



Business Environment & Concepts 1

1.	Sole proprietorship and joint venture.....	3
2.	General partnership	4
3.	Limited liability partnership	19
4.	Limited partnership.....	20
5.	Limited liability company	26
6.	Corporation	30
7.	Terminology	57
8.	Class questions	59

SOLE PROPRIETORSHIP AND JOINT VENTURE

I. ADVANTAGES, IMPLICATIONS AND CONSTRAINTS OF A SOLE PROPRIETORSHIP

A sole proprietorship is the simplest form of business ownership. One person owns the business and manages all of its affairs, and the sole proprietor is not considered an entity separate from the business. No formality is required to form a sole proprietorship, and nothing need be filed with the state in which the business operates (unless the state or city requires a business license). If a fictitious business name is used, then many states require publishing the true name of the business owner.

A. PERSONAL LIABILITY

The sole proprietor is personally liable for all obligations of the business.

B. LIFE OF ENTITY

A sole proprietorship cannot exist beyond the life of the sole proprietor.

C. TAX TREATMENT

For tax purposes, profits and losses from the business flow through the business to the sole proprietor.

D. TRANSFERABILITY

A sole proprietor is free to transfer his interest in the sole proprietorship at will.

E. BANKRUPTCY

A sole proprietorship is not considered an entity separate from the sole proprietor; therefore, a sole proprietor would have to file for bankruptcy personally under the Bankruptcy Code.

II. CHOICE AS A BUSINESS ENTITY

The sole proprietorship may be a good choice of business entity when an individual wants to form a business that he or she will manage, wants to claim the income or losses from the business on his or her personal taxes, and does not want to bother with a lot of formality. On the other hand, the individual risks all of his or her personal assets when this type of business entity is formed.

III. JOINT VENTURE DEFINED

A joint venture is an association of persons or entities with the intent of engaging in a single business venture for profit.

IV. JOINT VENTURE COMPARED TO A PARTNERSHIP

Courts sometimes try to distinguish joint ventures from general partnerships, but the legal requirements and consequences and advantages and disadvantages of forming a joint venture generally are identical to those of a general partnership. For exam purposes, the key difference between a joint venture and a general partnership is the fact that a joint venture is formed for a single transaction or project or a related series of transactions or projects. Joint ventures are treated as partnerships in most important legal aspects.

GENERAL PARTNERSHIP

I. ADVANTAGES, IMPLICATIONS AND CONSTRAINTS OF A GENERAL PARTNERSHIP

A general partnership is similar to a sole proprietorship except that there are at least two owners of a partnership. The right to manage a partnership is shared among all the partners. Little formality is required to form a partnership, just an intention to carry on as co-owners a business for profit.

A. OWNERS ARE NOT ALWAYS DISTINCT FROM ENTITY

The law treats partnerships as entities distinct from their owners for some purposes (e.g., property may be held in the name of the partnership; suits can be maintained in the name of the partnership), but not for others (e.g., partners are personally liable for obligations of the partnership).

B. LIFE OF ENTITY

Like a sole proprietorship, partnerships often are not perpetual. A partnership may be dissolved after a partner dies or otherwise dissociates from the partnership unless the partners have agreed otherwise or vote to continue the partnership.

C. TAX TREATMENT

For tax purposes, profits and losses of a partnership flow through the partnership directly to the partners. Partnerships are not recognized for federal income tax purposes as separate taxable entities.

D. TRANSFERABILITY

A partner cannot transfer his partnership interest and confer partnership status on the assignee without the unanimous consent of the other partners.

E. BANKRUPTCY

For purposes of filing for bankruptcy, a general partnership is considered an entity separate from its owners and is eligible to file for bankruptcy under the Bankruptcy Code. However, the partners remain personally liable for the partnership's debts.

F. CHOICE AS A BUSINESS ENTITY

If a person is interested in forming a business with more than one owner, does not want to bother with a lot of formality, does not mind sharing management rights with co-owners, does not mind putting personal assets at risk, etc., a general partnership might be an appropriate entity to form.

II. NATURE, FORMATION, OPERATION AND TERMINATION OF A GENERAL PARTNERSHIP

A. NATURE OF A GENERAL PARTNERSHIP

A partnership is an association of two or more persons who agree to carry on as co-owners a business for profit. *Compare:* A joint venture is similar, but it involves a single undertaking (e.g., transaction of limited duration).

1. Introduction to General Partnerships

All partnerships are assumed to be general partnerships unless otherwise stated. Many of the items listed below will be covered in separate parts of this chapter, but they are listed here together as an introduction. In a general partnership:

- a. All partners are general partners.
- b. All partners share in management.

- c. New general partners must be approved by all general partners.
- d. All partners have unlimited personal liability for obligations of the partnership.
- e. A general partner must give notice to creditors prior to withdrawal in order to avoid liability for subsequent acts or events.
- f. All partners (individually) have the apparent authority to bind the partnership with respect to all normal partnership business transactions (except when a third party knows the partner lacks actual authority).
- g. All partners must approve all major business decisions (e.g., the sale of goodwill).
- h. Absent provisions to the contrary, profits and losses are shared equally among the partners (even when capital contributions are not equal).
- i. Each partner is jointly and severally liable for all partnership obligations (whether arising from tort or contract) incurred within the scope of partnership business.
- j. When a judgment is obtained against the partnership and the partners, the partnership assets must be exhausted before any general partner's individual assets can be attached.

2. Generally an Entity Except for Federal Income Tax Purposes

Although many states treat a partnership as an entity for most purposes (e.g., property may be held in the name of the partnership, partnership may be sued in its own name, etc.), partnerships are not treated as entities for purposes of federal income taxes. This means that *a partnership does not pay federal income tax*; rather, profits and losses flow through the partnership proportionately to the partners, who must report their share of the partnership's gain or loss on their individual tax returns. Partnerships are, however, considered to be separate entities for employment purposes (i.e., partnerships must pay FICA, FUTA, and Workers Compensation).

3. Partnership May Be Sued

As a legal entity, a partnership may sue or be sued in its own name. However, unlike corporations, partnerships are not completely separate from their owners (i.e., the partners).

a. Full Personal Liability

As will be discussed later, partners are fully and personally liable for the debts of their partnership, and partners may be sued along with their partnership in the same action, provided they are properly served with process.

b. Judgment

To reach the personal assets of a partner, there must be a judgment against the partner, which means that the partner must be individually named as a defendant in the lawsuit. If only the partnership is named, a judgment against the partnership will not be treated as a judgment against a partner, so only the partnership's assets will be liable on the judgment.

B. FORMATION OF A GENERAL PARTNERSHIP

Under common law and the Revised Uniform Partnership Act (which has been adopted by a majority of the states) all that is necessary to form a general partnership is: (i) an agreement (ii) between at least two competent persons (iii) to carry on as co-owners a business for profit. There is no requirement for a general partnership to file with the state.

EXAMPLE

Alex and Becky inherit Blackacre, an apartment building, as tenants in common (a form of joint ownership). They are not automatically deemed partners. Mere joint ownership of property is not enough to establish a partnership relationship.

1. Capacity to be a Partner

Generally any party competent to make a contract can be a partner. Thus, an individual, a corporation or a partnership can be a partner. Even a minor can be a partner, but the partnership would be voidable at the option of the minor.

2. Intent to Form a General Partnership

Intent to form a partnership is the key to general partnership formation. *No express agreement is necessary.* An agreement can be implied from conduct showing intent to enter into a business for profit together.

EXAMPLE

Steve and Barb decide to operate a hot dog cart together. Steve agrees to pay for the cart, and Barb agrees to make and sell the hot dogs. The two also agree to split the profits. A partnership has been formed even though Steve and Barb never expressly agreed to form a partnership.

a. When Intent Unclear—Sharing of Profits

If it is unclear whether the parties intended to enter into a partnership, the courts will look at a number of factors to determine the parties' intent, the most important of which is whether the parties have agreed to share profits (which gives rise to a presumption of partnership).

b. Exception Possible

Although an agreement to share profits generally indicates an intent to form a partnership, no such inference will be drawn where the agreement to share profits was merely to repay a debt, interest on a loan, to pay an employee wages, to pay a landlord rent, etc.

EXAMPLE

Alex owns a piece of land. Becky desires to rent it and to build and operate a hotel on it. Alex leases the land to Becky, who agrees to pay Alex 10% of the net profits earned from the operation of the hotel. Cindy, who delivers goods to Becky for the hotel, seeks to hold Alex liable for the goods as Becky's partner when Becky fails to pay for the goods. Cindy cannot recover from Alex. The 10% payments are rent—there is no partnership.

c. Other Factors Considered

The courts will also consider (i) whether title to property is in a partnership name, (ii) whether the parties call the arrangement a partnership, and (iii) the amount of activity involved (e.g., did the parties merely purchase a piece of property together, or did they purchase the property, build apartments, manage the development, etc.).

3. Generally Writing Not Necessary

As a general rule, a general partnership agreement need not be in writing, even if the partnership is to own land. However, if the partners want to enforce an agreement to remain partners for *longer than one year*, a writing is required under the Statute of Frauds.

PASS KEY

The examiners often ask what is necessary to form a general partnership. The key is to remember three simple elements: (i) two or more persons, (ii) who agree (expressly or impliedly) (iii) to carry on as co-owners a business for profit. There is no requirement of a writing, even if the partnership is to own land, unless the partnership is to last for more than one year.



4. Fictitious Name Statutes

In almost all states, partnerships doing business under a fictitious name are required to register with the state. This registration must set forth the name under which the business is conducted and the real names and addresses of all persons conducting the business. Failure to comply with a "fictitious name" statute will not invalidate the partnership, but may result in a fine.

C. OPERATION OF A GENERAL PARTNERSHIP

Absent an agreement to the contrary, all partners have *equal rights* to manage the partnership business.

EXAMPLE

Alex, Becky, Cindy, Deanna, and Elias form a general partnership—Glorious Jeans—to manufacture coffee-colored clothing. Alex contributes 40% of the capital, Becky contributes 30% of the capital, Cindy contributes 20% of the capital, Deanna contributes 10% of the capital, and Elias agrees to design all the clothes. Each partner has an equal right to participate in management of the partnership.

1. Required Approval

Decisions regarding matters within the ordinary course of the partnership's business may be controlled by majority vote unless the partnership agreement provides otherwise. Matters outside the ordinary course of the partnership's business (e.g., sale of the partnership's goodwill) require consent of *all* the partners. Examples of areas requiring unanimous consent of all partners include:

- a. Admitting new partners;
- b. Confessing a judgment (admitting liability in a lawsuit) or submitting a claim to arbitration;
- c. Making a fundamental change in the partnership business (e.g., the sale of a partnership's goodwill);
- d. Changing the partnership agreement; and
- e. Assigning partnership property to others.

EXAMPLE

In the partnership described in the previous example, the decision whether to buy cloth from Supplier may be approved by any three partners, but a decision to shift production from the manufacture of clothing to the manufacture of small appliances would have to be approved by all the partners.

2. Agency Law Governs

The authority of a partner to bind the partnership when dealing with third parties is governed by the law of agency. Every partner is an agent of the partnership for the purpose of its business. Under Agency law, a principal (in the context of partnerships, the partnership) can be bound by the acts of its agent (in contract or tort) if the agent (in the context of partnerships, a partner) acted with actual or apparent authority. The partnership may also ratify previously unauthorized acts, either expressly or by accepting the benefits of a partner's unauthorized action with knowledge of all material facts regarding the action.

a. Actual Authority

Actual authority includes all authority that a principal expressly gives to an agent plus any authority that can reasonably be implied from the express grant (e.g., if a partner is appointed to manage a store, it would be reasonable to imply the authority to hire employees, buy merchandise, etc.). A partner, therefore, has whatever actual authority is granted to him in the partnership agreement plus whatever authority the partners subsequently agree that the partner has.

b. Apparent Authority

Apparent authority is the authority that a third party reasonably believes an agent has based on the principal's holding the agent out as being the principal's agent. A partner has broad apparent authority. Any act of any partner for apparently carrying on in the ordinary course of the partnership business, or business of the kind carried out by the partnership, will bind the partnership through apparent authority. It is important to remember that this authority cannot be limited by resolutions or instructions of which the third party is unaware.

EXAMPLE

Ann and Bob form Kappa Associates, a partnership to sell kitchen equipment. The partnership agreement requires each partner to get the approval of the other for purchases over \$500. Thus, Ann and Bob each have actual authority to purchase \$500 in equipment. If Bob wants to purchase \$1,000 of inventory from XYZ Kitchen Supply, and he asks Ann for approval and she agrees, he has actual authority to purchase the \$1,000 of equipment. If Bob does this three times and on a fourth occasion decides not to seek Ann's pre-approval, he lacks actual authority to make the fourth \$1,000 purchase, but Kappa Associates nevertheless would be bound on the \$1,000 purchase because Bob would have apparent authority, as the purchase was apparently for carrying on the partnership's business.

c. Limitations—Transactions Outside Ordinary Course of Business

A partner has no apparent authority to bind the partnership to transactions apparently outside the regular course of the partnership's business. Thus, in the example above, if Bob had purchased a lawn tractor purportedly on behalf of the partnership, the partnership would not be bound. Note that the following are generally outside the scope of partnership business and so do not come within a partner's apparent authority:

- (1) Confessing a judgment against the partnership (i.e., admitting partnership liability in court);
- (2) Selling the partnership's goodwill (e.g., selling use of the company's name);
- (3) Submitting an issue to arbitration on behalf of the partnership;
- (4) Committing an act that would prevent the partnership from continuing in business; and
- (5) Changing the partnership agreement.

d. Partner Liable for Damages

A partner who acts outside the scope of his actual authority will be liable to the partnership for any damages caused by the unauthorized act.

3. Expanding and Limiting Authority—Statement of Authority

The general rule is that a partnership may expand or curtail a partner's authority to enter into transactions on behalf of the partnership by filing a statement of authority with the secretary of state.

a. Personal Property Transfers

(1) Grant of Authority

If a statement of authority filed with the secretary of state *grants* a partner authority to enter into transactions on behalf of the partnership, other than transfers of real property, the partner will generally be treated as having the authority granted, even if the partners later agree that the partner should not have the authority.

EXAMPLE

Alex, Becky, and Cindy are partners in Glorious Jeans Clothing Company, which manufactures jeans using a special patented process. The company falls on hard times, and the partners file a Statement of Authority with the secretary of state giving Cindy the power to sell the company's patent. Before Cindy can find a buyer, business turns around, the company is once again running at a profit, and the partners agree that a sale is no longer needed. Six months later, a Starbucks Jeans representative gives Cindy a large sum of money to purchase the patent. Glorious Jeans will be bound because it never canceled the Statement of Authority, unless it can show that Starbucks actually knew that Cindy lacked authority to sell the patent.

(2) Limitation on Authority

The rule is different for limitations on authority. A person is not considered to know of a limitation on a partner's authority to enter into transactions not involving real estate transfers merely because the limitation is filed with the secretary of state. In other words, *the filing of a limitation does not give third parties constructive knowledge of the limitation*.

EXAMPLE

In the previous example, if the Statement of Authority filed by Glorious Jeans also contained a provision that Alex does not have authority to purchase cloth on behalf of the partnership, and Alex purchased cloth from Supplier, the limitation is not effective against Supplier unless Supplier actually knows of it.

b. Transfers of Real Property

If a Statement of Authority either grants *or limits* power of a partner to sell the partnership's real property, the grant or limitation is conclusive if: (i) it is filed with both the secretary of state and the county recording office and (ii) the buyer gives value for the real property without knowledge that the partner lacked authority. Thus, unlike the rule for personal property, a person will be considered to know of a properly filed limitation on a partner's authority to transfer real property. In other words, *the filing here serves as constructive knowledge of the limitation*.

c. Statement of Denial

A partner listed in a filed statement of partnership authority may effectively deny her authority by filing a statement of denial with the secretary of state.

D. TERMINATION—DISSOCIATION AND DISSOLUTION OF A GENERAL PARTNERSHIP**1. Dissociation**

Dissociation is a change in the relationship of the partners caused by any partner ceasing to be associated in the carrying on of the business. Dissociation of a partner does not necessarily cause a dissolution and winding up of the business of the partnership.

a. Events of Dissociation

A partner is dissociated from the partnership when:

- (1) The partner notifies the partnership that he or she wants to withdraw (the notice does not have to be in writing);
- (2) An event occurs that was set out in the partnership agreement as an event that would cause a dissociation;
- (3) The partner is expelled from the partnership by unanimous vote or as provided in the partnership agreement or by judicial decree;
- (4) The partner becomes a debtor in bankruptcy or the like; or
- (5) The partner dies (or if the partner is not a natural person, such as a corporation, its existence is terminated).

b. Wrongful Dissociation

A partner will be deemed to have wrongfully dissociated if the dissociation is a breach of an express term of the partnership. The dissociation is also wrongful if the partnership is for a definite term or a particular undertaking and the partner withdraws, is expelled, or becomes bankrupt before the end of the term or undertaking.

(1) Wrongful Partner is Liable for Damages

A partner who wrongfully dissociates is liable for the damages caused by the dissociation.

(2) Compare—Rightful Dissociation

If the partnership is "at will," partners are free to quit at any time. A partnership is presumed to be at will unless the partners specifically agree otherwise.

c. Consequences

When a partner dissociates, the partner's right to participate in management ceases.

(1) Purchase of Partner's Interest

If the partnership business continues after a partner dissociates, the partnership must purchase the dissociated partner's interest based on the greater of (i) the partnership's liquidation value or (ii) the value of the partnership business as a going concern without the dissociated partner. Damages for wrongful dissociation reduce the amount due to the dissociated partner.

(2) Deferred Payment if Premature Dissociation

If a partner wrongfully dissociates before expiration of a definite term, the partner is not entitled to payment or interest until the expiration of the term. However, the deferred payment must be adequately secured and bear interest.