

## Q9 – July 2016 – Selected Answer 1

(1) The terms of the agreement prevent Buck and Loretta from becoming a general partnership and a limited partnership but do not prevent the Pratts from becoming a limited liability company. The issue here is whether any of the terms violate the requirements for each type of business under the Texas Business Organizations Code.

a. First, a general partnership is an agreement between co-owners to carry on a business together for profit. A general partnership requires no filing in order to be valid. In a general partnership, each person is a general partner and has joint and several liability for the debts and obligations of the partnership and the debts obtained in the ordinary course of business by any of the other partners. Additionally, general partners as a default share in profits equally and share in losses in accordance with the profits. Each general partner in a general partnership has an equal right to participate in the management of the partnership. Given this information, Buck and Loretta cannot form a general partnership. Under their agreement, Buck and Loretta agreed that they would jointly make management decisions and Loretta will be the sole employee and receive a salary. These requirements are fine for the general partnership. But the agreement then seeks to limit Buck's liability for any aspect of the business. This is not a valid term in a general partnership agreement. A general partner cannot limit their liability for the business because as a general partner they are jointly and severally liable for the debts of the partnership. The agreement also states that Buck will receive the first 5% of profits from the business each year. Although a general partnership as a default requires equal splitting of the profits between partners, this may be changed by a partnership agreement so this provision is allowed along with the distribution of profits after an agreement to retain some of the profits for operating capital.

b. Second, a limited partnership is a partnership with one or more general partners and one or more limited partners. A general partner in a limited partnership, like a general partner in a general partnership will have joint and several liability for the debts and obligations of the partnership as well as for the debts arising from other partner partners in the ordinary course of business. Therefore, like in a general partnership, the provision limiting Buck's liability would be ineffective if Buck were the general partner in a limited partnership. Further, in a limited partnership a limited partner has limited liability. This means the limited partner is only liable for their contribution to the limited partnership and is not personally liable for the debts of the limited partnership or the other partners. But this limited liability protection may be lost if the limited partner participates in control of the business. Although the Texas Business Organization Code does not clearly define what control is, it provides a list of safe harbors. Not within that list, is joint management decisions. The provision in the agreement between Buck and Loretta which requires all management decisions to be made jointly by Buck and Loretta would therefore require both partners to lose their limited liability protection as a limited partner and make the limited partnership form useless. Loretta's employment and salary would not constitute control though as those are safe harbors in the code that do not constitute control. Further, in a limited partnership the partners may distribute profits in accordance with their capital accounts or change this by agreement. Here, the distribution of profits first to Buck and then proportionally after allocating an amount for operating capital is an allowable provision in the operating agreement. But because the agreement provides each potential partner too much ability to control the business, the limited partnership is not a good form.

c. Lastly, the limited liability company is a good option for Buck and Loretta based on the terms of their agreement. A limited liability company is formed upon filing and paying the fee with the secretary of state. A limited liability company is operated pursuant to a company agreement. The agreement may provide that the company is member managed or manager managed. Here, as the creators of Pratt's House it appears that Buck and Loretta also want to be able to manage the business. Therefore, they can make the company member managed and the provision allowing all management decisions to be jointly made between Buck and Loretta is valid. Additionally, a member can be an employee of the company and retain a salary of the company as Loretta wants to do in the agreement without destroying the company form. Also, in a limited liability company, each member has joint and several liability. This means no member is personally liable for the debts of the company. The provision in the agreement stating that Buck will have no liability for any aspect of the business is going to be valid in the company then. Lastly, the members may split the profits and allocate funds in any way that they agree in a limited liability company. Although as a general rule, the profits should be distributed and the company is managed according to the capital accounts of members, this can be changed by the company agreement. Therefore, the provision allowing Buck to advance \$100,000 as operating capital, take a 5% return first from any profit and then have the company distribute profits not allocated to operating capital equally between partners is valid. Therefore, the agreement does not prevent Pratt's Hats from becoming a limited liability company.

2. To legally use the name Pratt's Hats, Buck and Loretta must file an assumed name certificate. The issue here is whether Pratt's House is a proper name of an entity and what is required to use that name legally.

An entity formed by filing, which is anything besides a general partnership and a sole proprietorship, has a requirement for its name that it designate its entity type in the name. This means a limited partnership would have to include "limited partnership" in its name or an abbreviation of that. Therefore, Pratt's Hats is not a proper legal name. But any entity may operate under such a name by filing an assumed name certificate in the county of the principal office is located. The assumed name certificate sets forth the owner, it states the legal name of the entity if it is an entity that filed a certificate of formation with the secretary of state and the assumed name under which the business will be operating. The name must also not be misleading. Here, if Buck and Loretta file an assumed name certificate, no matter what type of business association they form, then they may legally use the name Pratt's Hats. They would just need to state their names on the certificate or the legal name of the association formed and the name "Pratt's House." Failure to file the assumed name certificate would not prevent Pratt's Hats from operating under that name but it would prevent them from suing in the state until the name is on file.