter considers how partnerships are terminated as well as special types of partnerships. The first section of this chapter considers the nature of the partnership relationship, how partnerships are created, and how they function. |

## Chapter36: Partnerships: Nature, Formation, and Operation

# Nature of the Partnership

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| |  |  |  |  |  |  |  | | --- | --- | --- | --- | --- | --- | --- | | What exactly is a partnership? According to UPA Section 6, a **partnershipA voluntary association between two or more people who co-own a business for profit.** is “an association of two or more persons to carry on as co-owners a business for profit.” Let's analyze all four parts of this definition to understand their implications. (See [Exhibit 36-1](http://highered.mheducation.com/sites/0077339177/student_view0/ebook/chapter36/chbody1/nature_of_the_partnership.htm#id_0073377678_001_021517).) |  | |  |  | | --- | --- | |  |  | | What is a partnership? |  | |   **Exhibit 36-1** Characteristics of a Partnership   |  |  |  |  |  |  |  |  |  |  |  |  |  |  | | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | | |  | | --- | | **A partnership is:** | | **An association** |  | It is a consensual and voluntary relationship, meaning that no one was forced into the partnership. | | **Between two or more legal persons** |  | It consists of two or more individuals, partnerships, corporations, or other forms of business organization. | | **To carry on a business for profit** |  | Its purpose is to make several business transactions for the trade, occupation, or profession with the intention of making a profit from the business. | | **As co-owners** |  | The partners share in the management and profits of the business. No party can receive a share of the profit for the purpose of payment of debt, interest, or annuity or from the sale of property. | |        First, by “association,” UPA means that the partnership is a voluntary and consensual relationship. No one can force someone else to enter into a partnership with him or her. Second, a partnership requires “two or more persons.” UPA defines *persons* as “individuals, partnerships, corporations, and other associations.” Therefore, almost any individual or group of people could serve as a partner, but these persons must have the legal capacity to be partners. Although minors can serve as partners, the resulting partnership agreement is voidable.     Third, in a partnership, the partners must operate the business for a profit. This criterion is interpreted to mean that the partners must intend to make some kind of profit from the business.     Finally, the partners must serve as co-owners. Being co-owners means that they must share its profits or losses as well as share in the management of the business.  p. 795     The fourth element of the definition is that the partnership be “for profit,”     To summarize, a partnership has the following characteristics:   |  |  |  | | --- | --- | --- | | **•** |  | *Voluntary* and *consensual* relationship. | | **•** |  | Between two or more *individuals, partnerships, corporations,* or other forms of business organization. | | **•** |  | Who engage in *numerous business transactions* over a period of time. | | **•** |  | Intending *to make a profit.* | | **•** |  | And *sharing* the *profits* and *management* of the business. |   Courts look for these factors when parties dispute whether a partnership exists.   |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  | | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | | Probably the most important factor in determining whether a partnership exists is whether the profits from the business are shared. UPA has established several exceptions in which a sharing of profits does not constitute a partnership. For example, when an employer shares profits with an employee as payment for work, or when a landlord accepts shares of profits for payment of rent, there is no partnership. If a party receives a share of profits for any of the following reasons, there is no partnership:   |  |  |  | | --- | --- | --- | | **•** |  | Payment of a debt. | | **•** |  | Payment of an annuity to a widow or representative of a deceased partner. | | **•** |  | Payment from the sale of goodwill of a business or some other property. | | **•** |  | Payment of interest on a loan. | |  | |  |  |  | | --- | --- | --- | |  | To see a description of considerations a business manager ought to have regarding whether a partnership will result in synergy, please see the **Connecting to the Core** activity on the text Web site at [www.mhhe.com/kubasek2e](http://www.mhhe.com/kubasek2e). |  | |   **Legal Principle:**  **Perhaps the most important factor in determining whether a partnership exists is whether the profits are shared. Furthermore, this sharing of profits must not meet one of the UPA exceptions.**  [Case 36-1](http://highered.mheducation.com/sites/0077339177/student_view0/ebook/chapter36/chbody1/nature_of_the_partnership.htm#id_0073377678_001_021561) illustrates the court's analysis of whether a partnership relationship indeed exists.   |  |  |  |  | | --- | --- | --- | --- | |  | **CASE**   **36-1** |  | **INGRAM v. DEERE** **SUPREME COURT OF TEXAS 52 Tex. Sup. J. 1030 (2009)** |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  | | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | |  | *Jesse Ingram, a licensed psychologist, and Louis Deere, a board certified psychiatrist, entered into an oral agreement providing that Dr. Deere would serve as the medical director for a multidisciplinary pain clinic. Dr. Deere contends that they agreed he would receive one-third of the clinic's revenues, Dr. Ingram would receive one-third, and the remaining one-third would be used to pay the clinic's expenses. Dr. Deere also claims that when he and Ingram began working together, Ingram told him their work “was a joint venture, or [they] were partners, or [they] were doing this together.”*  *Fourteen months after Dr. Deere began working at the clinic, Dr. Ingram prepared a written agreement to memorialize their arrangement. The document stated Dr. Ingram was the “sole owner” of the clinic. Subsequently, Dr. Deere refused to sign the document, claiming that it contradicted their initial arrangement. Immediately after Deere received the document, he ceased working at the clinic and later sued Ingram, asserting claims of common law fraud, statutory fraud, fraudulent inducement, breach of contract, and breach of fiduciary duty. The appellate court supported the jury's finding that a partnership existed between Dr. Deere and Dr. Ingram. Subsequently, the Supreme Court of Texas must determine whether Dr. Deere and Dr. Ingram indeed created a partnership for their pain clinic.*  **JUDGE WAINWRIGHT:** The Texas Uniform Partnership Act (TUPA) was passed in 1961 and substantially adopted the major provisions of the Uniform Partnership Act (UPA), which itself was adopted in every state except Louisiana after it was approved by the National Conference of Commissioners on Uniform State Laws in 1914. TUPA was replaced by The Revised Partnership Act (TRPA), effective January 1, 1994, the result of a project of the Partnership Law Committee of the State Bar of Texas Section on Business Law and the Texas Business Law Foundation Act of May 31, 1993. TRPA carried forward some of the common law modifications in ways relevant to this case that were promulgated in TUPA. The partnership in this case was allegedly formed in 1997. It is uncontested that TRPA governs this dispute; rather, the parties contest whether Deere has proven the existence of a partnership under TRPA.  p. 796     TRPA provides that “an association of two or more persons to carry on a business for profit as owners creates a partnership.” Unlike TUPA, TRPA articulates five factors, similar to the common law factors, that indicate the creation of a partnership. They are:   |  |  |  |  | | --- | --- | --- | --- | |  | (1) |  | receipt or right to receive a share of profits of the business; | |  | (2) |  | expression of an intent to be partners in the business; | |  | (3) |  | participation or right to participate in control of the business; | |  | (4) |  | sharing or agreeing to share:   |  |  |  | | --- | --- | --- | | (A) |  | losses of the business; or | | (B) |  | liability for claims by third parties against the business; and | | |  | (5) |  | contributing or agreeing to contribute money or property to the business. |      The common law required proof of all five factors to establish the existence of a partnership. TRPA contemplates a less formalistic and more practical approach to recognizing the formation of a partnership.     First, TRPA does not require direct proof of the parties' intent to form a partnership. Formerly, the intent to be partners was a “prime,” although not controlling, element in the creation of a partnership. Instead, TRPA lists the “expression of intent” to form a partnership as a factor to consider. Second, unlike the common law, TRPA does not require proof of *all* of the listed factors in order for a partnership to exist. Third, sharing of profits—deemed essential for establishing a partnership under the common law—is treated differently under TRPA because sharing of profits is not required. Still, TRPA comments note that the traditional import of sharing profits as well as control over the business will probably continue to be the most important factors.  **Profit Sharing**  Deere argues that he received or had the right to receive a share of the clinic's profits because he and Ingram had an agreement in which each of them would receive one-third of the clinic's “gross revenue” and the remainder would be used for expenses. It is true that the “receipt or right to receive a share of profits of the business” may be indicative of the existence of a partnership under TRPA, but a share of profits paid as “wages or other compensation to an employee or independent contractor” is not indicative of a partnership interest in the business. The evidence does not establish that Deere received a share of profits as contemplated under TRPA … [because] the agreement between Ingram and Deere cannot constitute Deere's receipt of “profits,” but rather of gross revenue.     Second, Ingram wrote twenty checks to Deere as compensation from January 1997 until March 1999. These checks referred to Deere as a “medical consultant” and the payments as “contract labor.” Therefore, they contradict his argument that he received profits as a partner in the clinic.  **Expression of Intent to be Partners**  “[E]xpression of an intent to be partners in the business” is one of five factors courts use in determining whether a partnership exists. This is different from the common law definition of a partnership that required proof that the parties intended to form a partnership at the outset of their agreement. When analyzing expression of intent under TRPA, courts should review the putative partners' speech, writings, and conduct. Evidence of expressions of intent could include, for example, the parties' statements that they are partners, one party holding the other party out as a partner on the business's letterhead or name plate, or in a signed partnership agreement.     Deere argues that he expressed his intent to be a partner with Ingram by sharing the clinic's profits and losses and having access to the clinic's records. His evidence of other factors, sharing of profits and losses and control of the business, is insufficient to establish expression of intent. Deere's evidence is also insufficient because there must be evidence that both parties expressed their intent to be partners.     Deere also testified that the clinic kept its established name after he joined as the medical director, and he and Ingram never discussed a name change. He never signed a lease agreement for the building owned by Ingram where the clinic was housed, was not named on the clinic's bank account, never signed a signature card for the clinic's bank account, and never filed taxes representing that he was co-owner of the clinic. Additionally, Deere paid his own medical malpractice insurance, which he acknowledged was his common practice when he did contract work. Deere cannot provide the content, context, or circumstances to give any of the alleged expressions of intent legal significance as evidence of a partnership.  p. 797  **Control**  Deere argues he had an equal right to control and manage the clinic's business because, although he was never allowed to see the books and records, he repeatedly requested to see them. He also points to Ingram's testimony that “maybe” Deere viewed the clinic's books on one occasion. Furthermore, Deere argues that he had control because Ingram discussed with him how much the clinic made, the amounts paid to the staff, and the need to hire Ingram's wife as personnel director. No other evidence supports these statements and proves he participated in or had the right to control the clinic's business.  **Sharing of Losses and Liability for Third Party Claims**  According to Deere, he and Ingram agreed that Deere would receive one-third of the clinic's gross revenue, Ingram would receive one-third of the clinic's gross revenue, and the remainder would be used to pay clinic expenses. Deere argues that this agreement determined how losses would be shared, but he testified that there was never a discussion of how expenses in excess of one-third of the clinic's gross revenue would be divided between him and Ingram. Here, Ingram and Deere never discussed what would happen to the allocation if expenses exceeded one-third of the revenue or gross income. They never discussed losses, only expenses. There is no legally cognizable evidence to support the contention that Ingram and Deere agreed to share losses.  **Contribution of Money or Property**  Finally, there is no evidence that Deere “contribut[ed] or agree[d] to contribute money or property” to the clinic as a partner. Deere does not argue that there was any *agreement* that he contribute either money or property to the enterprise. Furthermore, Deere does not contend that he actually contributed money to the clinic. In fact, Deere acknowledged at trial that he did not contribute to clinic renovations or the purchase of medical equipment and supplies and that he did not agree to use his personal resources to pay for any expenses in the operation of the clinic. Rather, Deere's only argument regarding this factor is that he contributed his reputation as property to the alleged partnership.     In this case, Deere has not provided legally sufficient evidence of any of the five TRPA factors to prove the existence of a partnership. Accordingly, we reverse the court of appeals' judgment. | |  | **REVERSED.** |  |  | | --- | |  |  |  |  |  |  |  |  |  |  | | --- | --- | --- | --- | --- | --- | --- | --- | |  | |  |  | | --- | --- | | |  | | --- | | **CRITICAL THINKING** | |     What evidence led the court to determine that the two doctors were not partners? Do you think any evidence hints at suggesting the two men could have formed a partnership? |  | |  |  | | --- | --- | | |  | | --- | | **ETHICAL DECISION MAKING** | |     Suppose for a moment that the court did believe a partnership existed. Perhaps Ingram was objecting to the partnership because he did not want to give Deere as large a portion of the revenue or profits. Notice that business ethics requires that we think beyond ourselves. Use the universalization test to explain why one should not attempt to avoid partnership responsibilities. |        In situations where there are no articles of partnership, the courts may look at other documentation to determine whether a partnership existed. Informal documentation, such as e-mails, notes, and memos, may be used to identify the existence of a partnership and/or the terms of a partnership. For example, before actress Vanessa Hudgens became famous through her recurring role in the *High School Musical* movie series, she worked with business manager Johnny Vieira. During their time together, Vieira claimed that he and Hudgens agreed to work together to launch her career and also agreed to share in the profits of her success equally. However, once Hudgens became a teen star, Vieira claims that she stopped working with him and failed to pay him his portion of the profits. Consequently, Vieira filed a lawsuit against Hudgens, asking for $5 million in punitive damages. In his lawsuit, Vieira noted a signed photograph on which Hudgens wrote “Johnny, thank you for everything, without you, I would be no where, we will make it BIG—Vanessa Hudgens.”[1](http://highered.mheducation.com/sites/0077339177/student_view0/ebook/chapter36/chbody1/nature_of_the_partnership.htm#id_0073377678_001_021623) The case was set to go to trial; however, two weeks before trial, Hudgens and Vieira reached a settlement outside court.  p. 798   |  |  |  |  |  |  |  | | --- | --- | --- | --- | --- | --- | --- | | |  | | --- | |  |  |  |  | | --- | --- | |  | **E-COMMERCE AND THE LAW** | |  |  |  |  |  |  |  | | --- | --- | --- | |  | **Forms of Partnerships in the ICT Sector in Developing Countries**  In the information and communication technology (ICT) sector of developing countries, businesses use partnerships between local and multinational companies to create a support structure. Three forms of partnership are especially important: (1) industrial districts, (2) *keiretsu* (a group of businesses in which each individual business has a stake in the others), and (3) offshore partnerships.     Industrial districts are loosely structured collectives of small to medium-size firms located in a specific area and highly specialized in one or more phases of a production process. Industrial districts are coordinated through both personal relationships and marketlike mechanisms. One purpose is to pool local competencies.  *Keiretsus* bring foreign ICT companies into a partnership and act as “hubs” served by local ICT ventures. *Keiretsus* add the strength of a competent hub, but over time this strength could make it less likely that local firms will develop strength of their own.     Offshore partnerships combine the strengths of outside firms with those of firms in developing countries. The developing-country firms use offshore partnerships to gain international exposure and technological competence. Foreign companies, such as U.S. and European Union (EU) firms, use offshore partnerships to gain (1) access to competent, low-cost workers and (2) the opportunity to enter developing markets. |  |      Now that you know how the courts determine whether a partnership exists, what kind of legal status do partnerships have? They can be either legal entities or aggregates of the partners.  **PARTNERSHIP AS A LEGAL ENTITY**  In some respects, a partnership is treated as a *legal entity,* a “person” separate from the partnership with a life of its own.     First, a partnership is often considered a legal entity when it is sued or being sued. States determine when the partnership can or cannot be named in the suit. Second, under the doctrine of marshaling assets, partnership assets are arranged in a certain order to pay any outstanding debts. Partnership creditors have first priority on partnership assets, while individual personal creditors have first priority on the assets of the individual partners. Thus, partnership assets are kept separate from the individual partner assets.     Third, the partnership may hold title to property that individual partners do not hold. If the partners want to sell partnership property, all must participate in the transaction. Finally, every partner is considered an agent of the partnership, and each has a fiduciary relationship with the others.  **PARTNERSHIP AS A LEGAL AGGREGATE**  Sometimes a partnership is considered a legal aggregate of the partners, such as when partnership debts eventually become the debts of the individual partners. Further, the partnership is not taxed as a separate being; instead, the partners pay taxes on the income generated through the partnership. Finally, because the partnership ceases to exist when one of the partners dies (unless otherwise established by the partnership agreement), the partnership is then considered an aggregate of the individual partners. |
| 1[www.people.com/people/article/0,20218606,00.html](http://www.people.com/people/article/0,20218606,00.html). |

## Chapter36: Partnerships: Nature, Formation, and Operation

# Formation of the Partnership

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| |  |  |  |  |  |  |  | | --- | --- | --- | --- | --- | --- | --- | | While an explicit written agreement is not required to create a partnership, partners are advised to create one to ensure that the terms of the partnership will be upheld. Suppose that you and your partner orally agree you will receive three-fourths of the profits because you are doing significantly more management tasks. However, when you distribute the funds, your partner sues you because you give him only one-fourth of the profits. Without a written partnership agreement, the courts will have a difficult time ruling in your favor. |  | |  |  | | --- | --- | |  |  | | What are the different ways in which a partnership can be formed? |  | |   p. 799     A written agreement that creates a partnership is called the **articles of partnershipThe written agreement that creates a partnership.,** What kind of information do the articles usually include? First, the partners' names, as well as the name of the partnership, should be listed. Second, the agreement should address the duration of the partnership, such as the date or event that signals the agreement's expiration, or it should make the partnership's term indefinite. Third, the agreement should state the division of profits as well as losses. Fourth, it should establish the division of management duties. Fifth, the agreement should state exactly what capital contributions each partner will make.  **Legal Principle:**  **A written agreement, although not legally mandatory, should be created when a partnership begins. This way, both parties can be protected if a dispute occurs or if an issue is brought to court.**  **PARTNERSHIP BY ESTOPPEL**  Parties not named in partnership agreements can sometimes be partners. How? Suppose you create a partnership agreement with your best friend. You then tell your first potential customer that your parents are also partners in the business. On the basis of your parents' participation, she decides to place an order with you. Your parents discover that you have reported they are your partners, but they do not contact the customer to tell her they are not partners. When your business cannot afford to purchase the goods to sell them to the customer, the customer sues you and your parents. Because your parents were aware of the misrepresentation but did not correct it, they will be estopped from denying they are your partners. While they will not be able to claim the rights associated with being a partner (such as sharing the profits), in many states they could be held liable for damages to the customer.     Most states recognize two situations in which a partnership by estoppel exists: (1) as in the example above, when a third party is aware of and consents to a misrepresentation of partnership, and (2) when a nonpartner has represented himself or herself as a partner and a third party *reasonably relies* on this information to his or her detriment. The nonpartner can be held liable for the third party's damages.  [Exhibit 36-2](http://highered.mheducation.com/sites/0077339177/student_view0/ebook/chapter36/chbody1/formation_of_the_partnership.htm#id_0073377678_001_021660) summarizes how a partnership can be created.  **Exhibit 36-2** Formation of a Partnership   |  |  |  |  |  |  |  |  | | --- | --- | --- | --- | --- | --- | --- | --- | | |  | | --- | | **A partnership can be formed by:** | | Articles of partnership |  | A partnership is formed by a written agreement that states the partners' names, the name of the partnership, the duration of the partnership, the division of profits and losses, the division of management duties, and the capital contributions that will be made by each partner | | Estoppel |  | If a third party is aware of and consents to a misrepresentation of partnership, a partnership can be formed. Or if a nonpartner acts as a partner and a third party reasonably relies on this information, the nonpartner can be considered a partner and thus be liable for the third party's damages. | | |

## Chapter36: Partnerships: Nature, Formation, and Operation

# Interactions between Partners

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| |  |  |  |  |  |  |  | | --- | --- | --- | --- | --- | --- | --- | | p. 800  The operation of the partnership encompasses two types of interactions: those between the partners and those between the partnership and third parties. The partners have certain rights and duties within each type.  **DUTIES OF PARTNERS TO ONE ANOTHER**  Most partners' duties to one another include the duty to be loyal. The duty to be loyal functions as an example of the fiduciary duty. Furthermore, most partners' duties include the duty of obedience. The duty of obedience is an example of the duty of care. |  | |  |  | | --- | --- | |  |  | | What are the rights of partners as they interact with each other? |  | |      Perhaps the most important type of duty partners have toward one another is the fiduciary duty. Partners must, in good faith, work for the benefit of the partnership. They should not take any action that will undermine it, such as engaging in business that competes with it.     Partners must disclose any material facts affecting the business. A partner who derives benefit from the partnership without the consent of the other partners must notify them of this benefit. [Case 36-2](http://highered.mheducation.com/sites/0077339177/student_view0/ebook/chapter36/chbody1/interactions_between_partners.htm#id_0073377678_001_021681) considers how a partner's fiduciary duty conflicts with a partner's belief that another partner is behaving unethically.   |  |  |  |  | | --- | --- | --- | --- | |  | **CASE**   **36-2** |  | **COLETTE BOHATCH v. BUTLER & BINION** **SUPREME COURT OF TEXAS 977 S.W.2D 543 (1998)** |  |  |  | | --- | --- | |  | *Colette Bohatch became an associate in the Washington, D.C., office of Butler & Binion in 1986. John McDonald and Richard Powers, both partners, were the only other attorneys in the office. After Bohatch was made a partner in February 1990, she became concerned that McDonald was overbilling Pennzoil, the office's main client. Bohatch met with the law firm's managing partner, Louis Paine, to report her concern. In July 1990, McDonald met with Bohatch to report that Pennzoil was dissatisfied with her work.*  *The next day, Bohatch spoke to Paine, as well as two other members of the law firm's management committee. Paine led an investigation of Bohatch's complaint and discussed the billed hours with the in-house counsel at Pennzoil, who concluded the bills were reasonable. In August 1990, Paine met with Bohatch, telling her that there was no basis for her claims against McDonald and that she should look for work elsewhere. The firm refused Bohatch a year-end partnership distribution for 1990. Finally, in August 1991, Bohatch was given until November to vacate her office. She filed suit in October 1991, and the firm voted to expel her from the partnership three days later.*  *At trial, the jury ruled the firm breached the partnership agreement and its fiduciary duty and awarded Bohatch $57,000 for past lost wages, $250,000 for past mental anguish, $4,000,000 total in punitive damages (this amount was apportioned against several defendants), and attorney's fees. Later, the trial court reduced the punitive damages to around $237,000. The court of appeals ruled the firm's only duty to Bohatch was not to expel her in bad faith. When it found no evidence the firm had fired Bohatch for its own gain, the appeals court ruled Bohatch could not recover for breach of fiduciary duty. The case was appealed to the Supreme Court of Texas.*  **JUDGE ENOCH:** We have long recognized as a matter of common law that “the relationship between … partners … is fiduciary in character, and imposes upon all the participants the obligation of loyalty to the joint concern and of the utmost good faith, fairness, and honesty in their dealings with each other with respect to matters pertaining to the enterprise.” Yet, partners have no obligation to remain partners; “at the heart of the partnership concept is the principle that partners may choose with whom they wish to be associated.” The issue presented, one of first impression, is whether the fiduciary relationship between and among partners creates an exception to the at-will nature of partnerships; that is, in this case, whether it gives rise to a duty not to expel a partner who reports suspected overbilling by another partner.  p. 801     While Bohatch's claim that she was expelled in an improper way is governed by the partnership agreement, her claim that she was expelled for an improper reason is not. Therefore, we look to the common law to find the principles governing Bohatch's claim that the firm breached a duty when it expelled her.     Courts in other states have held that a partnership may expel a partner for purely business reasons. Further, courts recognize that a law firm can expel a partner to protect relationships both within the firm and with clients. Finally, many courts have held that a partnership can expel a partner without breaching any duty in order to resolve a “fundamental schism.”     The fiduciary duty that partners owe one another does not encompass a duty to remain partners or else answer in tort damages. Nonetheless, Bohatch and several distinguished legal scholars urge this Court to recognize that public policy requires a limited duty to remain partners—i.e., a partnership must retain a whistleblower partner. They argue that such an extension of a partner's fiduciary duty is necessary because permitting a law firm to retaliate against a partner who in good faith reports suspected overbilling would discourage compliance with rules of professional conduct and thereby hurt clients.     While this argument is not without some force, we must reject it. A partnership exists solely because the partners choose to place personal confidence and trust in one another. Just as a partner can be expelled, without a breach of any common law duty, over disagreements about firm policy or to resolve some other “fundamental schism,” a partner can be expelled for accusing another partner of overbilling without subjecting the partnership to tort damages. Such charges, whether true or not, may have a profound effect on the personal confidence and trust essential to the partner relationship. Once such charges are made, partners may find it impossible to continue to work together to their mutual benefit and the benefit of their clients.     We are sensitive to the concern expressed by the dissenting Justices that “retaliation against a partner who tries in good faith to correct or report perceived misconduct virtually assures that others will not take these appropriate steps in the future.” However, the dissenting Justices do not explain how the trust relationship necessary both for the firm's existence and for representing clients can survive such serious accusations by one partner against another. The threat of tort liability for expulsion would tend to force partners to remain in untenable circumstance—suspicious of and angry with each other—to their own detriment and that of their clients whose matters are neglected by lawyers distracted with intra-firm frictions.     We emphasize that our refusal to create an exception to the at-will nature of partnerships in no way obviates the ethical duties of lawyers. Such duties sometimes necessitate difficult decisions, as when a lawyer suspects overbilling by a colleague. The fact that the ethical duty to report may create an irreparable schism between partners neither excuses failure to report nor transforms expulsion as a means of resolving that schism into a tort.     We hold that the firm did not owe Bohatch a duty not to expel her for reporting suspected overbilling by another partner. | |  | **AFFIRMED.** |  |  | | --- | |  |  |  |  |  |  |  |  |  |  | | --- | --- | --- | --- | --- | --- | --- | --- | |  | |  |  | | --- | --- | | |  | | --- | | **CRITICAL THINKING** | |     Think about the judge's reasoning that led to the conclusion that the firm did not owe Bohatch a duty not to expel her for reporting suspected overbilling. Is there any additional information you would have liked to know to determine whether the firm should have been allowed to dismiss Bohatch? |  | |  |  | | --- | --- | | |  | | --- | | **ETHICAL DECISION MAKING** | |     Bohatch made a decision about ethics when she chose to report what she suspected to be overbilling by a colleague. Do you think she made a good ethical decision? Would you guess she was guided by the Golden Rule, deontology, the universalization test, or some other method of ethical reasoning? |        The second type of duty the partners have is a duty of care to the other partners. Each partner must perform her management functions to the best of her abilities. A partner who makes an honest mistake in fulfilling responsibilities to the partnership will not be held liable for the mistake.  [Exhibit 36-3](http://highered.mheducation.com/sites/0077339177/student_view0/ebook/chapter36/chbody1/interactions_between_partners.htm#id_0073377678_001_021713) summarizes the primary duties of partners to one another.  p. 802  **Exhibit 36-3** Duties of Partners to One Another   |  |  |  |  |  |  |  | | --- | --- | --- | --- | --- | --- | --- | | |  |  |  | | --- | --- | --- | | Fiduciary duty |  | The partners must work for the benefit of the partnership and not engage in any action or business that could undermine or compete with the partnership. The duty of obedience is an example of a fiduciary duty. The partners must obey the partnership agreement; if they disobey the agreement, they can be held liable for any losses. | | Duty of care |  | The partners must perform their management functions to the best of their abilities. | |     **RIGHTS OF THE PARTNERS IN THEIR INTERACTIONS WITH OTHER PARTNERS**  According to the law, partners have certain rights regarding their interactions with other partners.  **Right to Share in Management.**    Unless otherwise stated in the partnership agreement, all partners have a right to participate equally in the management of the partnership. Even if one partner has an unusually large proportion of the management duties, each partner will have one vote in determining how the partnership is managed.     While most decisions are made by majority vote, some require agreement by all partners. If the partners are voting on whether to change some element of their partnership agreement, they all must agree with the change. Other decisions that require a unanimous vote include the admission of new partners and alterations in the nature of the business.  **Right to Share in Profits.**    If the partnership agreement does not establish another division of profits, all partners share equally in both profits and losses.  **Right to Compensation.**    Unless otherwise agreed, no partner will receive a salary for participation in the business regardless of the amount of time and effort put in. Of course, the partners may agree to create salaries for certain partners, but no partner enters the partnership relationship with a right to compensation for performing business activities. If a partner dies during the term of the partnership, however, the surviving partners are entitled to compensation for services in closing the partnership's business affairs.  **Property Rights.**    Partners have three property rights: (1) the right to participate in the management of the business, (2) the right to specific partnership property, and (3) the right to their partnership interest. (See [Exhibit 36-4](http://highered.mheducation.com/sites/0077339177/student_view0/ebook/chapter36/chbody1/interactions_between_partners.htm#id_0073377678_001_021735).) We've discussed the first right above; here we discuss the other two.     First, partners own the partnership property as *tenants in property,* which means they own it as a group. Any property brought into or acquired by the partnership is considered property of the partnership. Property in the name of an individual partner but purchased with partnership funds will be considered partnership property.     One way to determine whether specific property is a partnership asset is to determine the relationship of the asset to the partnership. If the asset is closely related to the business of the partnership, it will likely be considered a partnership asset.     Each partner has the right to possess partnership property. However, a partner cannot use this property to pay a personal debt. Similarly, the partner cannot sell or use the property if the purpose is outside the partnership interest.  p. 803  **Exhibit 36-4** A Partner’s Property Rights   |  |  |  |  |  |  |  |  |  |  | | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | | |  |  |  | | --- | --- | --- | | Right to participate in the management of the business |  | All partners have a right to participate equally in the management of the partnership. | | Right to specific partnership property |  | Partners own the partnership property as a group, and any property that is acquired by the partnership is considered property of the partnership. They have a right to this property but cannot use it to pay a personal debt and cannot sell or use the property if the purpose is outside the partnership interest. If a partner dies, the surviving partners receive the rights to the specific partnership property. | | Right to partnership interest |  | Each partner has a right to the interest of the partner's share of the profits and a return on capital contributed by the partner. If a partner dies, the interest earned by the deceased partner is added to his or her estate and is not given back to the partnership. | |        What happens to the partnership property if a partner dies? According to the **right of survivorshipThe right that specific partnership property will pass on to the surviving partner(s).,** the rights in specific partnership property pass to the surviving partners. However, the surviving partners must account to the deceased partner's estate for the value of that partner's interest in the specific property.     Second, a partner has a right to interest in the partnership. This interest, composed of a combination of the partner's share of the profits and a return of capital contributed by the partner, is part of the partner's personal property. If necessary, a partner can sell his interest in the partnership to a creditor. A partner's personal creditor cannot seize specific items of partnership property; however, the creditor can obtain a **charging orderAn order that entitles a creditor to collect a partner’s profits.,** which entitles the creditor to the partner's profits while the partner continues to act as a partner and engage in the partnership business.  **Right to Inspect Books.**    Each partner has the right to receive full information regarding partnership matters. This right corresponds to the partners' fiduciary duty to disclose any information affecting the partnership. Thus, partners must have access to all partnership books and records and be allowed to make copies of them. Unless otherwise agreed, the records must be kept at the principal business office.  **Right to an Account.**    An **accountingA review and listing of all partnership assets and/or profit.** is a review and listing of all partnership assets and/or profit and typically lists the distribution of assets and profit to the partners. Each partner has a right to an accounting in four circumstances:   |  |  |  | | --- | --- | --- | | **•** |  | Whenever the partnership agreement provides for an accounting. | | **•** |  | Whenever the copartners wrongfully exclude a partner from the partnership or from access to the books. | | **•** |  | Whenever any partner fails to disclose a profit or benefit from the partnership, thus breaching his or her fiduciary duty. | | **•** |  | Whenever circumstances render an accounting “just and reasonable.” |   **Legal Principle:**  **Unless otherwise stated in the partnership agreement, a partner's rights include the right to share in management, the right to share in profits, the right to compensation, property rights, the right to inspect books, and the right to an account.** |

## Chapter36: Partnerships: Nature, Formation, and Operation

# Interactions between Partners and Third Parties

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| |  |  |  |  |  |  |  | | --- | --- | --- | --- | --- | --- | --- | | p. 804  Each partner can serve as an agent for the other partners as well as for the partnership. As long as the partner has authority to act, each partner's act in performing business duties as well as making agreements with third parties is binding for the partnership. If the partner has authority to act and the partnership is bound by the act, each partner has unlimited personal liability for the obligation.  **ACTUAL AUTHORITY OF THE PARTNERS** |  | |  |  | | --- | --- | |  |  | | Are all members of a partnership liable for interactions with third parties? |  | |   According to UPA, general agency principles establish that partners have the authority to bind a partnership in an agreement. If a partner, following normal business procedures, binds the partnership to an agreement, both the partner and the partnership are liable for the obligation in the agreement.     Suppose Brittany is a partner in a firm. While allegedly carrying on partnership business, she engages in a business transaction and binds the partnership to the agreement. Yet suppose Brittany really didn't have authority to bind the partnership to the agreement with the third party. In this case, both Brittany and the firm are liable for the obligation. However, if the third party was aware that Brittany did not have the authority to bind the partnership to the agreement, Brittany will be held liable for the obligation but the partnership will not.  **IMPLIED AUTHORITY OF THE PARTNERS**  Because of the nature of the partnership, partners generally have greater implied authority than do typical agents. Their implied authority is usually determined by the nature of the business, and it permits partners to enter into agreements necessary to carry on partnership business. Thus, a partner has the authority to purchase goods necessary to perpetuate the business. However, a partner does not have implied authority to sell any property without the consent of all other partners.  **LIABILITY TO THIRD PARTIES**  According to UPA, if a partnership is liable, each partner has unlimited personal liability. That is, all partners are **jointly liableA term applied to partners who share liability for the partnership’s debts.** for the partnership's debts. To bring a claim, a party must either name all partners as defendants or simply name the partnership. If the claim is successful, each partner is liable for the judgment. If one partner pays the entire judgment, the other partners must indemnify, or reimburse, him or her. In the Case Opener, the partners in Jax Restaurant were concerned about their joint liability for the accident that occurred in their dough press. The partners argued that they should not be held jointly liable because it was the negligence of one partner that caused her own son's injury. They argued that if they were liable, Moren should have to indemnify the other partners as a result of her negligent behavior. Do you think the court made all the partners pay the damages?     When a partner commits a tort or a breach of trust, all partners are jointly and severally liable. In fact, all partners are jointly and severally liable for the entire amount of any judgment rendered. **Joint and several liabilityA type of liability in which a third party can choose to sue the partners separately or to sue all partners jointly in one action.** means that a third party can choose to sue the partners separately or all partners jointly in one action. Suppose William sues your partnership, which has four partners. William might name one of the partners in the first action. If the partner is found liable, William can sue all three other partners separately. However, if in the first claim the court ruled that the partnership was not liable in any form, William cannot bring a successful claim against a second partner on the issue of the partner's liability.  p. 805     If William brings a successful claim against a partner, he can collect the judgment only on the assets of one partner. The partner is required to reimburse the partnership for the damages it pays to William. [Case 36-3](http://highered.mheducation.com/sites/0077339177/student_view0/ebook/chapter36/chbody1/interactions_between_partners_and_third_parties.htm#id_0073377678_001_021796) considers how other partners can be held liable for the negligence of one partner.   |  |  |  |  | | --- | --- | --- | --- | |  | **CASE**   **36-3** |  | **ERIC JOHNSON & LORI JOHNSON v. ST. THERESE MEDICAL CENTER** **APPELLATE COURT OF ILLINOIS, SECOND DISTRICT 296 ILL. APP. 3D 341; 694 N.E.2D 1088; 1998 ILL. APP. LEXIS 301** |  |  |  | | --- | --- | |  | *In November 1990, Eric and Lori Johnson brought their 22-month-old daughter, Erica, to St. Therese Medical Center, where she was treated and released by Dr. Bruce Sands. Dr. Sands was a partner of Northern Illinois Emergency Physicians, Ltd. Drs. Richard Keller, Michael Oster, Thomas Braniff, Rodney Haenschen, and Phillip Gillespie were the other partners. The Johnsons filed suit against Dr. Sands and the partnership, arguing that Dr. Sands negligently caused the death of Erica and the partnership was liable because St. Therese acted on its behalf. A jury gave the Johnsons a $4 million award against Dr. Sands, St. Therese, and the partnership. Dr. Sands later filed for bankruptcy.*  *All the partners were issued citations to discover the assets of the partnership. At the citation hearings, all the partners (except Gillespie) admitted they were partners in the partnership at the time of the Johnson incident. In February 1997, the trial court judge ruled the Johnsons could proceed against the general partners individually if they were partners at the time of the incident. Consequently, the plaintiffs started motions to withhold the wages of all partners. Court proceedings ensued in which various partners argued they should not be held personally liable. Several were sentenced to jail time because they refused to testify regarding their personal assets. In June 1997, the trial court ruled that the assets of Keller, Haenschen, and Braniff be turned over to the Johnsons.*  **JUSTICE MCLAREN:** We acknowledge that all partners are jointly and severally liable for everything chargeable to the partnership for the loss or injury of a third person due to any wrongful act or omission of any partner acting in the ordinary course of the business of the partnership. Further, “an unsatisfied judgment against a partnership in its firm name does not bar an action to enforce the individual liability of any partner.” However, “[a] judgment entered against a partnership in its firm name is enforceable only against property of the partnership and does not constitute a lien upon real estate other than that held in the firm name.” Therefore, where judgment is entered against a partnership, but not against the individual partners, the judgment may not be satisfied by the personal assets of the individual partners.     For example, in Cook, the Department of Revenue issued a notice of tax liability to a partnership. The Department of Revenue was unable to enforce the tax liability against the partnership because the Partnership had previously filed for bankruptcy. Therefore, the Department of Revenue attempted to enforce the partnership's tax liability against the plaintiff, a general partner. The partner received a copy and was aware of the contents of the notice of tax liability issued to the partnership. However, the Department of Revenue did not issue a notice of tax liability or a final assessment to the partner in his individual capacity. Thus, the trial court granted the partner's motion for summary judgment.     This court affirmed, stating that, because a partnership can own property, it is a separate entity from its partners. Because the Department of Revenue issued notice of tax liability and the final assessment to the partnership, and not to the partner individually, and, because the Department of Revenue did not join the partner, the partner did not have notice that he could be liable personally for the partnership's tax debt. Thus, this court reasoned that the partner was denied due process.     The case at bar is closely analogous to Cook. The plaintiffs in the instant case named the Partnership, but not the individual Partners, in their complaint. The plaintiffs served the Partnership, but not the individual Partners. In addition, the Partners in this case, just like the partner in Cook, were aware of the contents of the plaintiffs' complaint against the Partnership. However, because the Partners were not named defendants and were not served in their individual capacities, they were not put on notice that their personal assets were at risk. Further, the plaintiffs in this case are unable to collect from Sands because he has filed for bankruptcy protection. Finally, judgment was entered against the Partnership, but not the individual Partners. Thus, the Partners were not judgment debtors and were not subject to citations proceedings to the extent that the plaintiffs had any claim upon the Partners' individual assets. Accordingly, the trial court erred when it attempted to enforce the judgment against the Partners by ordering the turnover of the Partners' assets and holding the Partners in contempt.  p. 806     The plaintiffs argue that the Partners are judgment debtors because the partnership name is on the judgment order. However, the plaintiffs fail to recognize that “[a] judgment entered against a partnership in its firm name is enforceable only against property of the partnership.” Because nothing in the record indicates that the Partners held assets which belonged to the Partnership, their argument fails.     Next, the plaintiffs argue that the Partners are judgment debtors because they are jointly and severally liable for the debts of the Partnership. We do not dispute this statement. However, the plaintiffs ignore the fact that judgment was entered against the Partnership, and not the Partners as individuals. Thus, until a judgment is entered against the Partners individually, the plaintiffs cannot recover from the Partners' personal assets.     The plaintiffs also argue that section 2-411(b) of the Code of Civil Procedure permits the enforcement of liability in supplementary proceedings against an individual partner. Section 2-411(b) provides, “An unsatisfied judgment against a partnership in its firm name does not bar an action to enforce the individual liability of any partner.” Although “action” is not defined, the plaintiffs assert that a supplementary proceeding to collect a judgment is an “action” within the meaning of section 5/2-411(b). We disagree.     Section 12-102 of the Code of Civil Procedure provides that “[a] judgment entered against a partnership in its firm name is enforceable only against property of the partnership and does not constitute a lien upon real estate other than that held in the firm name.” Under the plaintiffs' interpretation of section 2-411(b), this section has no meaning. Under the plaintiffs' interpretation, a judgment against only a partnership is enforceable against the partners individually without a judgment being entered against the partners individually. Because the plaintiffs' interpretation of section 2-411(b) renders section 12-102 ineffective, it cannot be adopted by this court.     Next, the plaintiffs assert that “a judgment against a partnership, by definition, is a judgment against each partner.” However, this court's decision in Cook clearly contradicts the plaintiffs' position. In Cook, we held that, although partners are liable for the debts of the partnership, to be able to collect from the partners the plaintiff must provide the partners with notice that they will be individually liable for the partnership's debt. Since the plaintiffs failed to provide such notice, their argument fails. | |  | **REVERSED.** |  |  | | --- | |  |  |  |  |  |  |  |  |  |  | | --- | --- | --- | --- | --- | --- | --- | --- | |  | |  |  | | --- | --- | | |  | | --- | | **CRITICAL THINKING** | |     Part of the confusion in this case was based on the ambiguity in Section 2-411(b) of the Code of Civil Procedure. Can you identify the ambiguity and explain how different interpretations of the code lead to different conclusions? |  | |  |  | | --- | --- | | |  | | --- | | **ETHICAL DECISION MAKING** | |     Suppose you were one of the partners in this case. If you were guided by duty ethics, would any of the details of the case be altered? |     **Legal Principle:**  **As a general rule, if the partnership is liable, all partners are liable for the debts of the partnership. Furthermore, all partners are liable for a tort or breach of trust committed by a single partner.**  **LIABILITY OF INCOMING PARTNERS**  When a partnership adds another partner, the new partner assumes limited liability for any obligations that occurred before he or she was added. The new partner cannot be held personally liable for them, but the capital the new partner adds can be used to pay them off. Clearly, because an incoming partner assumes limited liability, the dates of agreements, as well as the date the new partner was added, are extremely important.  p. 807   |  |  |  |  |  |  |  | | --- | --- | --- | --- | --- | --- | --- | | |  | | --- | |  |  |  |  | | --- | --- | |  | **COMPARING THE LAW OF OTHER COUNTRIES** | |  |  |  |  |  |  | | --- | --- | |  | **Silent Partnerships in Germany**  The original intent behind silent partnerships was to allow two people to engage in a partnership without having to inform the third party. Recently, both civil and common law countries have been moving away from this total anonymity. France permits the silent partner to choose whether to disclose the relationship. Germany, however, has held to the original intent of silent partnerships.     Under German law, a contract is formed between the silent partner (usually the financier) and the proprietor of the business. In exchange for his or her investment, the silent partner receives a designated share of the profits. Enlisting a silent partner does not require registration, and the company should continue to operate under the proprietor's name.     Because business is conducted under the proprietor's name and the partnership remains a secret to the third party, silent partners are not held personally liable for damages incurred in the course of business. This nonliability makes silent partnerships less widely used in Germany than in other countries. Nevertheless, it creates unique situations. A proprietor could enlist his or her child as a silent partner, who collects assets while remaining anonymous and ineligible for any liability claims. Nonliability guards the interests of the silent partner.     In Germany, the benefits swing in favor of the silent partner. While the proprietor transacts all the business and the third party remains unaware of the existence of the partnership relationship, silent partners enjoy minimal responsibility and no risk of personal liability.     You may be surprised that the silent partnership arrangement is legal in Germany. But as a critical thinker you have a responsibility to rethink your reasoning. Can you create a list of reasons why our own legal system should encourage silent partnerships? | |

## Chapter36: Partnerships: Nature, Formation, and Operation

# The Revised Uniform Partnership Act

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
| Just as the original Uniform Partnership Act governs partnerships in the absence of an express agreement, the Revised Uniform Partnership Act (RUPA) has significantly changed several laws that relate to partnerships. Since being approved in 1996, RUPA has been adopted in roughly half the states, so it is wise to determine whether the state in which a partnership was formed operates under UPA or RUPA. Although RUPA generally serves to expand UPA, there is some disagreement between them about the rules of partnership.   |  |  |  |  |  | | --- | --- | --- | --- | --- | |  | |  |  |  | | --- | --- | --- | |  | **CASE OPENER**  **WRAP-UP** |  |     **Crushed Hand in the Dough Press at Jax Restaurant**  Under Minnesota's Uniform Partnership Act (UPA), a partnership is liable for loss or injury caused to a person “as a result of a wrongful act or omission, or other actionable conduct, of a partner acting in the ordinary course of business of the partnership or with authority of the partnership.” Thus, the key questions the court considered in the Jax Restaurant case were whether this injury occurred in the regular course of business of Nicole Moren or under the authority of the partnership.     Indeed, the court correctly concluded that Moren's conduct was in the ordinary course of business of the partnership and, as a result, that she did not need to indemnify (reimburse) the partnership for any negligence on her part. The incident happened in the ordinary course of the partnership's business because one of the cooks scheduled to work that evening did not come in and Moren's partner asked her to help in the kitchen. It was also undisputed that Moren was making pizzas for the partnership when her son was injured, and even though she was simultaneously acting in her role as a mother, her conduct remained in the ordinary course of the partnership business. Therefore, the entire partnership can be found liable for Moren's actions, and she would not need to reimburse the other partners for her own negligence.  p. 808     To prevent potential lawsuits, it is important for business owners and partners to establish clear guidelines of conduct for partners to follow. The rules of the partnership did not prohibit bringing unauthorized persons back to the kitchen or establish clear protocol for family members of partners. Furthermore, another partner, Amy Benedetti, authorized Moren's conduct by calling Moren to replace a worker and by not telling her that her child must leave the kitchen. Under Minnesota law, authorization from the other partners is merely an alternative basis for establishing partnership liability. The outcome of this case might have been quite different if the partnership had rules preventing negligence or if one of the partners had not authorized Moren's son to be near the dough press. Under those circumstances, Moren would have been responsible for reimbursing the partnership for damages resulting from her own negligence. | |

## Chapter37: Partnerships: Termination and Limited Partnerships

# Chapter Opener

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| p. 812   |  |  |  |  | | --- | --- | --- | --- | |  | | | | |  | PART 7 |  | Business Organizations |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  | | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | |  | |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  | | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | | |  |  | | --- | --- | |  | **LEARNING OBJECTIVES** |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  | | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | |  | After reading this chapter, you will be able to answer the following questions:   |  |  |  |  | | --- | --- | --- | --- | |  | [**1**](http://highered.mheducation.com/sites/0077339177/student_view0/ebook/chapter37/chbody1/termination_of_the_partnership.htm#lo1) |  | What are the steps in the termination of a partnership? | |  | [**2**](http://highered.mheducation.com/sites/0077339177/student_view0/ebook/chapter37/chbody1/limited_partnerships.htm#lo2) |  | How is a limited partnership formed? | |  | [**3**](http://highered.mheducation.com/sites/0077339177/student_view0/ebook/chapter37/chbody1/limited_partnerships.htm#lo3) |  | What are the rights and privileges of a limited partner and a general partner? | | |  |  |  |  | | --- | --- | --- | |  | **CASE OPENER** **Partnership Problems of Wildmeadow Village** |  |  |  |  |  |  |  |  |  |  | | --- | --- | --- | --- | --- | --- | --- | --- | |  | Christian Wyller was a partner in Wildmeadow Village partnership, which owned an office building in Juneau, Alaska. Under difficult economic circumstances, the partnership received an invitation to bid (ITB) from the state of Alaska to lease approximately 7,000 square feet of office space for five years. Wildmeadow secured the bid from the state. The partners held a partnership meeting and approved the state lease and various improvements necessary to meet the bid specifications. At the partnership meeting, it was reported that improvements of roughly $120,000 were necessary to meet the state bid. However, some of Wyller's partners authorized work on the entire building, including repairs not necessary for the state lease and not properly approved by the partnership. The total cost of repairs and improvements actually made to the building was $257,000, and the excess repairs were not authorized by the entire partnership.     After construction began, the partners discovered that their loan application to the bank was rejected and they would have to pay for the entirety of the repairs out of pocket. Wyller expressed reluctance to pledge cash or personal collateral for a loan, objected to substantial expenditures made without authorization, and said that he was at the limit of his resources. He would not pay for repairs he did not approve. Subsequently, the construction bills were not paid, and the construction company brought suit against Wildmeadow Village partnership and its individual partners. At trial, Wyller argued that he was entitled to damages because he did not authorize the repairs and he did not wrongfully cause the dissolution of the partnership. The court found Wyller partially at fault for the dissolution of the partnership and therefore not entitled to damages from the other partners. Wyller appealed to the supreme court of Alaska.   |  |  |  | | --- | --- | --- | | p. 813  1. |  | Should Wyller have to pay construction costs for the repairs he did not authorize? | | 2. |  | How are partnerships dissolved? |   The Wrap-Up at the end of the chapter will answer these questions. | | |

## Chapter37: Partnerships: Termination and Limited Partnerships

# Termination of the Partnership

|  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- |
| |  |  |  |  |  |  |  | | --- | --- | --- | --- | --- | --- | --- | | Before any partnership can be considered completely terminated, it must go through the *dissolution stage* and the *winding-up stage.***DissolutionThe change in the relation of partners caused by any partner’s ceasing to be associated with the carrying on of the partnership’s business.** is complete when any partner stops fulfilling the role of a partner to the business (by choice or default). Partners complete the **winding-upThe process of completing unfinished partnership business.** stage by taking account of the assets of the partner who has left and redistributing them among the other partners. The sections below explain the steps that must occur in the dissolution and winding-up stages for the termination to be complete. ([Exhibit 37-1](http://highered.mheducation.com/sites/0077339177/student_view0/ebook/chapter37/chbody1/termination_of_the_partnership.htm#id_0073377678_001_021978) summarizes all the stages in the life cycle of a partnership.) |  | |  |  | | --- | --- | |  |  | | What are the steps in the termination of a partnership? |  |   x |   **Exhibit 37-1** The Life Cycle of a Partnership |

## Chapter37: Partnerships: Termination and Limited Partnerships

# Dissolution of the Business

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| p. 814  Section 29 of UPA defines *dissolution* as “the change in the relation of the partners caused by any partner's ceasing to be associated with the carrying on, as distinguished from the winding up”—the activity of completing unfinished partnership business, collecting and paying debts, collecting partnership assets, and taking inventory—“of the business.” It is important to note that dissolution does not necessarily mean that the business cannot continue functioning; it simply means that there is a significant change in partner relations. Indeed, a partnership can continue after dissolution.     What might cause the dissolution of the partnership? The dissolution may occur by an act of the partners, an operation of the law, or an act of the court (see [Exhibit 37-2](http://highered.mheducation.com/sites/0077339177/student_view0/ebook/chapter37/chbody1/dissolution_of_the_business.htm#id_0073377678_001_021986)). One significant issue in the case of the Wildmeadow Village partnership was whether the dissolution of the business occurred properly. As you read this section, keep the chapter opener in mind to decide for yourself how Wyller's partnership was dissolved.  **ACT OF PARTNERS**  The partnership is a voluntary and consensual relationship, so the partners have the power to dissolve it at almost any time. They may simply agree that it will terminate at a certain time. Suppose Soo and Gerarldo, two partners in a college preparation business, are graduating from college. They both plan to accept jobs at other firms; neither expects to continue the college preparation business. When they created this business, they might have agreed to dissolve the partnership when one of them graduated from college. However, if the business is either a flop or an enormous success, they can agree to dissolve the partnership early or extend its term after graduation.     Alternatively, partners might agree to dissolve the partnership once they achieve a certain objective. Consider a partnership to sell homes in a housing development. Once all the homes have been sold, the partners may agree to dissolve the partnership.     When can a partnership be **rightfully dissolvedA term applied to the dissolution of a partnership in a way that does not violate the partnership agreement.,** meaning the dissolution does not violate the partnership agreement? We have established two circumstances above (after meeting an established objective and at the end of the term stated in the partnership agreement). Here are others:   |  |  |  | | --- | --- | --- | | 1. |  | *A partner withdraws from the partnership at will.* (A *partnership at will* is an agreement that does not specify the objective or duration of the partnership.) | | 2. |  | *A partner withdraws in accordance with the partnership agreement.* The partnership agreement may establish specific reasons that a partner may withdraw. | | 3. |  | *A partner is expelled from the partnership in accordance with the partnership agreement.* Suppose you are a partner in a law firm and you steal some type of property from the partnership. The partnership agreement will usually determine the reasons a partner may be removed from the partnership, and theft is often one of them. |   If a partnership is rightfully dissolved, all partners can demand that it be wound up and can participate in that process. Moreover, if the partners unanimously agree, they can continue the business using the partnership's name.  **Exhibit 37-2** Causes of a Partnership Dissolution  p. 815   |  |  |  |  |  |  |  | | --- | --- | --- | --- | --- | --- | --- | | |  | | --- | |  |  |  |  | | --- | --- | |  | **CASE NUGGET** | |  |  |  |  |  |  |  | | --- | --- | --- | |  | **Partnership Dissolution**  **In re Leah Beth Woskob, Debtor; Alex Woskob; Helen Woskob; the Estate of Victor Woskob v. Leah Beth Woskob, Appellant U.S. Court of Appeals for the Third Circuit 305 F.3d 177 (2002)**  In 1996, Leah Beth Woskob and Victor Woskob formed a partnership, the Legends Partnership, to construct, own, and operate the Legends, an apartment building. Married when they formed the partnership, the Woskobs separated and filed for divorce the following year. During the divorce proceedings, Victor prevented Leah from receiving any of the partnership proceeds. Leah was granted a petition for special relief and awarded the exclusive right to manage and derive income from the partnership. Shortly thereafter, Victor filed for bankruptcy. Leah continued to file tax returns on behalf of the partnership, each of which listed Victor as a general partner. When Victor died in a car accident in 1999, Leah gave his estate notice that she was exercising her right to buy out Victor's interest in the partnership. Victor's estate sued, claiming the partnership had already been dissolved and requesting that someone be appointed to oversee its winding up and a full accounting of the company's assets. When Leah filed for bankruptcy, the suits were moved to the bankruptcy court. The bankruptcy court ruled in favor of Leah, finding that the partnership had dissolved on Victor's death. Victor's estate appealed to the district court, which found that the partnership had dissolved two years *before* Victor's death, making Leah's attempt to buy out Victor's interest untimely. Leah appealed.     The task before the appeals court was to determine the timeliness of Leah's attempt to buy out Victor's interest in the partnership, which depended entirely on the date of the dissolution of the partnership. The court looked to the Uniform Partnership Act (UPA), which defined the dissolution of a partnership as “the change in the relation of the partners caused by any partner ceasing to be associated in the carrying on, as distinguished from the winding up, of the business.” Victor's estate claimed that the dissolution occurred at any one of three points, each at least 18 months before Victor's death. First, Victor excluded Leah from the partnership after they separated; second, Leah excluded Victor from the partnership after seeking special relief from the Court of Common Pleas; third, Victor filed for bankruptcy.     The appeals court found that the exclusions of Leah and Victor from the partnership were not, in and of themselves, grounds for automatic dissolution of the partnership. Rather, they could have provided a *basis* for dissolution, had either Leah or Victor sought judicial decree of the dissolution after being excluded. In addition, bankruptcy in and of itself is not grounds for automatic dissolution of the partnership. If the nondebtor partner does not consent to continue the partnership with the debtor, bankruptcy may be grounds for dissolution. However, Leah continued to list Victor as a general partner on the tax returns she filed for the partnership, even after he filed for bankruptcy. Thus, the appeals court found that the partnership had not dissolved prior to Victor's death in 1999 and that Leah's attempt to buy out Victor's interest in the partnership was therefore timely. |  |      However, a partner who dissolves the partnership in violation of the partnership agreement can be held liable for **wrongful dissolutionA partnership dissolution that violates the partnership agreement..** That partner cannot require that the business be wound up but can be held liable for damages to the remaining partners. They can choose to continue the business under the partnership name or wind it up.     In the chapter opener, if Wyller dissolved the partnership wrongfully, he could be liable for damages resulting from the failure to pay construction costs for the renovations. Because none of the partners withdrew at will or left the partnership in accordance with the partnership agreement, it appears that the Wildmeadow Village partnership was dissolved wrongfully. Now the court must decide who was responsible for the dissolution and whether it was indeed Wyller who dissolved the partnership wrongfully. If Wyller is responsible, he cannot require the winding up of his partnership and he may be held liable for the damages to the construction company.  p. 816  **Legal Principle: As a general rule, the partners have the power to dissolve the partnership at almost any time.**  **OPERATION OF LAW**  Several circumstances provided by law can dissolve a partnership: if a partner dies, if a partner is adjudicated bankrupt, or if the partnership business engages in an activity that suddenly becomes illegal. Suppose Congress decides cigarettes are illegal. A partnership that manufactures and sells cigarettes will be automatically dissolved.  **ACT OF THE COURT**  A partner may apply to the court to dissolve the partnership for any of the following reasons:   |  |  |  | | --- | --- | --- | | **•** |  | A partner is adjudicated insane | | **•** |  | It becomes impractical to carry out the business of the partnership (continuing will result only in lost profits). | | **•** |  | A partner is incapable of carrying out his or her duties as established by the partnership agreement. | | **•** |  | Other special circumstances exist. Suppose partners begin bitterly disagreeing about how the business should be managed, preventing the cooperation necessary for a partnership to exist. In this instance, the court can dissolve the partnership. |   [Case 37-1](http://highered.mheducation.com/sites/0077339177/student_view0/ebook/chapter37/chbody1/dissolution_of_the_business.htm#id_0073377678_001_022050) is one in which the court decided to dissolve a partnership.   |  |  |  |  | | --- | --- | --- | --- | |  | **CASE**   **37-1** |  | **LIEM PHAN VU v. DAVIS HA ET AL.** **SUPERIOR COURT OF CONNECTICUT 1997 CONN. SUPER. LEXIS 259** |  |  |  |  |  |  |  |  |  |  |  |  |  |  | | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | |  | *Liem Phan Vu and Davis Ha had an oral agreement to create a partnership to run a new nail salon. They agreed Ha would hold 60 percent of the partnership interest while Vu would hold 40 percent. Vu was responsible for advertising as well as keeping the books and records for the salon. Ha was responsible for operating and managing the business. The salon opened in summer 1995, and the partnership ended in November 1995. In November, Vu presented Ha with a proposed agreement to make the partnership a limited liability company. Ha was unhappy with the agreement and changed the locks on the salon. Ha testified that he thought Vu had taken items from the salon and was not doing sufficient record keeping. Vu argued Ha was excluding her from the business in violation of the partnership agreement. When the dispute went to trial, each party attempted to show he or she had invested more in the partnership. Vu brought suit for fourteen claims of relief; however, she really wanted the partnership to be dissolved and her portion of the investment returned. After reviewing her claims, the court considered the dissolution of the partnership.*  **JUDGE D’ANDREA:** The court has the power to dissolve a partnership by judicial decree, and may do so if it finds circumstances which would render a dissolution equitable. The court cannot imagine circumstances more compelling than exist in this case for such a finding. The parties have lost faith completely in each other; they each levy charges against the other for the failure of the business; one believes the other failed to keep proper records and to keep him apprised of the state of the finances; one claims physical exclusion from the business by the other and verbal attacks upon her.  p. 817     Since the court cannot affix blame for the demise of the partnership on either party, and does not find that a breach of the partnership contract has been proven, the rights of the parties are generally governed by Connecticut General Statutes 34–76.     Accordingly, the court orders dissolution of the partnership between the parties. Because the defendant Ha has continued in possession of the premises and continues to operate the business of the partnership, he is ordered to pay the plaintiff Vu the value of her interest in the partnership. No expert evidence was presented as to the value of the business, and the court can only be guided by the testimony of the defendant as to the value of the stock in trade. This figure is $2,000 and the plaintiff's interest in the partnership being forty percent; she is entitled to forty percent of that amount, or $800. The court also views the security deposit for the lease on the premises to be an asset of the business. That amount being $10,800, the plaintiff is entitled to forty percent thereof, or $4,320. Furthermore, the plaintiff shall not be responsible for the terms of the lease or for any existing obligation of the partnership.     Therefore, the court orders:   |  |  |  | | --- | --- | --- | | **(1)** |  | A decree of dissolution of the partnership between the parties; | | **(2)** |  | That the defendant pay to the plaintiff the sum of $5,120 as the value of her interest in the partnership; | | **(3)** |  | That the defendant indemnify and hold the plaintiff harmless from any liability under the lease of the premises at 21 High Ridge Road, Stamford, and from all liabilities for the debts and obligations of the partnership. | | | | |  | **Finding for the plaintiff.** | | | |  | | | | | |  | |  | | --- | | **CRITICAL THINKING** |   Review the court’s reasoning in *Liem Phan Vu*. What evidence would the court have needed to refuse to dissolve the partnership despite the feuding between the partners? The court provides hints about what that evidence would be. |  | |  | | --- | | **ETHICAL DECISION MAKING** |  |  | | --- | | The text discusses the dissolution of the partnership and explains how partners can be penalized if they attempt to leave the partnership wrongfully. What values are upheld by the court’s protection of the partnership? In other words, if the court did not hold value *X*, the demise of the partnership would not be considered such a liability. | |  | |

## Chapter37: Partnerships: Termination and Limited Partnerships

# Consequences of Dissolution

|  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| A partner who intends to dissolve or withdraw from the partnership must give the other partners notice of this intent. Once the partnership is dissolved, the partner no longer has actual authority to bind the partnership. However, if the partnership does not notify third parties of the dissolution, the partner can still have implied authority to bind the partnership. Suppose one of the partners in the college preparation business intends to dissolve the partnership. Before Soo can notify Geraldo of her intent, he makes an agreement to begin working with five new students to prepare them for college. Because Soo has not yet given notice of her intent to dissolve, she is still liable for the agreement Geraldo has made.     To ensure that a dissolving partner does not create additional liability for the partnership, firms usually take active steps to notify third parties about the dissolution, often by placing an advertisement in the newspaper. However, firms must provide direct verbal or written notice to any third party that has provided credit to the partnership.     Read the [Comparing the Law of Other Countries](http://highered.mheducation.com/sites/0077339177/student_view0/ebook/chapter37/chbody1/consequences_of_dissolution.htm#id_0073377678_001_022098) box on Scotland. What ethical behavior does the Scottish law encourage that might not be encouraged under U.S. law?  p. 818   |  |  |  |  |  |  |  | | --- | --- | --- | --- | --- | --- | --- | | |  | | --- | |  |  |  |  | | --- | --- | |  | **COMPARING THE LAW OF OTHER COUNTRIES** | |  |  |  |  |  |  |  | | --- | --- | --- | |  | **Termination of Partnerships in Spain**  In Spain, full dissolution is permitted in four situations (*full dissolution* simply means that the partnership ends without litigation or a waiting period): (1) One partner dies, (2) a partner is declared insane and unfit to manage the business, (3) a partner is declared bankrupt, and (4) a partner requests that the partnership be terminated.     Spain also allows for *provisional* (temporary) *dissolution,* followed by litigation to determine the legitimacy of the termination request. Provisional dissolution occurs when (1) a partner fails to comply with provisions of the contract, (2) a partner inexplicably abandons the partnership and does not return on request, (3) a partner fails to bring the capital he or she promised, (4) a partner is accused of fraud or mismanagement, (5) a partner exceeds the limits of his or her power, and (6) a partner uses capital belonging to the partnership in his or her own name.     During partial dissolution, the accused partner is excluded from all managerial responsibilities and profits and from any liability from business conducted during this time. Provisional dissolution prevents those unfairly accused of certain behaviors from losing their position in the partnership. But the process can be a tedious and lengthy one, whether the partial dissolution moves to complete termination or the partnership resumes. |  |      After the dissolution of the partnership, the partners' next step is either winding up the business or continuing the partnership or business. We'll discuss winding up the business first. |

http://highered.mheducation.com/olcweb/styles/hm/images/toolbar_top.gif

## Chapter37: Partnerships: Termination and Limited Partnerships

# Winding Up the Business

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| Once a partnership has been liquidated, the partners begin the process of winding up, the activity of completing unfinished partnership business, collecting and paying debts, collecting partnership assets, and taking inventory. During the process, the partners must still fulfill their fiduciary duty to one another and disclose all information about the partnership assets. However, they can engage in business that competes with the partnership business. [Case 37-2](http://highered.mheducation.com/sites/0077339177/student_view0/ebook/chapter37/chbody1/winding_up_the_business.htm#id_0073377678_001_022103) examines a partner's fiduciary duty during the winding-up period of the termination of the partnership.   |  |  |  |  |  |  |  | | --- | --- | --- | --- | --- | --- | --- | | |  | | --- | |  |  |  |  | | --- | --- | |  | **COMPARING THE LAW OF OTHER COUNTRIES** | |  |  |  |  |  |  |  | | --- | --- | --- | |  | **Effects of Dissolution in Scotland**  In many countries, a partner's ability to bind the partnership immediately ceases on the termination of the partnership. In Scotland, however, a partner may engage in business transactions in the name of the partnership for an unlimited time, provided the transactions are necessary to wind up the affairs of the former relationship. The intention behind this law is to prepare for any instances in which a partnership wants to terminate quickly but may have pending business. The partners can go ahead and cease the relationship and then tie up any loose ends.     For example, a partnership waiting to collect profits from a certain venture can dissolve before the profits have been deposited. Scottish law ensures that a bank is justified in accepting the signature of a partner wanting to deposit or withdraw money from a dissolved partnership's trust. The deposit and withdrawal are considered necessary in winding up the business of the partnership. |  |   p. 819   |  |  |  |  | | --- | --- | --- | --- | |  | **CASE**   **37-2** |  | **JACK A. KAHN AND DENISE W. KAHN v. STEWART MESHER AND LIESELOTTE MESHER** **COURT OF APPEALS OF WASHINGTON, DIVISION ONE 2000 WASH. APP. LEXIS 2090 (2000)** |  |  |  |  |  |  |  |  |  |  |  | | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | |  | *Stewart Mesher and Jack “Alder” Kahn jointly invested in real estate for approximately 30 years. In October 1993, Mr. Kahn notified Mr. Mesher that he was dissolving the partnership. One year later, the parties entered into an agreement (the “SMAK Agreement”) which governed the terms of the wind-down of the partnership, including the distribution of partnership properties. The SMAK Agreement specifically addressed the sale of a parcel of land called the Bothell property.*  *An outside party known as Sundquist wanted to make an offer on the Bothell property. Mr. Mesher arranged to sell the property secretly for $984,000 without informing Mr. Kahn of the offer. Mr. Mesher then went to Mr. Kahn to arrange for Mr. Kahn to sell him his shares in the Bothell property, still without telling him about the impending sale of the property. After the transfer of shares, Mr. Mesher signed a purchase and sale agreement for the Bothell property for $961,000 Subsequently, Mr. Kahn sued Mr. Mesher for breach of fiduciary duty to the partnership during the winding-up process. The trial court ruled in favor of Mr. Kahn. Mr. Mesher appeals.*  **JUDGE WEBSTER:** Washington law has long held “that the relationship among partners is fiduciary in character and imposes upon the partners the obligation of candor and utmost good faith in their dealings with each other.” There is no stronger fiduciary relationship known to the law than that of co-partners, and each partner is a trustee for all. The good faith obligation of a partner demands that the partner abstain from any and all concealment concerning matters pertaining to the partnership business.     Furthermore, Washington statutory and case law provides that the partners owe one another these fiduciary duties through the “winding-up” period of the partnership. The Washington statute provides in pertinent part:   |  |  |  | | --- | --- | --- | |  | Every partner must account to the partnership for any benefit, and hold as trustee for it any profits derived by him without the consent of the other partners for any transaction connected with the formation, conduct, or liquidation of the partnership or from any use by him of its property. |  |      Moreover, in *Bovy,* the Court of Appeals held that partners are “obligated to fully disclose any information pertaining to the winding up of partnership affairs.” Thus, the obligations of good faith and full disclosure continue during the winding up of the partnership and until the partnership affairs are completely settled.     The Meshers argue that *Elmore v. McConaghy* controls, and limits the scope of fiduciary duties the parties owed to one another during the winding-up of the partnership. In *Elmore,* the Supreme Court stated that:   |  |  |  | | --- | --- | --- | |  | Whatever fiduciary relation was imposed on the partners toward each other during the continuance of the partnership, the relation ceased when they began to negotiate between themselves as to the price to be paid by one for the other's interest |  |      The Meshers' reliance on *Elmore* is misplaced. *Elmore* was decided prior to this State's adoption of the Uniform Partnership Act, which explicitly defined the fiduciary duty of partners as continuing through the winding-up of the partnership.     In this case, the winding-up of the partnership was not complete, and fiduciary duties did not cease, until the Kahn/Mesher transaction closed on September 30, 1997. The closing of the real estate transaction represented the final settlement of the partnership affairs.     Indeed, the SMAK agreement, which delineated the terms of the winding-up of the partnership, specifically provided that the partnership would not terminate until all partnership accounts were settled. While Mesher argues that his fiduciary duties ceased upon the agreement of the parties on a price on August 22, 1997, the SMAK agreement required that Mesher pay Kahn and Kahn transfer the Kahns' interest to Mesher. This requirement was not met until the transaction closed on September 30. Thus, under the SMAK agreement, Mesher owed Kahn fiduciary duties until at least September 30, 1997.     Because Mesher owed Kahn a fiduciary duty after August 22, 1997, we must determine whether he breached that duty by not revealing the Sundquist offer to Kahn.     As noted above, partners are “obligated to fully disclose any information pertaining to the winding up of partnership affairs.” Mesher admits that he never notified Kahn of the Sundquist offer, which is information pertaining to the winding up of partnership affairs. Moreover, when partners engage in transactions with each other, they are obligated to disclose all material facts. Here, the ability of the partnership to dispose of partnership property at a higher price is a material fact.  p. 820     Instead of disclosing the Sundquist offer to Kahn, Mesher kept the offer to himself in order to keep the entire profit for himself. This was a breach of his fiduciary duty, and the Kahns were thus entitled to judgment as a matter of law. | | | |  | **AFFIRMED.** | | | |  | | | | | |  | |  | | --- | | **CRITICAL THINKING** |   The Meshers relied on the precedent of *Elmore v. McConaghy* to support their conclusion that Stewart Mesher did not owe a fiduciary duty to disclose information to Jack Kahn. Why was reliance on *Elmore* erroneous? |  | |  | | --- | | **ETHICAL DECISION MAKING** |  |  | | --- | | Suppose a classmate argues that injustice occurred with the court’s decision. Your classmate thinks that Mesher should not have been punished because he was just receiving the products of his labor. After all, he was the one negotiating the sale of the property, and he didn’t *force* Mr. Kahn to sell his shares. How would you argue against your classmate? | |  |      Who can demand that the winding-up process begin? We've seen that if a partnership has been rightfully dissolved, any partner can do so. However, a partner who wrongfully dissolves a partnership has no such right. In [Case 37-3](http://highered.mheducation.com/sites/0077339177/student_view0/ebook/chapter37/chbody1/winding_up_the_business.htm#id_0073377678_001_022139), the court considers a demand for an accounting in the winding-up phase.   |  |  |  |  | | --- | --- | --- | --- | |  | **CASE**   **37-3** |  | **ROBERT M. TAFOYA v. DEE S. PERKINS, NO. 95CA0408** **COURT OF APPEALS OF COLORADO, DIVISION FOUR 932 P.2D 836; 1996 COLO. APP. LEXIS 206; 20 BTR 1115** |  |  |  |  |  |  |  |  |  |  |  | | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | |  | *Robert Tafoya and Dee Perkins, brother and sister, entered into a partnership with Dee's husband, Eugene Perkins. Eugene bought an apartment complex in 1977; however, he did not want to manage it. He held the title to the land in his name and contributed all necessary capital. Dee was to keep the books and assist in the management of the complex. Finally, Robert Tafoya was to live at, manage, and maintain the complex. In 1979, the apartment complex was sold. The partnership took back a 10-year promissory note with a balloon payment due in 1989.*  *Ten years later, when the balloon payment was due, Eugene purchased the apartments again at a foreclosure sale. In December 1989, he issued a Notice of Termination of Partnership because of losses associated with the partnership. At the same time, Robert Tafoya ceased being associated with the partnership. In July 1990, Eugene Perkins died. The trial court ruled that his death, as well as Tafoya's separation from the partnership, were sufficient to dissolve the partnership. Dee continued to manage the property until January 1994, when she sold it for a profit. Tafoya filed his complaint before the sale of the property, arguing Dee had breached her fiduciary duty and requesting an accounting of the partnership's assets. The trial court found no breach of fiduciary duty yet concluded Tafoya was entitled to an accounting and awarded him a share of the proceeds from the apartment complex sale. Dee Perkins appealed, arguing Tafoya's claim was barred by a statute of limitations.*  **JUDGE DAVIDSON:** Section 7-60-129, C.R.S (1986 Repl. Vol. 3A) of the Uniform Partnership Law (the Act) provides that:   |  |  |  | | --- | --- | --- | |  | The dissolution of any partnership is the change in relation of the partners caused by any partner ceasing to be associated in the carrying on as distinguished from the winding up of the business. |  |   p. 821  Under this section, when a partner withdraws from the business, the partnership is dissolved as to that party. However, the remaining partners may elect to continue operating as a partnership.     Section 7-60-143, C.R.S. (1986 Repl. Vol. 3A) of the Act states as follows:   |  |  |  | | --- | --- | --- | |  | The right to an account of his interest shall accrue to any partner or his legal representative, as against the winding up partners, the surviving partners, or the person or partnership continuing the business at the date of dissolution, in the absence of any agreement to the contrary. |  |      Courts have reached varying conclusions, depending on the circumstances, about when a statute of limitations begins to run on a claim seeking an accounting. However, §§ 7-60-129 and 7-60-143, taken together, provide that, absent an agreement to the contrary, at least in the circumstances of a withdrawing partner seeking an accounting against any partners winding up or continuing the business, the cause of action accrues on the date the withdrawing partner ceases to be associated with the business, resulting in dissolution of the partnership. Hence, regardless of the legal effect of the husband's notice of termination or his later death, once plaintiff himself ceased to be associated with the partnership, not only did this dissolve any still-existing partnership, it also caused the statute of limitations to begin to run on his own claim for an accounting against plaintiff.     The Act does not set forth or specify the applicable statute of limitations. Nor does any statute of limitations specifically address an action for partnership accounting. We therefore conclude that the applicable statute of limitations is § 13-80-102(1)(i), C.R.S. (1987 Repl. Vol 6A), which sets forth a two-year “catch-all” period of limitations for “all other actions of every kind for which no other period of limitation is provided.”     We do not agree with plaintiff's suggestion that, because the action is one to “recover … an unliquidated, determinable amount of money due” him, the appropriate statute of limitations for this action is six years under § 13-80-103.5. Because the amount due from the accounting was not capable of ascertainment by reference to the partnership agreement or by a simple computation derived from the agreement, that statute does not apply.     The trial court found that plaintiff ceased to be associated with the partnership in 1989, causing a dissolution of the then-existing partnership. That finding is not challenged on appeal. Plaintiff did not file his complaint until January of 1994. As a result, his claim for an accounting is not timely because it falls outside the two-year period of limitation in § 13-80-102(1)(i). | | | |  | **REVERSED.** | | | |  | | | | | |  | |  | | --- | | **CRITICAL THINKING** |     How do you react to the evidence in this case? Does it strike you as incomplete? What additional information would you like to have if you were deciding the case? |  | |  | | --- | | **ETHICAL DECISION MAKING** |  |  | | --- | | What primary values did the court uphold in its decision? If you were the judge reviewing the case, which values would motivate your decision? | |  |        Once all the partnership assets have been gathered, the assets are distributed to the partners or any creditors the partnership might have. If the partnership has been successful (it has very little or no debt), the order of distribution of assets is not too important. However, if a dissolved partnership has many creditors, the order of distribution of the assets is immensely important. According to UPA, distribution of liquidated assets must take the following order:   |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  | | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | | |  |  |  | | --- | --- | --- | | 1. |  | Payment to creditors of the partnership. | | 2. |  | Payment of refunds or loans to partners for loans made to the firm. | | 3. |  | Payment to partners of the capital they invested. | | 4. |  | Payment of profits distributed to partners on the basis of the partnership agreement. | |  | |  |  |  | | --- | --- | --- | |  | See the **Connecting to the Core** feature at the text Web site at [www.mhhe.com/kubasek2e](http://www.mhhe.com/kubasek2e) for a description of allocating income among partners. |  | |   p. 822   |  |  |  |  |  |  |  | | --- | --- | --- | --- | --- | --- | --- | | |  | | --- | |  |  |  |  | | --- | --- | |  | **CASE NUGGET** | |  |  |  |  |  |  |  | | --- | --- | --- | |  | **Continuing Partnership after Dissolution**  **Sanfurd G. Bluestein and Sylvia Krugman, Plaintiffs v. Robert Olden, Defendant U.S. District Court for the Southern District of New York 2004 U.S. Dist. LEXIS 3631**  In 1978, Bluestein, Krugman, and Olden formed a partnership, the principal asset of which is a building located in New York City. For 26 years, Olden operated Olden Camera and Lens Company, Inc., in part of the building. Olden Camera itself had been in the building for more than 60 years. In 2001, the plaintiffs sent a letter to Olden to terminate the partnership in accordance with the terms of the partnership agreement. After the letter was sent, the partnership continued to operate in dissolution. The partners agreed to sell the building, but they could not agree on whom to sell to and how much to charge. Olden offered $9 million for the plaintiff's combined interest in the partnership, but he wanted the plaintiffs to release any claims against him and his business, as well as any claims to profits from the partnership for 2002–2003. A competing offer from a third party contained no requirements and offered $15,400,000 for the building, to be reduced by $200,000 if Olden's business remained in the building.     The plaintiffs filed an order to show cause, requesting “1) the appointment of plaintiff Bluestein as Liquidating and/or Winding Up Partner of the general partnership; 2) a direction that Olden cooperate in the liquidation of the assets of the partnership; and 3) enjoining Olden from entering into any new leases or renewing any leases for space in the building.” Because the partnership was terminated in accordance with the partnership agreement, the court ruled that Olden could not prevent maximization of the partnership's assets. Bluestein was appointed the liquidating partner and given sole authority to liquidate the partnership's assets and divide the proceeds after paying the partnership's debts. Olden was ordered to cooperate in the liquidation of the assets and enjoined from entering into or renewing any leases or agreements affecting the partnership's building in New York City. The court retained jurisdiction to ensure that the partners complied with its orders. |  |   If the partners' liabilities for the partnership are greater than their liquidated assets, the partners are liable for the losses. Each partner must contribute his or her share of the losses to pay the creditors. If one partner is unable to contribute his or her share and another partner covers the first partner's unpaid share, the second partner has a right of contribution against the partner who did not pay.  **CONTINUING THE PARTNERSHIP AFTER DISSOLUTION**  After a partnership has been dissolved, the remaining partners have several options, one of which is to continue the partnership. What happens to the noncontinuing partner? Regardless of why the partner is noncontinuing, this partner must receive his or her interest in the partnership. A noncontinuing partner who holds, say, 20 percent of the partnership in which the assets are valued at $10,000 must receive $2,000 after dissolution.  **Legal Principle: After the dissolution of a partnership, the remaining partners may continue the partnership.**     Perhaps the best way that partners can preserve a partnership business is through a *continuation agreement.* This agreement states that continuing partners can keep partnership property and carry on the partnership business, particularly when a partner dies. |

http://highered.mheducation.com/olcweb/styles/hm/images/toolbar_top.gif

* http://highered.mheducation.com/olcweb/styles/hm/images/toolbaricon_left.gif
* http://highered.mheducation.com/olcweb/styles/hm/images/toolbaricon_right.gif

Top of Form

Go

Bottom of Form

* http://highered.mheducation.com/olcweb/styles/hm/images/icon_print.gif

Top of Form

Search eBook...Go

Bottom of Form

http://highered.mheducation.com/olcweb/styles/hm/images/toolbar_bottom.gif

## Chapter37: Partnerships: Termination and Limited Partnerships

# Limited Partnerships

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| |  |  |  |  |  |  |  | | --- | --- | --- | --- | --- | --- | --- | | Limited partnerships, introduced in [Chapter 35](http://highered.mheducation.com/sites/0077339177/student_view0/ebook/chapter35/chapter_opener.htm) and also known as *special partnerships,* originated in Europe more than 500 years ago and have existed in the United States for nearly 200 years. Recall that the **limited partnershipA partnership consisting of at least one general partner and at least one limited partner in which the general partners assume all liability for the partnerships’s debts and the limited partners assume no responsibility beyond their originally invested capital.** is an agreement between at least one general partner and at least one limited partner. The general partner has management responsibility for the partnership and assumes unlimited personal liability for the debts of the partnership. In contrast, the limited partner assumes no liability for the partnership beyond the capital he or she invested in the business. Limited partnerships are attractive to potential investors because of the limited liability and tax advantages they offer. |  | |  |  | | --- | --- | |  |  | | How is a limited partnership formed? |  | |   p. 823   |  |  |  |  |  |  |  | | --- | --- | --- | --- | --- | --- | --- | | |  | | --- | |  |  |  |  | | --- | --- | |  | **COMPARING THE LAW OF OTHER COUNTRIES** | |  |  |  |  |  |  |  | | --- | --- | --- | |  | **Dissolution of Partnership in Germany**  In Germany, a partner who wishes to leave a partnership must give notice of his intention at least six months before the end of the business year. On receiving notification, the other partners may begin placing bids for the purchase of the leaving partner's shares. The shares do not become officially available until the end of the business year.     If the remaining partners want to continue the partnership after one leaves, declares bankruptcy, or dies, this possibility must be provided for in the contract agreement to terminate the partnership. The remaining partners may also opt to fully dissolve the relationship. Under this option, they become liquidators whose duties include concluding all current business transactions, converting all assets to money, and paying all creditors, ideally within eight months. All claims against the partnership are dismissed five years after termination. |  |      Functioning as the equivalent of RUPA, the Revised Uniform Limited Partnership Act (RULPA) is the law governing limited partnerships. Like all law, RULPA is not static; it changes as lawmakers revise it to handle new issues that arise and to better achieve social goals. RULPA was originally drafted in 1976, revised in 1985, and revised again in 2001. About one-fourth of the states have adopted the 1976 version of RULPA, and about three-fourths have adopted the 1985 version. Only a handful of states have adopted the 2001 version. Louisiana is the only state not to have adopted any version of RULPA.  **FORMATION OF THE LIMITED PARTNERSHIP**  How is the limited partnership created? In contrast to the often-informal partnership agreements described in the previous chapter, the formation of a limited partnership must follow very specific statutory requirements. The general and limited partners must sign a **certificate of limited partnershipA document signed on the formation of a limited partnership and filed with the secretary of state.** and file it with the secretary of state to receive limited liability.   |  |  |  |  |  |  |  | | --- | --- | --- | --- | --- | --- | --- | | **RIGHTS AND LIABILITIES OF THE LIMITED PARTNERS AND THE GENERAL PARTNERS**  Limited partners generally have all the rights given to partners in general partnerships, as discussed in the previous chapter. Thus, the limited partner (as well as the general partner) has the right to share in the profits of the business and to receive an account of the partnership. A general partner who wants to add a partner must have the consent of all partners in the limited partnership. Finally, an additional right of limited partners is that they often recover their investment before general partners do. |  | |  |  | | --- | --- | |  |  | | What are the rights and privileges of a limited partner and a general partner? |  | |      However, the limited partner has a few special rights under RULPA. For example, if a general partner fails to bring a suit on behalf of the limited partnership, the limited partner can bring the suit.     What about the duties and liabilities of the partnership? The general partner has unlimited personal liability for the debts of the partnership. This broad liability is in contrast to the limited partner's liability, restricted to the amount of capital the partner has invested in the business. Thus, if you enter into a limited partnership by contributing $10,000 to it, as a limited partner you cannot be held liable for more than $10,000.  p. 824   |  |  |  |  |  |  |  | | --- | --- | --- | --- | --- | --- | --- | | |  | | --- | |  |  |  |  | | --- | --- | |  | **E-COMMERCE AND THE LAW** | |  |  |  |  |  |  |  | | --- | --- | --- | |  | **How the Internet Assists Business Owners Who Use Limited Partnerships**  The Internet is making it easier for business owners to engage in business as limited partnerships. For example, at the Michigan Corporation Division page [www.michigan.gov/cis/0,1607,7-154-10557\_12901-25254—,00.html](http://www.michigan.gov/), you can download a certificate of limited partnership.     The Internet also provides partnerships with an easy opportunity to advertise to the public when there is a change in the partnership. For example, a partnership in the dissolution stage that must notify third parties can simply post information on the Internet explaining the dissolution. You can see a sample partnership dissolution notice at [http://smallbusiness.findlaw.com/business-forms-contracts/be28\_8\_1.html](http://smallbusiness.findlaw.com/business-formscontracts/be28_8_1.html). |  |      A limited partner's limited personal liability depends on the partner's maintaining three conditions:   |  |  |  | | --- | --- | --- | | 1. |  | The limited partner has complied in good faith with the requirement that a certificate of limited partnership is filed. | | 2. |  | The limited partner does not participate in the control of the business. | | 3. |  | The limited partner's surname is not part of the partnership name. |   If any of these conditions are violated, the limited partner surrenders his or her limited liability. For example, the general partner typically has exclusive control and management of the limited partnership; the limited partner, in contrast, does not share in this control, so the courts will likely rule that the partner has forfeited his or her limited liability.  [Exhibit 37-3](http://highered.mheducation.com/sites/0077339177/student_view0/ebook/chapter37/chbody1/limited_partnerships.htm#id_0073377678_001_022239) distinguishes several aspects of general partners and limited partners.  **DISSOLUTION OF THE LIMITED PARTNERSHIP**  Dissolution of the limited partnership is very similar to dissolution of the general partnership. The limited partner has no right or power to dissolve the partnership. While the death or bankruptcy of the limited partner rarely dissolves the partnership, the death of the general partner usually does (unless the agreement specifies otherwise). According to RULPA, a limited partnership can be dissolved for any of the following reasons:   |  |  |  | | --- | --- | --- | | 1. |  | The expiration of the term established in the certificate of limited partnership. | | 2. |  | The completion of the objective established in the certificate. | | 3. |  | The unanimous written consent of all partners (limited and general). | | 4. |  | The withdrawal of the general partner (unless the certificate establishes that other general partners will continue). | | 5. |  | An act of the court. |   **Exhibit 37-3** Comparison of General Partners and Limited Partners  p. 825     If the limited partnership is dissolved, the limited partnership's assets are distributed in the same format as described earlier in this chapter: payment to third-party creditors, payment to partners who have loaned the partnership money, payment to the partners according to their investments in the partnership, and payment to the partners on the basis of their shares of the profits. |

http://highered.mheducation.com/olcweb/styles/hm/images/toolbar_top.gif

* http://highered.mheducation.com/olcweb/styles/hm/images/toolbaricon_left.gif
* http://highered.mheducation.com/olcweb/styles/hm/images/toolbaricon_right.gif

Top of Form

Go

Bottom of Form

* http://highered.mheducation.com/olcweb/styles/hm/images/icon_print.gif

Top of Form

Search eBook...Go

Bottom of Form

http://highered.mheducation.com/olcweb/styles/hm/images/toolbar_bottom.gif

## Chapter37: Partnerships: Termination and Limited Partnerships

# Limited Liability Companies

|  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| |  |  |  |  |  |  | | --- | --- | --- | --- | --- | --- | | Limited partnerships have been around for a number of years, but the *limited liability company (LLC)* is relatively new*.* An LLC is similar to a limited partnership in that each member has limited liability dependent on the investment he or she makes, while still receiving the tax breaks often afforded to those in a partnership. Like the limited partnership, the LLC is created with an agreement between members. Each member also gets a say in the management of the company, whereas in a limited partnership only the general partners make management decisions. Basically, in limited partnerships, for an LLC to obtain limited liability, the owner (referred to as a *member*) does not have to give up his right to participate in management of the LLC. In fact, an additional advantage of the LLC form is the flexibility it offers members in terms of alternative ways to structure its management. |  | |  |  |  | | --- | --- | --- | |  | To see how dissolution relates to a partnership's accounts, please see the **Connecting to the Core** activity on the text Web site at [www.mhhe.com/kubasek2e](http://www.mhhe.com/kubasek2e). |  | |      However, because LLCs are new, the Uniform Limited Liability Company Act that has been drafted to govern them has not been accepted by many states. Until a uniform system has been adopted, managers should check the laws with regard to LLCs in each state to ensure that the liabilities, as well as rights and duties, of a company established in one state continue to apply when conducting business outside that state.   |  |  |  |  | | --- | --- | --- | --- | | |  |  |  | | --- | --- | --- | |  | **CASE OPENER** **WRAP-UP** |  |     Wildmeadow Village Partnership Problems  Ultimately, the supreme court of Alaska ruled against Wyller. The court determined that he was partially at fault for the wrongful dissolution of the Wildmeadow partnership, and therefore Wyller was not entitled to damages from the other partners. Even though the other partners conducted business behind Wyller's back and approved spending that Wyller did not know about, his conduct in the situation was less than ideal. Specifically, the court observed that shortly after the bank's loan refusal, Wyller informed the other partners that he did not consider himself bound to provide financing for *any* of the improvements that by then had been made to the property. This fact is important because Wyller approved some of the renovations but refused to pay his fair share of the cost. Furthermore, Wyller refused to complete the loan application process despite having previously approved the state of Alaska as a tenant and the submission of the loan application. For these reasons, Wyller was not justified in preventing the partnership from paying for any of the improvements. Nor was he justified in denying personal or partnership responsibility for the costs.     After consideration of the facts, the court found that Wyller's failure to pay for the construction contributed to the dissolution of the partnership. Wyller wrongfully denied responsibility for any of the construction costs, and his denial of authorization to pay construction costs contributed to the course of events that precipitated the dissolution. Failure to pay construction costs brought about the suit, and that suit resulted in wrongful dissolution of the partnership. Therefore, the supreme court of Alaska affirmed the lower court's decision. To avoid such partnership problems in future scenarios, it is important to stress the importance of transparency in partnerships. Had Wyller been allowed to authorize or reject the additional construction costs, the partnership would probably not have been sued in the first place. Furthermore, an understanding of the Uniform Partnership Act and how partnerships are rightly dissolved is something all partners should have before forming a business to avoid legal problems. | |

http://highered.mheducation.com/olcweb/styles/hm/images/toolbar_top.gif

* http://highered.mheducation.com/olcweb/styles/hm/images/toolbaricon_left.gif
* http://highered.mheducation.com/olcweb/styles/hm/images/toolbaricon_right.gif

Top of Form

Go

Bottom of Form

* http://highered.mheducation.com/olcweb/styles/hm/images/icon_print.gif

Top of Form

Search eBook...Go

Bottom of Form

http://highered.mheducation.com/olcweb/styles/hm/images/toolbar_bottom.gif

## Chapter38: Corporations: Formation and Financing

# Chapter Opener

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| p. 830   |  |  |  |  | | --- | --- | --- | --- | |  | | | | |  | PART 7 |  | Business Organizations |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  | | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | |  | |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  | | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | | |  |  | | --- | --- | |  | **LEARNING OBJECTIVES** |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  | | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | |  | After reading this chapter, you will be able to answer the following questions:   |  |  |  |  | | --- | --- | --- | --- | |  | [**1**](http://highered.mheducation.com/sites/0077339177/student_view0/ebook/chapter38/chbody1/characteristics_of_corporations.htm#lo1) |  | What are the characteristics of corporations? | |  | [**2**](http://highered.mheducation.com/sites/0077339177/student_view0/ebook/chapter38/chbody1/corporate_powers.htm#lo2) |  | What are the powers granted to corporations by the states? | |  | [**3**](http://highered.mheducation.com/sites/0077339177/student_view0/ebook/chapter38/chbody1/classification_of_corporations.htm#lo3) |  | How are corporations classified? | |  | [**4**](http://highered.mheducation.com/sites/0077339177/student_view0/ebook/chapter38/chbody1/formation_of_the_corporation.htm#lo4) |  | How are corporations formed? | |  | [**5**](http://highered.mheducation.com/sites/0077339177/student_view0/ebook/chapter38/chbody1/potential_problems_with_formation_of_the_corporation.htm#lo5) |  | What are some potential problems with the formation of corporations? | |  | [**6**](http://highered.mheducation.com/sites/0077339177/student_view0/ebook/chapter38/chbody1/corporate_financing.htm#lo6) |  | How do corporations get funding? | | |  |  |  |  | | --- | --- | --- | |  | **CASE OPENER** **The Formation of the Facebook Corporation** |  |  |  |  |  |  |  |  |  |  |  | | --- | --- | --- | --- | --- | --- | --- | --- | --- | |  | On October 28, 2003, Mark Zuckerberg was a sophomore at Harvard University when he created a Web site called Facemash that was similar to an existing Web service called Hot or Not. However, the following semester, in 2004, Zuckerberg began working on a new code for a new Web site to be called Facebook. His friends Eduardo Saverin, Dustin Moskovitz, Andrew McCollum, and Chris Hughes joined Zuckerberg to promote the new social networking site. Membership on the site quickly grew from only students at Harvard College to students at most universities in the United States. In the summer of 2004, Facebook was incorporated. As a corporation, Facebook is an “artificial person,” a status with legal ramifications for both the corporate entity and its owners.   |  |  |  | | --- | --- | --- | | 1. |  | What are the legal implications of Facebook's status as a corporation? | | 2. |  | How are corporations formed? What factors should a businessperson consider in forming a corporation? |   The Wrap-Up at the end of the chapter will answer these questions. |  | |  |   p. 831  This chapter explains the steps necessary to establish a corporate entity. Although state law generally governs corporations and each state has its own corporate regulatory statutes, the Revised Model Business Corporation Act (RMBCA) is the basis of most state statutes. More than 25 states have adopted at least part of RMBCA. This chapter refers to specific RMBCA guidelines, but remember that not all states follow them.     The first two sections of this chapter examine corporations' characteristics and powers. The third section describes different classifications of corporations. The next section explains the process of corporate formation and problems associated with it, and the final section covers corporate financing. |

http://highered.mheducation.com/olcweb/styles/hm/images/toolbar_top.gif

* http://highered.mheducation.com/olcweb/styles/hm/images/toolbaricon_right.gif

Top of Form

Go

Bottom of Form

* http://highered.mheducation.com/olcweb/styles/hm/images/icon_print.gif

Top of Form

Search eBook...Go

Bottom of Form

http://highered.mheducation.com/olcweb/styles/hm/images/toolbar_bottom.gif

## Chapter38: Corporations: Formation and Financing

# Characteristics of Corporations

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| |  |  |  |  |  |  |  | | --- | --- | --- | --- | --- | --- | --- | | How are corporations different from other forms of business organization? We addressed some of their characteristics in [Chapter 35](http://highered.mheducation.com/sites/0077339177/student_view0/ebook/chapter35/chapter_opener.htm). Let's now take a closer look.  **LEGAL ENTITY**  Under U.S. law, corporations are legal entities; in other words, they exist separately from their shareholders. Thus, corporations can sue or be sued by others. |  | |  |  | | --- | --- | |  |  | | What are the characteristics of corporations? |  | |   **RIGHTS AS A PERSON AND A CITIZEN**  Courts consider corporations to be “legal persons.” For example, in 2006 in Boston, a woman was killed when the ceiling of a tunnel collapsed over her. The ceiling was fastened with bolts that were supported by a glue distributed by the corporation Powers Fasteners. Apparently the contents of this glue were known to “creep,” that is, to slowly loosen. The company never informed anyone associated with the construction of the tunnel about the hazardous characteristics of the glue. The Massachusetts attorney general decided to take the corporation to court for manslaughter, just as an individual would be taken to court on such charges. Also, like natural persons, most corporations have certain rights according to the Bill of Rights. Specifically, the Fifth and Fourteenth amendments state that government cannot deprive any “person” of life, liberty, or property without due process. Courts have held that corporations are “persons” in this case and thus have a right to due process. Courts also consider corporations to be persons with respect to the Fourth Amendment and thus protected from unreasonable searches and seizures. Finally, corporations have free speech rights protected by the First Amendment. As [Chapter 5](http://highered.mheducation.com/sites/0077339177/student_view0/ebook/chapter5/chapter_opener.htm) explained, however, the First Amendment protects corporate *commercial* speech to a lesser degree than corporate *political* speech.     In [Case 38-1](http://highered.mheducation.com/sites/0077339177/student_view0/ebook/chapter38/chbody1/characteristics_of_corporations.htm#id_0073377678_001_022398), the Supreme Court considered whether the Federal Election Commission's regulations are unconstitutional limits on speech.   |  |  |  |  | | --- | --- | --- | --- | |  | **CASE**   **38-1** |  | **FEDERAL ELECTION COMM'N v. BEAUMONT** **UNITED STATES SUPREME COURT** **539 U.S. 146 (2003)** |  |  |  |  |  | | --- | --- | --- | --- | |  | *In 2003, the corporation North Carolina Right to Life, Inc. (NCRL,) sued the Federal Election Commission (FEC) claiming that two FEC regulations were unconstitutional. Specifically, the first regulation challenged the one that stops corporations from making contributions, and the second regulation was the one that provides an exemption from the ban for corporate contributions for particular nonprofit corporations.*  p. 832  *With respect to the second regulation, to be considered a “qualified nonprofit corporation,” or one that is exempt from the ban, a nonprofit corporation must have the following characteristics: Its only purpose is the advancement of political ideas, it does not engage in business activities, no shareholders or other individuals receive benefits that could discourage anyone from disassociating from the corporation on the basis of that corporation's political standpoints, and it was not founded by a business corporation or labor organization and accepts no form of donations from business corporations.*  *NCRL said that it met this exemption except for the fact that it accepted small corporate donations and dealt in “minor business activities incidental and related to its advocacy of issues.” NCRL further argued that its officers were subject to liability as criminals and thus, their First Amendment rights were suppressed.*  *Finally, NCRL contended that the Act's ban on corporate contributions to political candidates violated the organization's right to association.*  **JUDGE SOUTER:**   First, NCRL argues that on a class-wide basis “*[Massachusetts Citizens for Life]*-type corporations pose no potential of threat to the political system,” so that the governmental interest in combating corruption is as weak as the Court held it to be in relation to the particular corporation considered in *Massachusetts Citizens for Life.* But this generalization does not hold up. For present purposes, we will assume advocacy corporations are generally different from traditional business corporations in the improbability that contributions they might make would end up supporting causes that some of their members would not approve. But concern about the corrupting potential underlying the corporate ban may indeed be implicated by advocacy corporations. They, like their for-profit counterparts, benefit from significant “state-created advantages,” and may well be able to amass substantial “political”war chests. Not all corporations that qualify for favorable tax treatment under §501(c)(4) of the Internal Revenue Code lack substantial resources, and the category covers some of the Nation's most politically powerful organizations, including the AARP, the National Rifle Association, and the Sierra Club. Nonprofit advocacy corporations are, moreover, no less susceptible than traditional business companies to misuse as conduits for circumventing the contribution limits imposed on individuals.     Second, NCRL argues that application of the ban on its contributions should be subject to a strict level of scrutiny, on the ground that §441b does not merely limit contributions, but bans them on the basis of their source. This argument, however, overlooks the basic premise we have followed in setting First Amendment standards for reviewing political financial restrictions: the level of scrutiny is based on the importance of the “political activity at issue” to effective speech or political association. Restrictions on political contributions have been treated as merely “marginal” speech restrictions subject to relatively complaisant review under the First Amendment, because contributions lie closer to the edges than to the core of political expression. This is the reason that instead of requiring contribution regulations to be narrowly tailored to serve a compelling governmental interest, “a contribution limit involving 'significant interference' with associational rights” passes muster if it satisfies the lesser demand of being “‘closely drawn' to match a 'sufficiently important interest.’”     It is not that the difference between a ban and a limit is to be ignored; it is just that the time to consider it is when applying scrutiny at the level selected, not in selecting the standard of review itself. But even when NCRL urges precisely that, and asserts that §441b is not sufficiently “closely drawn,” the claim still rests on a false premise, for NCRL is simply wrong in characterizing §441b as a complete ban. As we have said before, the section “permits some participation of unions and corporations in the federal electoral process by allowing them to establish and pay the administrative expenses of [PACs].” The PAC option allows corporate political participation without the temptation to use corporate funds for political influence, quite possibly at odds with the sentiments of some shareholders or members, and it lets the government regulate campaign activity through registration and disclosure, without jeopardizing the associational rights of advocacy organizations' members.     NCRL cannot prevail, then, simply by arguing that a ban on an advocacy corporation's direct contributions is bad tailoring. NCRL would have to demonstrate that the law violated the First Amendment in allowing contributions to be made only through its PAC and subject to a PAC's administrative burdens. But a unanimous Court in *National Right to Work* did not think the regulatory burdens on PACs, including restrictions on their ability to solicit funds, rendered a PAC unconstitutional as an advocacy corporation's sole avenue for making political contributions. There is no reason to think the burden on advocacy corporations is any greater today, or to reach a different conclusion here. | | | |  | **REVERSAL.** | | | |  | | | | | |  | |  | | --- | | **CRITICAL THINKING** |     What is the assumption about advocacy corporations and traditional business corporations that Justice Souter makes? How does this assumption support his reasoning? |  | |  | | --- | | **ETHICAL DECISION MAKING** |  |  | | --- | | While the FEC does not completely ban the participation of corporations in electoral processes, such participation is strictly regulated. What is the ethical basis for the explanation Justice Souter gives for the necessity of such regulation? | |  |   p. 833  **CREATURE OF THE STATE**  State incorporation statutes establish the requirements for corporate formation. Each individual corporation's charter creates a contract between that corporation and the state.  **LIMITED LIABILITY**  Because corporations are legal entities separate from their shareholders, corporations assume liability for corporate actions. Shareholders' liability is therefore limited to their investment in the corporation. In 1977 Big O Tire Dealers sued Goodyear Tire & Rubber Company for copying its Bigfoot trademark on new tires. The court agreed and awarded Big O Tire several million dollars in damages, which the Goodyear corporation, and not individual Goodyear shareholders, paid. Although these damages may have reduced the dividends Goodyear shareholders received, the court did not hold the shareholders individually liable for any portion of the award.  **FREE TRANSFERABILITY OF CORPORATE SHARES**  Generally, shareholders can freely transfer their corporate shares. That is, they can sell their shares or give them to charity.  **PERPETUAL EXISTENCE**   |  |  |  |  |  |  | | --- | --- | --- | --- | --- | --- | | If shareholders die, corporations do not dissolve. If corporate directors or officers withdraw or die, the corporation continues to exist. The **articles of incorporationA document that contains basic information about a corporation and is filed with the state.,** the document a corporation files with the state explaining its organization, may include a restriction on the duration of the corporation. Otherwise, in most states, corporations can exist indefinitely. A few states, however, set a maximum length of life for corporations, after which they must formally renew their corporate existence. |  | |  |  |  | | --- | --- | --- | |  | To see why managers generally act in the interest of shareholders, please see the **Connecting to the Core** activity on the text Web site at [**www.mhhe.com/kubasek2e**](http://www.mhhe.com/kubasek2e)**.** |  | |   **CENTRALIZED MANAGEMENT**  Unless the articles of incorporation specify otherwise, shareholders do not participate in corporate management. Instead, they elect a board of directors that, in turn, selects officers to manage the day-to-day business of the corporation.  **CORPORATE TAXATION**  Because corporations are separate legal entities, government taxes their income directly (S corporations are an exception; we discuss them later). Corporations must pay federal and state taxes on their income, but they have control over that income. They can distribute it to shareholders in the form of **dividendsA distribution of corporate profits or income that is ordered by the directors and paid to the shareholders.,** although they do not receive tax deductions for doing so. In fact, shareholders pay taxes on dividends they receive. Since the corporation pays taxes on its income and the shareholders pay taxes on their dividends, dividends are subject to double taxation, a disadvantage for corporations. Corporations can also keep profits, or **retained earningsProfits that a corporation keeps.,** to reinvest. This can raise their stock prices, benefiting shareholders when they sell their stock.  p. 834  **LIABILITY FOR OFFICERS AND EMPLOYEES**  Because the relationship between corporations and their directors, officers, and employees is an agency relationship, corporations are liable for torts and crimes committed by their agents during the scope of their employment. Courts refer to this liability as the doctrine of *respondeat superior* (Latin for “let the master answer”). Although in the past courts were reluctant to impose criminal liability on corporations, prosecutions today are much more common. [Chapter 7](http://highered.mheducation.com/sites/0077339177/student_view0/ebook/chapter7/chapter_opener.htm), “Crime and the Business Community,” discusses corporate sentencing guidelines and punishment. |

http://highered.mheducation.com/olcweb/styles/hm/images/toolbar_top.gif

* http://highered.mheducation.com/olcweb/styles/hm/images/toolbaricon_left.gif
* http://highered.mheducation.com/olcweb/styles/hm/images/toolbaricon_right.gif

Top of Form

Go

Bottom of Form

* http://highered.mheducation.com/olcweb/styles/hm/images/icon_print.gif

Top of Form

Search eBook...Go

Bottom of Form

http://highered.mheducation.com/olcweb/styles/hm/images/toolbar_bottom.gif

## Chapter38: Corporations: Formation and Financing

# Corporate Powers

|  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- |
| |  |  |  |  |  |  |  | | --- | --- | --- | --- | --- | --- | --- | | Because corporations are creatures of the state, they have only those powers that states grant them through state incorporation statutes and each corporation's articles of incorporation. [Exhibit 38-1](http://highered.mheducation.com/sites/0077339177/student_view0/ebook/chapter38/chbody1/corporate_powers.htm#id_0073377678_001_022461) lists the powers of the corporation.  **Legal Principle:**    **The only authority possessed by corporations is respect to the powers granted to them in their articles of incorporation.** |  | |  |  | | --- | --- | |  |  | | What are the powers granted to corporations by the states? |  | |   **EXPRESS AND IMPLIED POWERS**  State incorporation statutes typically grant corporations the following express powers: the power to have perpetual existence, to sue and be sued in the corporation's name, to acquire property, to make contracts and borrow money, to lend money, to make charitable donations, and to establish rules for managing the corporation. Corporations may take whatever actions are necessary to execute these express powers. Thus, they also have implied powers, usually given in the statement of corporate purpose in the articles of incorporation.  **Exhibit 38-1** Powers of the Corporation |

http://highered.mheducation.com/olcweb/styles/hm/images/toolbar_top.gif

* http://highered.mheducation.com/olcweb/styles/hm/images/toolbaricon_left.gif
* http://highered.mheducation.com/olcweb/styles/hm/images/toolbaricon_right.gif

Top of Form

Go

Bottom of Form

* http://highered.mheducation.com/olcweb/styles/hm/images/icon_print.gif

Top of Form

Search eBook...Go

Bottom of Form

http://highered.mheducation.com/olcweb/styles/hm/images/toolbar_bottom.gif

## Chapter38: Corporations: Formation and Financing

# Classification of Corporations

|  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- |
| |  |  |  |  |  |  |  | | --- | --- | --- | --- | --- | --- | --- | | p. 835  Corporations can be classified as public or private; profit or nonprofit; domestic, foreign, or alien; publicly held or closely held; an S corporation; or a professional organization. |  | |  |  | | --- | --- | |  |  | | How are corporations classified? |  | |   **PUBLIC OR PRIVATE**  A **public corporationA corporation that is created by government to help administer law.** is a corporation created by the government to help administer law. Public corporations, like the Federal Deposit Insurance Corporation (FDIC), often have specific government duties to fulfill. Conversely, private persons create **private corporationsA corporation that is created by private persons and does not have government duties.** for private purposes. Private corporations do not have government duties.  **PROFIT OR NONPROFIT**  Most corporations are **for-profit corporationsA corporation whose objective is to make a profit..** Their objective is to operate for profit. Shareholders seeking to make a profit purchase the stock these corporations issue. Their profit if the firm prospers can take two forms. First, shareholders may receive dividends from the corporation. Second, the market price of the stock can increase, allowing shareholders to sell their stock at a higher price than they paid.  **Nonprofit corporationsA corporation that operates for educational, charitable, social, religious, civic, or humanitarian purposes, rather than to earn a profit.** may earn profits, but they do not distribute them to shareholders. In fact, nonprofit corporations do not have shareholders, their objective is not to earn profit, and they do not issue stock. Instead, nonprofit corporations provide services to their members (not shareholders) and reinvest most of their profits in the business. Churches and charitable organizations are examples of nonprofit corporations.  **DOMESTIC, FOREIGN, AND ALIEN CORPORATIONS**  A corporation is a **domestic corporationA corporation located in the state in which it is incorporated.** in the particular state in which it is incorporated. Corporations that operate in more than one state must obtain a certificate of authority in each state in which they do business. A corporation is a **foreign corporationA corporation that conducts business in a state in which it is not incorporated.** in states in which it conducts business but is not incorporated. The McDonald's Corporation is incorporated in Delaware but does business in all 50 states. Thus, it is a domestic corporation in Delaware and a foreign corporation in the other 49 states.     An **alien corporationA business that is incorporated in a foreign country.** is a business incorporated in another country. A U.S. corporation that wants to do business in Canada or Mexico is an alien corporation in those countries.  **PUBLICLY HELD OR CLOSELY HELD**  The stock of **publicly held corporationsA corporation whose stock is available to the public.** is available to the public. Thus, if you wanted to invest in a corporation, you could purchase stock in a publicly held corporation. Most publicly held corporations have many shareholders, and managers of these corporations usually do not own large percentages of the corporation's stock. Shareholders wishing to sell their shares do not face many transfer restrictions.     In contrast, **closely held corporationsA corporation that does not sell stock to the general public.** (also called *close, family,* or *privately held corporations*) generally do not offer stock to the general public. Shareholders are usually family members and friends, who often are active in or manage the business and maintain restrictions on the transfer of shares to prevent outsiders from gaining control. Although they account for only a small fraction of corporate assets and revenues, most U.S. corporations are closely held corporations. In fact, about 50 percent of all U.S. corporations are S corporations.  p. 836  **SUBCHAPTER S CORPORATION**  [Chapter 35](http://highered.mheducation.com/sites/0077339177/student_view0/ebook/chapter35/chapter_opener.htm) introduced **S corporationsA corporation that enjoys the tax status of a partnership.** (named after the subchapter of the Internal Revenue Code that provides for them), a particular type of closely held corporation that enjoys the tax status of partnerships. Thus, S corporation shareholders report their income from the corporation only once, as personal income.     S corporations offer two more tax advantages. First, shareholders may deduct corporate losses from their personal income, reducing their taxes in case of loss. Second, when the shareholder is part of a lower tax bracket than non-S corporations, the entirety of the corporation's income is taxed at the shareholder's lower rate, even if dividends are retained and not distributed. The lower rate applies because of the relationship between the corporation and the personal income of the shareholders.     An S corporation must meet certain requirements. First, it cannot have more than 100 shareholders. Second, only individuals, trusts, and (in certain circumstances) corporations can be shareholders (partnerships cannot be shareholders). Third, S corporations can issue only one class of shares, although they need not have identical voting rights. Fourth, all S corporations must be domestic corporations. Finally, no shareholder can be a nonresident alien.  **PROFESSIONAL CORPORATION**  If a group of dentists, doctors, or other professionals wants to practice as a corporation, all 50 states permit them to incorporate. Because of the nature of professional work, however, courts sometimes impose personal liability on doctors in professional corporations for medical malpractice performed under their oversight. |

http://highered.mheducation.com/olcweb/styles/hm/images/toolbar_top.gif

* http://highered.mheducation.com/olcweb/styles/hm/images/toolbaricon_left.gif
* http://highered.mheducation.com/olcweb/styles/hm/images/toolbaricon_right.gif

Top of Form

Go

Bottom of Form

* http://highered.mheducation.com/olcweb/styles/hm/images/icon_print.gif

Top of Form

Search eBook...Go

Bottom of Form

http://highered.mheducation.com/olcweb/styles/hm/images/toolbar_bottom.gif

## Chapter38: Corporations: Formation and Financing

# Formation of the Corporation

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| |  |  |  |  |  |  |  | | --- | --- | --- | --- | --- | --- | --- | | The creation of a corporation has two steps: general organizational activities and legal activities.  **ORGANIZING AND PROMOTING THE CORPORATION** |  | |  |  | | --- | --- | |  |  | | How are corporations formed? |  | |   Two groups of important players are responsible for the organization of the corporation: promoters and subscribers. **PromotersA person who begins the corporate creation and organization process.** begin the corporate creation and organization process by arranging for necessary capital, financing, and licenses. They raise capital for the infant corporation by making **subscription agreementsAn agreement between promoters (persons raising capital for a new corporation) and subscribers (investors) in which the subscribers agree to purchase stock in the new corporation.** with **subscribersAn investor who agrees to purchase stock in a new corporation.** (investors) who agree to purchase stock in the new corporation.  **Promoters.**    Promoters prepare the corporation's incorporation papers. They can also enter into contracts as needed, say, to purchase or lease buildings for the corporation. Frank Seiberling was the promoter who founded the Goodyear Tire & Rubber Company. In 1898, he purchased Goodyear's first plant in Akron, Ohio, with $3,500 borrowed from his brother-in-law and established Goodyear workers' hourly wages between 13 and 25 cents.     When problems with preincorporation contracts arise, courts generally hold promoters liable and rule that these contracts do not bind infant corporations. Promoters are not agents of the infant corporation, however, because they cannot serve as such for a principal that does not yet exist.     Once incorporated, corporations can accept or reject preincorporation agreements. Even so, if a corporation accepts a preincorporation agreement, courts usually still hold promoters liable for the contract.  p. 837     In two cases, however, promoters are not personally liable. They can include a clause in the contract stating that the corporation's adoption of the contract terminates their liability; or the corporation, the promoter, and a third party can enter into a **novationIn a contract, the substitution of a third party for one of the original parties. The duties remain the same under the contract, but one original party is discharged and the third party takes that original party’s place.,** agreeing to substitute the third party for one of the two original parties in a contract and terminating the rights under it.     In [Case 38-2](http://highered.mheducation.com/sites/0077339177/student_view0/ebook/chapter38/chbody1/formation_of_the_corporation.htm#id_0073377678_001_022557), the Colorado appellate court considered whether a promoter was liable for a preincorporation contract.   |  |  |  |  | | --- | --- | --- | --- | |  | **CASE**   **38-2** |  | **COOPERS & LYBRAND v. GARRY J. FOX** **COURT OF APPEALS OF COLORADO, DIVISION FOUR** **758 P.2D 683 (1988)** |  |  |  |  |  | | --- | --- | --- | --- | |  | *In November 1981, Garry Fox met with a representative of Coopers, a national accounting firm, to request a tax opinion and other accounting services. Fox told Coopers he was acting on behalf of G. Fox and Partners, Inc., a corporation he was in the process of forming. Coopers knew the corporation did not yet exist and accepted the agreement. G. Fox and Partners, Inc., incorporated in December 1981. When Coopers finished its work, it billed Fox $10,827. Neither Fox nor his corporation paid the bill. Coopers sued Fox personally, arguing he was liable because he was the promoter. The trial court found that no agreement obligated Fox individually to pay the fee and found in favor of Fox. Coopers appealed.*  **JUDGE KELLY:**   As a preliminary matter, we reject Fox's argument that he was acting only as an agent for the future corporation. One cannot act as the agent of a nonexistent principal.     On the contrary, the uncontroverted facts place Fox squarely within the definition of a promoter. A promoter is one who, alone or with others, undertakes to form a corporation and to procure for it the rights, instrumentalities, and capital to enable it to conduct business.     When Fox first approached Coopers, he was in the process of forming G. Fox and Partners, Inc. He engaged Coopers' services for the future corporation's benefit. In addition, though not dispositive on the issue of his status as a promoter, Fox became the president, a director, and the principal shareholder of the corporation, which he funded, only nominally, with a $100 contribution. Under these circumstances, Fox cannot deny his role as a promoter.     Coopers asserts that the trial court erred in finding that Fox was under no obligation to pay Coopers' fee in the absence of an agreement that he would be personally liable. We agree.     As a general rule, promoters are personally liable for the contracts they make, though made on behalf of a corporation to be formed. The well-recognized exception to the general rule of promoter liability is that if the contracting party knows the corporation is not in existence but nevertheless agrees to look solely to the corporation and not to the promoter for payment, then the promoter incurs no personal liability. In the absence of an express agreement, the existence of an agreement to release the promoter from liability may be shown by circumstances making it reasonably certain that the parties intended to and did enter into the agreement.     Here, the trial court found there was no agreement, either express or implied, regarding Fox's liability. Thus, in the absence of an agreement releasing him from liability, Fox is liable.     Coopers also contends that the trial court erred in ruling, in effect, that Coopers had the burden of proving any agreement regarding Fox's personal liability for payment of the fee. We agree.     Release of the promoter depends on the intent of the parties. As the proponent of an alleged agreement to release the promoter from liability, the promoter has the burden of proving the release agreement.     Fox seeks to bring himself within the exception to the general rule of promoter liability. However, as the proponent of the exception, he must bear the burden of proving the existence of the alleged agreement releasing him from liability. The trial court found that there was no agreement regarding Fox's liability. Thus, Fox failed to sustain his burden of proof, and the trial court erred in granting judgment in his favor.     It is undisputed that the defendant, Garry J. Fox, engaged Coopers' services, that G. Fox and Partners, Inc., was not in existence at that time, that Coopers performed the work, and that the fee was reasonable. The only dispute, as the trial court found, is whether Garry Fox is liable for payment of the fee. We conclude that Fox is liable, as a matter of law, under the doctrine of promoter liability. | | | |  | **REVERSED.** | | | |  | | | | | |  | |  | | --- | | **CRITICAL THINKING** |     What is the court's reasoning in this case? Given that reasoning, what if anything could Garry Fox have done differently to avoid liability? |  | |  | | --- | | **ETHICAL DECISION MAKING** |  |  | | --- | | The doctrine of promoter liability, like most other doctrines in business law, has ethical roots. Legal doctrines are trying to advance our achievement of particular values or, in the language of the WPH model, purposes. Try to discover the value emphasis underlying adherence to the doctrine of promoter liability. | |  |   p. 838  **Subscribers.**    Subscribers offer to purchase stock in a corporation during the incorporation process. A subscriber becomes a shareholder once the corporation incorporates or accepts his or her purchase offer, whichever occurs first.     Courts interpret subscription agreements in two ways. In some states, subscription agreements are continuing offers to buy stock in the corporation that subscribers may revoke at any time. In other states, courts view subscription agreements as contracts among various subscribers. These contracts cannot be revoked unless all subscribers consent. RMBCA says that subscribers cannot revoke subscription agreements for six months unless the agreements provide otherwise or all subscribers consent.  **SELECTING A STATE FOR INCORPORATION**  Next, an infant corporation must select a state in which to incorporate. Each state has different laws governing the incorporation process and different corporate tax rates. Other factors corporations consider when selecting a state for incorporation include:   |  |  |  | | --- | --- | --- | | **•** |  | How much flexibility does the state grant to corporate management? | | **•** |  | What rights do state statutes give to shareholders? | | **•** |  | What restrictions does the state place on the distribution of dividends? | | **•** |  | Does the state offer any kind of protection against takeovers? |      Although most corporations incorporate in the state in which they are located and do most of their business, more than half of all publicly held corporations, including more than half of the Fortune 500 companies, are incorporated in Delaware. Decades ago, Delaware offered extremely low corporate tax rates and granted more extensive rights to management in the event of a takeover than did other states. Thus, in the 1940s and 1950s, many corporations changed their state of incorporation to Delaware. Although other states have made their corporate laws more attractive since then, many corporations remain incorporated in Delaware because its courts are highly experienced in corporate law. Closely held corporations and professional corporations, however, almost always incorporate in the state in which most of their stockholders live.     Although a corporation can incorporate in only one state, it can file a certificate of authority to do business in other states. Some states fine corporations that fail to obtain a certificate of authority before conducting business in the state. Other states fine directors and officers of these corporations directly and hold them personally liable for contracts made in the state.     Once a corporation chooses a state for incorporation, it can begin the formal legal process of incorporation.  p. 839   |  |  |  |  |  |  |  | | --- | --- | --- | --- | --- | --- | --- | | |  | | --- | |  |  |  |  | | --- | --- | |  | **COMPARING THE LAW OF OTHER COUNTRIES** | |  |  |  |  |  |  |  | | --- | --- | --- | |  | **Corporate Structure in Germany**  German law establishes three tiers of corporate power. The board is the lowest, management makes up the second, and the supervisory board is the top tier. The supervisory board is similar to a board of directors in a U.S. corporation. The supervisors must approve managers' actions, including appointments, distribution of profits, and actions that affect the corporation's capital. Without the consent of the supervisors, managers are nearly powerless.     Supervisors cannot limit managerial authority to deal with third parties, however. Here managers enjoy considerable power and can act on their own discretion. Because supervisors cede considerable control in these situations, they have the power to appoint managers they feel will be reliable.     Although the board makes up the lowest tier of corporate power, it exercises considerable influence. Shareholders elect the board, a group of at least three members that acts as a mediator between shareholders and management. Because both managers and supervisors understand the importance of shareholders' interests, they listen to the board's recommendations. |  | |

http://highered.mheducation.com/olcweb/styles/hm/images/toolbar_top.gif

* http://highered.mheducation.com/olcweb/styles/hm/images/toolbaricon_left.gif
* http://highered.mheducation.com/olcweb/styles/hm/images/toolbaricon_right.gif

Top of Form

Go

Bottom of Form

* http://highered.mheducation.com/olcweb/styles/hm/images/icon_print.gif

Top of Form

Search eBook...Go

Bottom of Form

http://highered.mheducation.com/olcweb/styles/hm/images/toolbar_bottom.gif

## Chapter38: Corporations: Formation and Financing

# Legal Process of Incorporation

|  |
| --- |
| **SELECTION OF CORPORATE NAME**  All states require that corporations attach *Corporation, Company, Limited,* *Incorporated,* or an abbreviation of one of these terms to the end of the business name to indicate the firm is incorporated. Kraft Foods Inc., The Hershey Company, Facebook Inc., and McDonald's Corporation serve as examples of corporate names. Corporations must also distinguish their names from those of all other domestic or foreign corporations licensed to do business within the state. This requirement protects third parties from confusion over similar names. Once the corporation has chosen a name, this name is subject to the approval of the state.  **INCORPORATORS**  An **incorporatorAn individual who applies for incorporation on behalf of a corporation.** is an individual who applies to the state for incorporation on behalf of a corporation. RMBCA requires only one incorporator to incorporate a business, although it permits more. Although promoters frequently serve as incorporators, RMBCA does not require that incorporators be promoters or subscribers. In fact, RMBCA does not require that incorporators have an interest in the company. Generally, their only duty is to sign the articles of incorporation.  **ARTICLES OF INCORPORATION**  The *articles of incorporation* is a document providing basic information about the corporation. According to RMBCA, it must include (1) the name of the corporation, (2) the address of the registered office, (3) the name of the registered agent (the specific person who receives legal documents on behalf of the corporation), and (4) the names and addresses of the incorporators.     Many articles of incorporation include several additional elements, such as a clause describing the nature and purpose of the corporation. This statement of purpose grants the corporation power to engage in certain business activities. Many articles also describe the corporate capital structure and authorize the corporation to issue a certain number of shares of stock.     The incorporators must execute and sign the articles of incorporation and file the document with the secretary of state, including the required filing fee, to legally form the corporation. Once filed, the articles govern the corporation. Next, the secretary of state usually issues a **certificate of incorporationA document certifying that a corporation is incorporated in the state and is authorized to conduct business.,** a document certifying that the corporation is incorporated in the state and authorized to conduct business.  p. 840  **FIRST ORGANIZATIONAL MEETING**  After the secretary of state issues the certificate of incorporation, the shareholders usually meet to elect the corporate board of directors, pass corporate bylaws, and carry out other corporate business. Sometimes shareholders name the board members before this first organizational meeting and list them in the articles of incorporation. In these situations, the directors usually run the meeting.     At the meeting, shareholders adopt a set of corporate **bylawsRules and regulations that govern a corporation’s internal management.,** or rules and regulations that govern the corporation's internal management. The articles of incorporation determine who has the power to amend the corporate bylaws after the first organizational meeting: shareholders, directors, or both.     Shareholders may also authorize the corporation to issue shares of stock and approve preincorporation contracts that promoters have made in the corporation's name. |

http://highered.mheducation.com/olcweb/styles/hm/images/toolbar_top.gif

* http://highered.mheducation.com/olcweb/styles/hm/images/toolbaricon_left.gif
* http://highered.mheducation.com/olcweb/styles/hm/images/toolbaricon_right.gif

Top of Form

Go

Bottom of Form

* http://highered.mheducation.com/olcweb/styles/hm/images/icon_print.gif

Top of Form

Search eBook...Go

Bottom of Form

http://highered.mheducation.com/olcweb/styles/hm/images/toolbar_bottom.gif

## Chapter38: Corporations: Formation and Financing

# Potential Problems with Formation of the Corporation

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| |  |  |  |  |  |  |  | | --- | --- | --- | --- | --- | --- | --- | | Most businesses incorporate to enjoy limited liability or perpetual existence. Shareholders benefit, however, only if the promoters and incorporator formally and correctly incorporate the business. If there is an error or omission during the incorporation process, courts may rule the organization is a **defective corporationA corporation whose incorporation process included an error or omission..** Shareholders may be personally liable for a defective corporation's actions.  **RESPONSES TO DEFECTIVE INCORPORATION** |  | |  |  | | --- | --- | |  |  | | What are some potential problems with the formation of corporations? |  | |   Suppose an incorporator incorrectly indicates the address of the corporate office in the articles of incorporation. Does the corporation still exist? Depending on the seriousness of the error, courts may disregard it by recognizing the firm as a *de jure* or a *de facto* corporation.  ***De Jure* Corporations.**    A **de jure corporationLatin for “lawful corporation”; a corporation that has met the mandatory statutory provisions and thus received its certificate of incorporation.** (literally, “a corporation from law,” or a lawful corporation) has met the substantial elements of the incorporation process. Courts usually hold that corporations that make minor errors in the incorporation process still enjoy *de jure* corporate status. [Exhibit 38-2](http://highered.mheducation.com/sites/0077339177/student_view0/ebook/chapter38/chbody1/potential_problems_with_formation_of_the_corporation.htm#id_0073377678_001_022657) illustrates the process for creating a *de jure* corporation.     Thus, even if the incorporator wrote the incorrect address of the corporate office in the articles of incorporation, courts would not revoke the corporation's limited liability. No party can question a *de jure* corporation's status as a corporate entity in court.  **Exhibit 38-2** *De Jure* Corporation Formation  ***De Facto* Corporation.**    Suppose, however, that the incorporator makes a more serious mistake or omission, such as not filing the articles of incorporation with the secretary of state. In this case, courts may recognize the corporation as a **de facto corporationLatin for “corporation in fact”; a corporation that has not substantially met the requirements of the state incorporation statutes.** (literally, “a corporation from the fact,” or a corporation in fact). A *de facto* corporation has not substantially met the requirements of the state incorporation statute, but courts recognize it as a corporation for most purposes to avoid unfairness to third parties who believed it was properly incorporated. *De facto* corporations, regardless of whether the state has a general corporation statute, must meet the following requirements:   |  |  |  | | --- | --- | --- | | **•** |  | The promoters, subscribers, and incorporator made a good-faith attempt to comply with the incorporation statute. | | **•** |  | The organization has already conducted business as a corporation. |   p. 841     The process for recognizing a corporation as a *de facto* corporation is depicted in [Exhibit 38-3](http://highered.mheducation.com/sites/0077339177/student_view0/ebook/chapter38/chbody1/potential_problems_with_formation_of_the_corporation.htm#id_0073377678_001_022674).     Only the state can challenge a *de facto* corporation's existence as a corporate entity, in a suit called an action of *quo warranto* (Latin for “by what right”).  **Corporation by Estoppel.**    Defective corporations cannot escape corporate entity status due to mistakes or omissions in their incorporation procedures. Suppose a corporation's articles of incorporation do not include the name of its registered agent and the directors, managers, and shareholders are unaware of the mistake. If the corporation conducts business with a third party who later sues for breach of contract, the corporation cannot claim it is not a corporate entity to escape liability. Courts hold that the corporation is a **corporation by estoppelA defective corporation that has conducted business with a third party and therefore cannot deny its status as a corporation to escape liability.;** thus, they *estop* (bar) the corporation from denying its corporate status. This ruling does not remedy the error or grant the firm corporate status for conducting future business.     If a corporation makes a significant error in the incorporation process and is not a *de jure* or *de facto* corporation, and corporation by estoppel does not apply, courts usually deny the organization corporate entity status. Thus, the organization does not enjoy limited shareholder liability.  **Exhibit 38-3** *De Facto* Corporation Recognition Process  **Piercing the Corporate Veil.**    In some cases, courts will deny limited liability to a corporation that would normally have *de jure* or *de facto* status because shareholders have used the corporation to engage in illegal or wrongful acts. Shareholders attempt to hide behind the “corporate veil” of limited liability to protect themselves from personal liability. In these cases, courts *pierce the corporate veil,* or impose personal liability on shareholders. Shareholders of closely held and parent-subsidiary corporations frequently mix personal and corporate interests such that no separate corporate identity exists. Thus, courts often pierce the corporate veil of these corporations.  p. 842   |  |  |  |  |  |  |  | | --- | --- | --- | --- | --- | --- | --- | | |  | | --- | |  |  |  |  | | --- | --- | |  | **CASE NUGGET** | |  |  |  |  |  |  |  | | --- | --- | --- | |  | **De Facto Incorporation**  **Pharmaceutical Sales and Consulting Corporation v. J.W.S. Delavaux Co. District Court of New Jersey 59 F. Supp. 2d 398 (1999)**  Pharmaceutical Sales and Consulting sued J.W.S. Delavaux Co., alleging Delavaux failed to pay commissions due under a sales agreement between the parties. The sales agreement was signed by Pharmaceutical's president and on its behalf. The company had indicated it was a corporation, but Delavaux later discovered it was not a registered corporation and filed a motion to dismiss Pharmaceutical's complaint.     Delavaux maintained that Pharmaceutical's lack of corporate status as of the date of contract rendered the agreement invalid and unenforceable. Delavaux relied on the absence of several documents that, in its view, were essential to any claim that Pharmaceutical had attained *de facto* corporate status.     The court denied Delavaux's motion, but it also found that Pharmaceutical could not rely on the doctrine of *de facto* incorporation to demonstrate that it could sue Delavaux for breach of the parties' agreement, because Pharmaceutical had not made a bona fide attempt to incorporate before entering into the agreement with Delavaux. |  |     **Legal Principle:**   **The limited liability of corporate shareholders may not exist when shareholders have acted in an illegal or wrongful manner.**     Courts are likely to pierce the corporate veil when:   |  |  |  | | --- | --- | --- | | **•** |  | A corporation lacked adequate capital when it initially formed. | | **•** |  | A corporation did not follow statutory mandates regarding corporate business. | | **•** |  | Shareholders' personal interests and corporate interests are commingled such that the corporation has no separate identity. | | **•** |  | Shareholders attempt to commit fraud through a corporation. |   If a corporation does not carefully maintain separate corporate and shareholder funds and records, courts may pierce the corporate veil and impose personal liability on shareholders, as [Case 38-3](http://highered.mheducation.com/sites/0077339177/student_view0/ebook/chapter38/chbody1/potential_problems_with_formation_of_the_corporation.htm#id_0073377678_001_022707) illustrates.   |  |  |  |  | | --- | --- | --- | --- | |  | **CASE**   **38-3** |  | **J-MART JEWELRY OUTLETS, INC. v. STANDARD DESIGN** **COURT OF APPEALS OF GEORGIA** **218 GA. APP. 459 (1995)** |  |  |  |  |  | | --- | --- | --- | --- | |  | *Jim Halter, the major shareholder of J-Mart Jewelry Outlets, Inc., and several other corporations, was aware J-Mart was in financial trouble. Before the firm went out of business, Halter paid off his personal credit cards using corporate funds. He also paid the corporation $1 for a corporate car that had been purchased with corporation funds. Four of J-Mart's creditors brought suit against Halter in an attempt to recover corporate funds. The trial court jury pierced the corporate veil to hold Halter personally responsible for the debts. Halter appealed.*  p. 843  **JUDGE BLACKBURN:**   The concept of piercing the corporate veil is applied in Georgia to remedy injustices which arise where a party has over extended his privilege in the use of a corporate entity in order to defeat justice, perpetrate fraud or to evade contractual or tort responsibility. Because the cardinal rule of corporate law is that a corporation possesses a legal existence separate and apart from that of its officers and shareholders, the mere operation of corporate business does not render one personally liable for corporate acts. Sole ownership of a corporation by one person or another corporation is not a factor, and neither is the fact that the sole owner uses and controls it to promote his ends. There must be evidence of abuse of the corporate form. Plaintiff must show that the defendant disregarded the separateness of legal entities by commingling on an interchangeable or joint basis or confusing the otherwise separate properties, records or control.     In deciding this enumeration of error, we are confronted with two maxims that sometimes conflict. On the one hand, we are mindful that great caution should be exercised by the court in disregarding the corporate entity. On the other, it is axiomatic that “when litigated, the issue of 'piercing the corporate veil' is for the jury[,]” unless there is no evidence sufficient to justify disregarding the corporate form. Our examination of the trial transcript convinces us that there is evidence in this case rising to such level.     Halter knew as early as late April but not later than June 1991 that J-Mart would have to cease operations as a result of its financial difficulties. There was direct evidence that the $6,902.87 balance on Halter's American Express personal account was paid by J-Mart on December 23, 1991, eight days before it ceased doing business. The check was marked “PAYMENT IN FULL: JIM'S PERSONAL[,]” indicating that a material question of fact existed as to whether Halter used corporate funds to pay a personal debt. The evidence also established that J-Mart, with knowledge that it would soon cease doing business, purchased a new Cadillac for Halter's use. It thereafter made three payments on the vehicle before transferring it to Halter for $1 and allowing him to assume the remaining payments, indicating the presence of further questions of material fact relative to a de facto unauthorized payment for Halter's personal benefit. In light of the evidence presented, the trial court properly denied the motion for a directed verdict upon the claim of Halter's personal liability for violation of the corporate form.     Evidence raising material questions of fact as to Halter's possible abuse of the corporate form were thus properly before the jury. On appeal, we construe all the evidence most strongly in support of the verdict, for that is what we must presume the jury did; and if there is evidence to sustain the verdict, we cannot disturb it. So viewing the evidence, we conclude that the jury's verdict was proper and must stand. | | | |  | **AFFIRMED.** | | | |  | | | | | |  | |  | | --- | | **CRITICAL THINKING** |     Given what you know of the facts of the case, could Halter have provided any information that would lead you to believe he was not responsible for the debts? What would it be? |  | |  | | --- | | **ETHICAL DECISION MAKING** |  |  | | --- | | Describe the ethical conflict Halter was facing. For what purpose, or value, was he acting? Had Halter followed the Golden Rule, would he have acted as he did? What might have convinced Halter to refrain from using corporate funds to pay off his personal credit cards? | |  | |

http://highered.mheducation.com/olcweb/styles/hm/images/toolbar_top.gif

* http://highered.mheducation.com/olcweb/styles/hm/images/toolbaricon_left.gif
* http://highered.mheducation.com/olcweb/styles/hm/images/toolbaricon_right.gif

Top of Form

Go

Bottom of Form

* http://highered.mheducation.com/olcweb/styles/hm/images/icon_print.gif

Top of Form

Search eBook...Go

Bottom of Form

http://highered.mheducation.com/olcweb/styles/hm/images/toolbar_bottom.gif

## Chapter38: Corporations: Formation and Financing

# Corporate Financing

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| |  |  |  |  |  |  |  | | --- | --- | --- | --- | --- | --- | --- | | Corporations, like other businesses, need a source of funding. They most commonly obtain financing by issuing and selling corporate securities: debt securities, which represent loans to a corporation, and equity securities, which represent ownership in a corporation. |  | |  |  | | --- | --- | |  |  | | How do corporations get funding? |  | |   **DEBT SECURITIES**  **Debt securitiesA security that represents a loan to a corporation. Also called bond.,** or **bondsA security that represents a loan to a corporation. Also called Debt securities.,** represent loans to a corporation from another party. Bonds are usually long-term loans on which the corporation promises to pay interest. They frequently list a maturity date on which the corporation must repay the face amount of the loan. Before the maturity date, however, corporations usually pay bond holders fixed-dollar interest payments on a scheduled basis. Hence, bonds are sometimes called *fixed-income securities.*  p. 844     Corporations can issue the following types of bonds:   |  |  |  | | --- | --- | --- | | **•** |  | *Unsecured bonds (debentures):* No assets support corporations' obligation to repay the face value of unsecured bonds. | | **•** |  | *Secured bonds (mortgage bonds):* Specific property supports corporations' obligation to repay secured bonds. | | **•** |  | *Income bonds:* A corporation pays interest on income bonds in proportion to its earnings. | | **•** |  | *Convertible bonds:* Shareholders may exchange their convertible bonds for shares of company stock. | | **•** |  | *Callable bonds:* Corporations may call in and repay the bonds at specific times. |   **EQUITY SECURITIES**  While bond owners have loaned money to a corporation, stock owners actually own part of the corporation, in the form of shares of stock called **equity securitiesA security that represents ownership in a corporation..** Stockholders thus have a voice in the firm's control. Not all corporations issue bonds, but all issue stock. Common stock and preferred stock are the two major types.  **Preferred Stock.**    Owners of **preferred stockStock that conveys preferences to its holder with respect to assets and dividends.,** or *preferred shares,* enjoy preferences in the distribution of assets and dividends. They usually receive a percentage of dividends associated with the face value of their preferred stock, and they will receive dividends before owners of common stock do. Some corporations limit preferred stock owners' voting rights.  *Cumulative preferred stock* requires that if a corporation cannot pay the required dividends in a given year, it must pay them in the next year before it pays any common stock dividends. *Convertible preferred stock* allows its owner to convert shares into common stock at any time. *Redeemable preferred stock* (also known as *callable preferred stock*) permits the issuing corporation to buy shares back from shareholders in certain circumstances. *Participating preferred stock* entitles its owner to both preferred stock dividends and, after the corporation has paid common stock dividends, additional dividends.  **Common Stock.**    Owners of **common stockCorporate stock that does not convey any preference to its holders.,** or *common shares,* own a portion of a corporation but do not enjoy any preferences. A common stock owner is entitled to corporate dividends in proportion to the number of shares he or she owns and has the right to vote in corporate elections. Each share is usually worth one vote. Thus, if you own 20,000 common shares of a corporation, you have 20,000 votes. In some cases, however, most notably the election of the board of directors, corporations use a method called *cumulative voting* to increase the influence of shareholders who own a small number of shares. (The next chapter discusses cumulative voting in more detail.)     Common stock owners have the lowest priority when a corporation distributes dividends. Creditors and preferred stock owners receive dividends first. Once a corporation pays these groups, however, common stock owners have a claim to the remainder of the corporate earnings.  p. 845   |  |  |  |  |  |  |  | | --- | --- | --- | --- | --- | --- | --- | | |  | | --- | |  |  |  |  | | --- | --- | |  | **COMPARING THE LAW OF OTHER COUNTRIES** | |  |  |  |  |  |  |  | | --- | --- | --- | |  | **Company Law in France**  French law categorizes companies into two types: Société Anonymes (SA) and Société Responsabilité Limitée (SARL). Several factors determine a company's category, including its relationship to shareholders, its management hierarchy, and the extent of its liabilities.     SA companies offer shares to the public and must have at least seven shareholders. SARL companies, on the other hand, sell shares exclusively to company members. They must have at least 2 but no more than 50 shareholders. Their shares are nonnegotiable and freely transferable among company members.     One managing director, with as many as 14 subordinate directors, runs SA companies; at least one director must be a shareholder. SARL companies, in contrast, have one or two managers and allow nonmembers to serve. French law also requires that all SA companies appoint an independent auditor to verify the legality of their accounts. The auditor must report to the French government any irregularities she or he suspects to be criminal in nature. French law does not require that SARL companies appoint an auditor.     Member liability is closely related to the managerial structure of SA and SARL companies. Members of SARL companies are liable only to the extent of their contributions to the company. If the manager of a SARL company makes a transaction with a third party, all members are liable for the manager's action, regardless of whether he is a member of the company. Liability to third parties does not rest on all members in SA companies. Rather, in most cases the managing director is liable for damages caused by her actions, regardless of whether she benefited personally. |  |  |  |  |  |  |  |  | | --- | --- | --- | --- | --- | --- | |  | |  |  |  | | --- | --- | --- | |  | **CASE OPENER** **WRAP-UP** |  |     **Facebook**  Zuckerberg's actions in 2004 were instrumental in creating what is now Facebook today. There are currently over 250 million users on the Web site from all over the world. In 2007, Microsoft bought a 1.6 percent share of the corporation for $240 million. Facebook gained another investor in November of that year, a billionaire from Hong Kong, Li Ka-shing, for $60 million. Estimates put the corporation's value around $4 billion to $5 billion. Ultimately, its corporate status allows Facebook to enjoy perpetual existence; to sue and be sued; to acquire property; to make contracts; to borrow and lend money; to make charitable donations; and to establish rules for managing the corporation. Moreover, Facebook's shareholders enjoy limited liability. |  | |

http://highered.mheducation.com/olcweb/styles/hm/images/toolbar_top.gif

* http://highered.mheducation.com/olcweb/styles/hm/images/toolbaricon_left.gif
* http://highered.mheducation.com/olcweb/styles/hm/images/toolbaricon_right.gif

Top of Form

Go

Bottom of Form

* http://highered.mheducation.com/olcweb/styles/hm/images/icon_print.gif

Top of Form

Search eBook...Go

Bottom of Form

http://highered.mheducation.com/olcweb/styles/hm/images/toolbar_bottom.gif