

Question 1 – July 2012 - Selected Answer 1

PART1:

Art, Bill, and Chris have formed a **general partnership** names ABC Hardware Ltd. At issue, is what form of business was created. In Texas, a general partnership results when two or more people operate a business for profit, unless the statutory requirements for other forms of businesses are met.

Here, Art, Bill and Chris appear to have intended to create a Limited Partnership, rather than a general partnership, as indicated by the "ltd." in the firm's name. In order to have created a Limited partnership, they would have needed to complete the statutory requirements of filing with the The Secretary of State and paying the associated fee. The Secretary of State filing servers as constructive notice that lets everyone know that recourse is limited when dealing with the firm.

Bill, Art, and Chris did not file anything with the Secretary of State or pay a fee, and they are operating a business for profit in the state of Texas. Under these facts, ABC is a Texas General Partnership.

PART2:

Art, Bill, and Chis are **personally, jointly and severally, liable** for the torts and liabilities of the ABC general partnership. At issue is, are the partners of ABC liable despite their written partnership agreement that specifically states that they "will not be liable to third parties for any obligation of the business."

One major drawback of doing business as a general partnership in Texas is that the partners are personally, jointly and severally, liable for the liabilities and torts of the partnership. This liability can NOT be waived solely through a partnership agreement between the partners themselves - the partners can only escape liability if they have a contractual agreement stating such with the particular party who is asserting a claim against them.

Here, ABC's written agreement specifically states that they "will not be liable to third parties for any obligation of the business." Unfortunately for the partners, there are no third parties in privity to this agreement and they have formed a general partnership, so this agreement will not be effective against third parties.

If a third party successfully brings a claim against the firm and the partners, such as the Motorist that was injured when the ABC delivery truck ran a red light, the partners will be personally liable, jointly and severally, for the claim. Under such a situation, the firms resources will be exhausted first. Once the firms resources are exhausted, the partners will be responsible for the remainder.

PART3:

A) Chris and Bill have **breached their duty of loyalty** to the corporation. The **profits and the loan** from the warehouse sale will be treated as **assets of the firm**.

Partners owe the partnership a duty of loyalty. This duty of loyalty is breached when a partner usurps a corporate opportunity by taking advantage of the opportunity for his own personal profit. Here, Chris usurped the opportunity of the firm to sell the warehouse for \$110K by purchasing the warehouse for \$50K and then attempting to usurp \$60K of profit. This profit will be deemed as constructively in trust for the firm, rather than as Chris' personal gain.

Bill also breached his duty by taking out a, what seems to be, personal loan in the name of the firm. The firm and the partners will be responsible for payment of the loan because it was taken out under Bill's apparent authority to get such a loan. Bill is liable to the firm for the balance of the loan, \$25K. Alternatively, the firm can choose to take ownership of the vehicle purchased with the loan money - this would be advantageous only if the vehicle increased in worth.

B) The firm has **\$210K** available for distribution (\$150K of profits plus \$60K from the warehouse sale).

C) The profit should be distributed per the partnership agreement, contribution first then split the profits between the partners. In Texas, partners get an equal share. - Assuming that the warehouse was conveyed to the business when it was worth \$25K -

The \$210 should be distributed as follows:

Art - \$25K contribution + \$45K equal share

Bill - \$25K contribution + \$45K equal share, LESS \$25K to be paid to the bank for the loan

Chris - \$25K contribution + \$45K equal share

Question 1 – July 2012 - Selected Answer 2

(1) ABC Hardware Ltd. is a General Partnership. At issue is what business form Art, Bill and Chris entered into.

A general partnership in Texas is defined as an agreement between two or more persons to operate a business for profit as co-owners. Further, no formal requirements or writings are necessary to finalize this business type. Additionally, should the partners intend to create a form of limited partnership that fails due to formalities, the default is a general partnership and the parties are not entitled to the protections of a limited partnership. Here, Art, Bill and Chris signed a written agreement to form a for-profit hardware store that they would operate the business together and share profits equally. The use of the "Ltd." in the partnership name gives the appearance as a limited partnership, however, a formal filing is required to apply to have a limited

partnership with the Secretary of State. The facts further state that the partners did not file any documents with the Secretary of State, and as previously stated, an application and filing is necessary for the formation of a limited partnership, but none are needed to create a general partnership. Therefore, Art, Bill and Chris effectively created ABC Hardware, Ltd. as a general partnership.

(2) Art, Bill, and Chris are all personally liable to Motorist. At issue is the personal liability of the partners in a general partnership by the tortious acts of employees.

As a general rule, if an employee acts in a negligent manner within the scope of his employment, the employer is liable to the injured party. Additionally, there is no personal liability protection for partners in a general partnership. Here, an employee of ABC was driving an ABC delivery truck to make an order to a customer. While driving, the employee ran a red light and struck Motorist, injuring him. As this was within the scope of his employment, ABC is liable for the negligence of the employee. Further, because ABC is a general partnership, the partners are personally liable to Motorist for any judgment rendered against ABC for the personal injury action by Motorist.

However, to satisfy the judgment, Motorist would first have to seek to have the judgment paid off out of the partnership funds, and for any excess amount not paid by the partnership, the individual partners would be jointly and severally liable to Motorist. If the partners pay the amount of the judgment out of their own funds, they may seek indemnification from the partnership.

(3) (a) The First Bank Loan taken out by Bill should be deducted from the amount owed to Bill out of the distributions and the profit taken by Chris on the sale of the proceeds should be put back into the total profits generated by ABC.

All partners owe a duty of loyalty and duty of care to the partnership; meaning that they must exercise due care in a reasonably prudent manner and act in a good faith manner not to: compete against the partnership, represent another in competition with the partnership, or use confidential information derived from his position in the partnership for his own personal gain. If a partner encumbers partnership property for his own personal gain, it constitutes a breach of loyalty to the partnership. Further, when a partner engages in a transaction with a third party under the appearance of authority to act on behalf of the partnership, if the third party has no knowledge of the lack of authority, the partnership is bound to the transaction. However, the partnership may be able to seek indemnification from the partner acting without authority.

Here, Bill took out a loan with First Bank in the name of the partnership to buy himself a personal vehicle. The transaction has been paid down to \$25,000, but the remaining \$25,000 balance is still technically owed by the partnership as a result of the apparent authority Bill conveyed when he entered into the transaction. As such, the partnership will be required to pay off the remaining balance, which should be deducted from Bill's portion of the partnership profits due to his personal actions encumbering the partnership.

Additionally, Chris acted in a manner that violated the duty of loyalty by personally purchasing the warehouse then immediately re-selling it to the investor instead of conducting the transaction through the partnership. Pursuant to the prevailing law on the issue, the amount that the partnership would have realized from the transaction had it been properly conducted through the partnership should be placed back into the partnership for equal distribution among the partners.

(b) The amount to be available for distribution is \$210,000. At issue is the total amount realized for profit from the partnership.

The company has already stated a \$150,000 profit, plus the \$110,000 that the partnership would have received from the transaction with the investor, minus the \$50,000 that Chris paid for the warehouse.

This puts all parties exactly where they would have been had the transaction between Chris and the investor not taken place.

(c) Art and Chris are entitled to \$70,000 apiece and Bill is entitled to \$45,000. Art and Chris are entitled to their respective shares, and Bill's portion is reduced by the amount that the partnership will pay off the lien held by First Bank.

Question 1 – July 2012 - Selected Answer 3

1. ABC Hardware Ltd. is a general partnership. At issue is the requirements for forming a general partnership, a limited partnership, and a limited liability partnership. A general partnership may be formed through an agreement between two or more persons to run a business for profit as co-owners--intent to create a general partnership is not required. General partners are jointly and severally liable for liabilities of the partnership and for liabilities created by partners acting in the ordinary scope of partnership business. Any agreement between general partners limiting liability to third parties will operate only as an indemnity agreement between the partners--it will have no effect on partners' liability to third parties. Under TBOC, business partners may also agree to create limited partnerships (one or more general partners with unlimited liability and one or more limited partners whose liability is limited to their contribution) and limited liability partnerships (all partners' liability limited to contribution), but they must file a certificate with the secretary of state and pay a fee. The name of the partnership must also reflect the form (for example, ABC Hardware, LP or ABC Hardware, LLP).

Here, Art, Bill, and Chris created an entity with the term "Ltd." in its name and agreed not to be liable to third parties; however, they did not file a certificate with the secretary of state nor did they pay a fee. Because their actions were insufficient to create a limited-liability entity like an LLP or an LP, Art, Bill, and Chris created a general partnership.

2. Art, Chris, and Bill are jointly and severally liable to Motorist (along with ABC Hardware Ltd.), but Motorist must exhaust ABC's assets before suing any of the partners in their personal capacities. At issue is the personal liability of general partners for torts committed by a partnership employee in the scope of his employment. General partners are jointly and severally liable for partnership liabilities. Torts committed by an employee of the partnership, acting within the scope of his employment, are liabilities of the partnership under normal agency principles and respondeat superior. A plaintiff, must, however, exhaust partnership assets before suing partners in their personal capacities.

Here, an ABC employee was driving an ABC-owned truck to deliver an order to a customer. This is an act within the scope of an employee's employment, as it is directly related to the business of the principal (ABC). The employee was negligent when he ran the red light. Thus, the partnership is liable to Motorist for

the harm caused by the employee's negligent act. If Motorist sues ABC and exhausts its assets, she can also sue one partner or all three. Art, Chris, and Bill are jointly and severally liable, which means that any one of them could be required to pay the full remaining damages of the Motorist. As discussed above, the agreement limiting liability to third parties will not be effective and only entitles partners to indemnity if they are required to pay for another partner's tort. Here, there is no indication that Art, Chris, or Bill was directly negligent, so their only recourse would be against the other partners for contribution or against employee for indemnity.

3.

(a) Both the personal loan made to Bill and the profit taken by Chris from the sale should be considered in an accounting, with the loan to Bill being paid off with his share (if any) of the profits, and the profits made by Chris on the sale of the warehouse deducted from his share (with a constructive trust on the remainder owed to ABC). Partners share profits equally in the absence of an agreement otherwise. Partners owe a duty of loyalty and a duty of care to the partnership. Under the duty of loyalty, partners cannot use partnership assets for their own personal gain, usurp a partnership opportunity, or take out personal loans on partnership credit. Partners may have apparent authority to bind the partnership, even when actual authority not present. Here, Bill took out a \$50K loan by signing ABC's name as the partner. If the loan was in the ordinary course of business and the bank had reason to believe (created by ABC) that Bill could bind ABC, then the partnership is liable for the loan, even though it was not authorized. As Bill is a general partner, the Bank probably thought he could bind ABC, and so the partnership is probably liable to the bank for the loan, even though it breached the duty of loyalty. However, because the partnership turned a profit in the first year (\$50K of which belongs to Bill), the partnership may deduct the damages suffered by the breach of loyalty (the \$25K balance on the loan that is on partnership credit) from Bill's share of the profits.

Likewise, Chris breached the duty of loyalty when he usurped a partnership opportunity by making a profit for himself on the sale of the warehouse without disclosing to the other partners that the partnership could make the profit. Thus, Chris must account to the partnership for the \$60K profit that he made on the sale (note that this also wipes out Chris's capital contribution, so he will not be entitled to any money for the warehouse when the partnership winds up).

(b) Available for distribution is the \$150K profits from the first year and the \$60K owed by Chris, or \$210K total.

(c) Art should receive his full 1/3 or \$70K share, Bill should receive his \$70K share, but will be required to account for the loan made in partnership name, so \$25K of his share will go to pay the bank off. If Chris pays the partnership the full \$60K in profits he received, he will also get his \$70K, less any other incidental damages the partnership may have suffered for breach of duty of loyalty.