

## Question 7 – July 2015 – Selected Answer 1

### 1. FB Online Partners, Ltd. is a General Partnership in Texas.

Under Texas law, the default organization when two people choose to go into business together for profit is a general partnership. Though, Fred and Barney never filed anything with the Secretary of State, a partnership was created by their agreement to go into business together for money.

The courts look to factors to determine whether or not a partnership was created. These factors are: a sharing of profits, a sharing of management and control, any agreement that was made, and sharing of loss. Here, Fred and Barney made an express partnership agreement where they stated they would share profits equally. Similarly, they agreed to manage and run the business together. The two men also contributed to the partnership. Partners in a general partnership can contribute money, property, or services. Therefore, this also tends to show a partnership was created. Though they did not discuss losses, the factors to determine a general partnership are not dispositive. Thus, because the two entered into an agreement for profit and shared revenue and management, a general partnership was created.

Though Fred and Barney attempted to create a Limited Partnership, this can only be done by filing with the Secretary of State and meeting the requisite formalities. Therefore, the "Ltd." attached to their name does not change their status as a general partnership.

### 2. The court should split the profits equally, but the partnership may seek reimbursement from Barney.

#### *Generally:*

Under Texas law, partners have a fiduciary duty to the partnership. They have a duty of loyalty and good faith. They may not self-deal and must act in the best interest of the partnership. If a partner does breach his duty, he could be liable to the partnership.

Here, the general rule of partnership is that profits are split equally. Though their partnership agreement explicitly states so and would otherwise control, there was no other agreement about how revenue was to be distributed after the initial investment was paid back. Therefore, the general rule is that Fred and Barney should split the proceeds evenly and would therefore be entitled to \$75,000 each.

#### *Fred's Proceeds:*

The issue is whether or not Fred's proceeds and venture breached his fiduciary duty by competing with the partnership and/or are within the scope of the ordinary course of business of the partnership and therefore it is partnership property.

Under Texas law, partners may not compete with the partnership or take funds from the partnership. Here, Fred explicitly took clients and potential business from the partnership. By doing services that were in the ordinary course of business of FB, Fred breached his duty of loyalty to the company. However, Fred also used property and other resources from FB to provide for the resources. Therefore, a court may hold that Fred was acting within the scope of the partnership and was therefore acting as the partnership's agent while doing the services. Because he used the property and resources and did the same type of services that FB does, Fred was likely still acting within the scope of the ordinary course of business of the partnership.

Because he will either be seen as having taken away potential proceeds from the partnership by directly competing, or was acting within the scope of the partnership's ordinary course of business but put the \$20,000 in his personal bank account, Fred breached his fiduciary duty. When partners in a general partnership breach their duties and profit from such a breach, courts generally impose a constructive trust on the amount earned while breaching. Therefore, Fred's \$20,000 from the venture is constructively held in trust as partnership proceeds. He must distribute the \$20,000 to the partnership.

Because the \$20,000 will be held in trust by either the amount Fred profited by competing with the partnership or the amount he took away from the partnership while acting as its agent, the general rule is that the \$20,000 will also be split equally between the two partners. Though it was from Fred's work, the partnership agreement did not specify who was to get what percentage of income. Partners have no duty to pay another partner who does more work. Therefore, they will each be entitled to \$10,000.

#### *Barney's Loan:*

Barney's loan also breached his duty to the corporation. Under Texas law, when a third party gives credit or payment to a partner thinking that it is for the partnership, the partner will be estopped from arguing that the credit does not belong to the partnership. By using the partnership name in obtaining the loan, the loan belongs to the

partnership.

Though the partnership agreement attempts to disclaim liability for each other's breaches, this is void in Texas and is against public policy. The point of general partnerships is that all partners are jointly and severally liable, so they may not disclaim liability to each other or to third parties. Therefore, the \$10,000 loan will have to be paid back from the partnership's proceeds. Because Barney's breach of his duty caused the partnership to lose \$10,000, the partnership may seek reimbursement from that debt.

Therefore, because the partners split equally, Fred will be entitled to the \$75,000 from the equal split of the \$150,000 net profit, as well as the \$10,000 from the internet services, making his total amount \$85,000. Barney will also be entitled to split the proceeds from the net profit and will get his share of the \$75,000. Though he is entitled to the \$10,000 from Fred's "outside" services if it's seen as within the partnership scope, he will also have to reimburse the partnership for the \$10,000 loan he used to buy home computers. Therefore, Barney's total amount will be \$75,000.

## Question 7 – July 2015 – Selected Answer 2

### 1. This is a General Partnership

A general partnership is the amalgamation of two or more persons for the purpose of carrying on a business for profit. Partners or putative partners can contribute to the partnership via money, labor, tangibles, property, or intangibles and upon dissolution and winding up are generally entitled to return of investment provided there are enough assets after all debts of the partnership are taken care of. General partnerships may be formed via express written agreements or through conduct (implicitly). The default presumptions are that profits and losses are shared equally between partners. Each partner generally has a right to manage and has input as to business decisions, and the partnership enjoys pass thru taxation - meaning that the profits etc. are taxed only upon distribution to the partners and not on an entity level as they would be in a corporation. It is important to note that a partnership can sue and be sued and hold property - but if its assets cannot repay its debts, the partners are jointly and severally liable for the debts. In addition, partners are agents of the partnership so agency rules apply both in terms of contractual and tort liability.

There are other special partnerships - a limited partnership whereby there is a general partner and a limited partner with the limited partner being liable only to the extent of their investment and not being able to exert control or management (other than in certain limited indirect means). There are also limited liability partnerships, where the partners are only liable for their own torts and contracts and the torts or liability of the persons under their direct supervision. It is important to note, however, that both of these forms must be entered into with a filing with the secretary of state's office and the payment of the filing fee. Such a form includes - among other things - the name address, purpose of the partnership. While such an entity must have limited or certain other 'buzz words' which denote that they are a limited form of partnership in their name - simply putting limited on the end of the name of a general partnership will not suffice.

That being said, it is worth noting that third parties who reasonably and honestly believe they are dealing with a limited partnership form in transactions may be estopped or equitably prevented or constrained to treating their interactions with a general partnership acting like a limited or limited liability partnership and not as a general partnership - although that is not relevant or necessarily applicable here.

At any rate, applied here, Barney and Fred might **want** to be a limited form of partnership - likely a limited liability partnership - but they haven't filed with the secretary of state. You cannot disclaim personal liability simply by putting a Ltd. at the end of the partnership name or signing some document which declares that you aren't personally liable. Clearly, this is a general partnership as they equally own and operate the partnership and will equally share the profits. They are definitely looking for a LLP or limited liability partnership form or at least the perks due to the language involving liability only for their own mistakes and obligations of the business, but the lack of a filing dooms their effort.

### 2. Both Fred and Barney Breached Their Fiduciary Duties

Partners owe each other and the partnership fiduciary duties including the duty of care (to act in the exercise of reasonable care), and duty of loyalty/not to compete. The duty of loyalty encompasses duties or obligations to avoid co-mingling personal and partnership assets, to avoid usurping partnership opportunities,

to avoid self dealing unless and only if the materially relevant facts are disclosed to the other partners, and generally a duty to exercise good faith and not compete and especially avoid unfair competition. Profits or monies derived from such prohibited conduct is deemed to be held in trust for the benefit (constructive trust) for the partnership pending - of course- an action to return such assets to the partnership.

Applied here, we see that Barney engaged in self dealing - using the credit of the corporation to get a 10k loan which he then deposited in his own personal account and with which he bought equipment to replace the equipment which was his contribution to the partnership (thus becoming assets of the partnership). Barney has breached his fiduciary duties thru his comingling and self dealing. The question then becomes one of damages - Barney only had to pay interest on the loan and not principal for the first 12 months which he apparently has done for 6 months from June to December. Thus, the principal of 10k remains outstanding and there are likely another 6 months of interest to be paid - both of which are owed from Barney to the Partnership. Note however, that Barney has the goods bought with the credit in his control, so it is not as simple as characterizing this as lost profits and there really is no point to forcing Barney to simply turn over the goods - after all they would be redundant of the equipment Barney already gave the partnership.

As for Fred, just because a partner engages in running the business or generates a greater share of revenues - absent an agreement to compensation and/or anything other than a equal split of profits, the partner is not entitled to compensation or a greater share of the profit. As mentioned above, there is a duty to avoid competition with the partnership and a duty to avoid usurping partnership opportunities. Here, Fred has both engaged in competition and apparently usurped partnership opportunities- after all the partnership is engaged in consulting services and Fred is doing the same. Consequently, Fred owes the 20k from his 'side venture' to the partnership as they are profits flowing from his breaches. Unlike Barney's debts, these are clearly profits that should have gone to the partnership and thus will be factored into the division of profits of the partnership at the end of the year once they are properly returned, whereas Barney's debts should be docked from Barney's share of the profits to take care of that loan right away before it accrues interest.

Under the partnership agreement both partners are to receive their contributions prior to distribution of profits. Given the circumstances of both of the partners' breaches of fiduciary duties the amounts owed the partnership must be similarly factored in prior to distributing the profits. We start with 150k - we then subtract 10k for each partner - 10k for the money Fred deposited and 10k for the value of the equipment donated by Barney (per the partnership agreement specifying no distribution prior to recompense for the partners' contributions). That leaves us with 130k and we must then add in the 20k that Fred owes the partnership for his breach for a total of 150k as those were lost profits. We divide that in half to find that both Fred and Barney get 75k. However, we must still account for Barney racking up a debt to National Bank and subtract another 10k from Barney's share to immediately pay back National Bank (or to hold for the partnership to pay national bank).

In sum: We start with 170k - the 150k plus the 20k from Fred's side venture.

Fred: 10k contribution + 75k profits (including the 20k Fred took) = 85k

Barney: 10k contribution + 75k(including the 20k Fred took) -10k (the debt improperly incurred by Barney) = 75k

### Question 7 – July 2015 – Selected Answer 3

1. FB Online Partners, Ltd. is a Texas general partnership.

The issue is what type of business organization is formed when two people agree to start a for-profit business, do not file any documents with the Texas Secretary of State, but do execute a written agreement dictating the terms of their agreement. Under the Texas Business Organizations Code ("TBOC"), a general partnership is created when two or more people (or entities) agree to carry on a business for profit. A general partnership does not require that any specific documentation be filed with the Texas Secretary of State nor does it require any specific suffix to the business name. Indeed, a general partnership is the only business entity that may be formed for two or more entities without filing any documents with the Texas Secretary of State. General partners are jointly and severally liable for the debts and obligations of the partnership, as well as their own personal torts and debts. Partners in a general partnership may agree to limit their liability to each other, but they may not disclaim liability to third parties unless the third party specifically agrees to the liability disclaimer

in contract. This is good public policy because third parties, in determining whether to extend credit or do business with a partnership, should be entitled to know whether the partners intend to be personally liable for their debts and obligations. A limited liability partnership, however, does limit each partners' liability to only their capital contribution and own torts. A Texas limited liability partnership requires that the partners (1) file formation paperwork with the Texas Secretary of State, (2) attach a proper limited liability partnership suffix to its business name (e.g., "LLP" or "Limited Liability Partnership," (3) register an agent for process, and (4) procure liability insurance for the limited liability partnership.

In this case, FB Online Partners, Ltd. is a Texas general partnership. While Fred and Barney's written agreement contains provisions that tend to show they intended to create a limited liability partnership, they did not comply with the filing requirements to properly form a Texas limited liability partnership. Specifically, Fred and Barney did not (1) file formation paperwork with the Texas Secretary of State, (2) register an agent for process, and (3) procure liability insurance for their partnership. Fred and Barney cannot disclaim personal liability by agreement (unless the third party agrees via contract) in this manner because third parties will not have constructive (record) notice of their liability limitation when deciding whether to extend credit or do business with FB. Fred and Barney may argue that attaching "Ltd." to their business name gives third parties constructive notice of their liability limitation, but this does not overcome their noncompliance with TBOC requirements.

Therefore, because Fred and Barney did not file any business formation paperwork with the Texas Secretary of State, thereby precluding them from asserting they are a limited liability entity, FB Online Partners, Ltd. is a Texas general partnership.

2. The Court should apportion FB's profits as follows: \$85,000 to Fred and \$75,000 to Barney.

At issue is how a court should apportion partnership profits when each partner breached their fiduciary duty to the partnership. Partners in a general partnership owe the partnership and each other a duty of loyalty and duty of care. They must not engage in self-dealing, misappropriations, competitive conduct, or any other bad faith acts against the partnership or each other. Breach of a partner's duty results in a claim on behalf of the Partnership and other partners for damages.

Here, Barney obtained a \$10,000 loan from National Bank by executing on behalf of FB ("FB by Barney"). Under agency law, Barney bound FB to this loan because he signed the loan documents with apparently authority (i.e., a third party reasonably believed Barney had the authority to bind the partnership). Barney therefore breached his fiduciary duty to the partnership and is liable to the partnership for this debt. Fred, on the other hand, engaged in competitive conduct when he began using FB's resources to consult clients on the side. Fred collected \$20,000 in fees from this competitive conduct and therefore breached his fiduciary duty to the partnership as well. The \$20,000 may be recovered by the partnership because Fred used their resources and competed against the partnership, thereby taking away that business from the partnership.

The Court should apportion FB's profits as follows: \$170,000 total profit (including Fred's collection on the side) should first be used to repay each partner for their capital contribution per their valid agreement. Each partner receives \$10,000 and that is their capital contribution value (cash or property). The remaining \$150,000 will then be split evenly per their agreement. Fred should therefore collect \$85,000 (\$75,000 profit + \$10,000 capital contribution) and Barney should collect \$75,000 (\$75,000 profit + \$10,000 capital contribution - \$10,000 debt to National Bank).

Therefore, the Court should apportion FB's profits as stated in consideration of their breach of fiduciary duties and capital contributions.