Question 4

Alfred, Beth, and Charles orally agreed to start ABC Computers ("ABC"), a business to manufacture and sell computers. Alfred contributed $100,000 to ABC, stating to Beth and Charles that he wanted to limit his liability to that amount. Beth, who had technical expertise, contributed $50,000 to ABC. Charles contributed no money to ABC but agreed to act as salesperson. Alfred, Beth, and Charles agreed that Beth would be responsible for designing the computers, and that Charles alone would handle all computer sales.

ABC opened and quickly became successful, primarily due to Charles' effective sales techniques.

Subsequently, without the knowledge or consent of Alfred or Charles, Beth entered into a written sales contract in ABC's name with Deco, Inc. ("Deco") to sell computers manufactured by ABC at a price that was extremely favorable to Deco. Beth's sister owned Deco. When Alfred and Charles became aware of the contract, they contacted Deco and informed it that Beth had no authority to enter into sales contracts, and that ABC could not profitably sell computers at the price agreed to by Beth. ABC refused to deliver the computers, and Deco sued ABC for breach of contract.

Thereafter, Alfred became concerned about how Beth and Charles were managing ABC. He contacted Zeta, Inc. ("Zeta"), ABC's components supplier. He told Zeta's president, "Don't allow Charles to order components; he's not our technical person. That's Beth's job."

Charles later placed an order for several expensive components with Zeta. ABC refused to pay for the components, and Zeta sued ABC for breach of contract.

Not long afterwards, ABC went out of business, owing its creditors over $500,000.

1. How should ABC's debt be allocated? Discuss.

2. Is Deco likely to succeed in its lawsuit against ABC? Discuss.

3. Is Zeta likely to succeed in its lawsuit against ABC? Discuss.

Answer A to Question 4

1. How should ABC's Debt be Allocated?

To begin, one must determine the nature of the organization that was created. In this instance, there were no formalities or written arrangements to begin a business with Alfred (A), Beth (B), and Charles (C). Corporations require formal articles of organization to be filed with the state. In this instance, it is much more likely that a partnership existed. No formalities are required to form a partnership. Partnerships exist when two or more people agree to carry on a business for profit. In this case, ABC was formed to sell computer items for profit. Generally, partnerships are also presumed if there is an agreement to share profits equally. In this instance, there is no indication as to what profit sharing arrangement existed, if any at all. As such, the default rule is that this would be a partnership with equal sharing of profits. Furthermore, without an express agreement as to how losses will be shared, the default is that they will be shared just as the profits are shared. Therefore, losses will also be shared equally. The amount of capital contribution by each partner is irrelevant to this equation.

A will argue that he expressed a desire to limit this liability. However, absent a formal agreement and filing of the proper limited liability forms with the state (articles of organization and an operating agreement) for a Limited Liability Company, A is going to be considered a general partner. This is further indicated by his general managerial position, apparent equal voting rights, and active management in the company. A was the one to call Zeta (Z) and tell them not to accept orders from C. This indicates his active management. Limited partners, those with limited liability, generally have no managerial functions. Given there is no formal limited liability structure or arrangement, and given the various management positions by each person, they are all general partners who will share equally in the profits and losses of the business.

On top of profit and loss sharing, each general partner is liable for the debts of the entire partnership. Each partner is considered an agent of the partnership. Under agency law, any contract or tort entered into in the scope of the partnership is deemed to be partnership debt, and all partners are jointly and severally liable. As such, any of the following contracts that were properly entered into and authorized by a partner having

authority are partnership debts that A, B and C will be jointly and severally liable for as individuals.

In the event that the copy is forced to liquidate and pay, the order of payment is as follows. First, the company must pay all debt creditors first. Second, the company must pay back all capital contributions from each partner, which would be $100,000 to A and $50,000 to B. While C may argue that his contribution was in sales, partners generally have no right to salary or compensation for services unless they are winding up. As such, C is not entitled to this amount as a capital contribution absent any other agreement. Finally, any remaining loss or profit would be distributed as applicable, which is equally in this case.

2. Is Deco likely to Succeed in its Lawsuit against ABC?

Validity of the Agreement

In order to prevail Deco (D) must show that B was authorized to enter the contract. In general, all partners are authorized as agents. However, the nature of their authority may vary. Express authority exists when the arrangement expressly states what an agent may do. Here, there is no indication that B was told to enter into a sales contract. In fact, sales were expressly reserved to C. Implied authority exists when the function is 1) necessary to carry out other responsibilities, 2) one that has been done in the past dealings without object[ion], or 3) normal custom for someone with the position of the agent. Here, sales are not necessary to B's technical design responsibilities, and she has never sold before. However, D could argue that a general partner in a business customarily has authority to enter contracts. Still, the express reservation of the right to likely kills this argument. Finally, D may argue apparent authority. This exists when the company cloaks the agent with authority to do certain things and later withdraws or limits that authority without notifying a customer who is still relying on that authority. In this case, there is no indication that ABC held B out to be a sales representative in the first instance. There was likely no good basis that D had to rely on any authority from ABC. However, given that B herself is a managing partner, D likely could argue that B's actions were sufficient to show that the corporation had given her authority to act. As such, they will argue that it was reasonable to rely on this without any other notice. This would bind ABC. Failing to perform on the contract is a breach of duty and the

partnership, as well as the individual partners, will be obligated to pay as described above.

Breach of Duty of Good Faith and Loyalty

Partners have fiduciary duties to each other that are described as the utmost duty of good faith and loyalty. Under the duty of loyalty, a partner must not engage in self-dealing, usurping business opportunities, or competing against the company. In this instance, B engaged in a transaction with her sister who owned D. The terms were apparently very favorable to D. This could be viewed as self-dealing because it promoted B's familial interest with her sister and was not in the best interest of the company. The duty of good faith requires that partners act in a way that solely benefits and is advantageous to the partnership. Again, B's deal with D didn't garner the profits that it should have. Furthermore, this duty requires disclosure of conflicts of interest to the other non-interested partners so that they can either cleanse the transaction through ratification or disapprove it. There is no indication that B informed her partners. The other partners have a very strong argument to bring a claim against B for these breaches in duty. This would place the entire liability for the breached contract on B, which would deviate from the normal liability scheme described above.

3. Is Zeta likely to Succeed in its Lawsuit against ABC?

Validity of the Agreement

Zeta's (Z) claim on this contract again hinges on the authority of C to enter into it. In this instance, C has the express authority to enter into sales contracts. However, this contract was for components being purchased by C, which is outside his express authority. Z may argue that components are necessary to production and later sales, which gives C implied authority to enter into contracts. Plus, it is reasonable to assume that a partner who can sell can also buy. This also lends credence to a claim of apparent authority. Z will argue that ABC has held C out as a person whose sole responsibility is to contract, and it reasonably relied on that representation. Z's main issue is that A called and gave actual notice that C could not enter into this contract. This would destroy any reasonable reliance that Z had. A told Z that B was the technical person, not C. As such, Z should have seen that his was outside the scope of C's authority.

Notwithstanding the arguments above, C is still a general partner in the company. If Z is at all knowledgeable about agency law and partnerships, Z could rightly assume that one partner doesn't have the sole authority to terminate the management authority of another partner. Management functions are only transferable and alterable upon a unanimous vote of the partnership. In this case, A alone tried to limit what C could do. Z may argue that it knew this wasn't a proper action by A and more reasonably relied on C. In the end, I think it is likely that the court would find that Z at least should have investigated further once given notice that C may not have authority, and failure to follow through made there [sic] reliance on his apparent authority unreasonable. As such, this contract is invalid and will not bind ABC. Should the court disagree, any resulting contract liability would be distributed among the partnership and A, B and C as described above.

Effect of A's Notice on C's Duties

A might also claim that C's activities outside his scope of duty were not in good faith. There is no indication that loyalty of fair dealings are implicated. So far as we know, the contract with Z could have been completely advantageous and proper. However, the argument is that acting in an area in which C knows nothing about shows a lack of obedience to his agency limits and lack of good faith in honoring partnership agreements on authority. However, nothing in C's behavior indicates an improper motive. This is a young startup with new partners. It is unlikely that C thought he was doing anything wrong. Rather, it is reasonable to assume he thought he was helping out in another area. Also, A didn't act with the consent of B. As such, there is no indication that the majority of management is at odds with C's decision to enter the contract. This appears to be solely the reservation of A with B and C. In the end, there was likely no breach of duty and any potential liability from this contract would flow to all, not just C.

Answer B to Question 4

1.) How should ABC's Debt be Allocated?

The preliminary issue to determine is what type of business was formed when Alfred (A), Beth (B), and Charles (C) agreed to start ABC computers.

Formation of a General Partnership

A general partnership is formed when two or more people agree to run a business for profit, contribute funds or services in exchange for a share of the profits. Unlike a limited liability corporation or limited partnership, a general partnership requires no formal paperwork to be filed with the secretary of state. If the above definition of a general paratnership is met, then the business will be presumed to operate like a general partnership. Here, A,B, and C agreed orally to start ABC computers and did not file any corporate or partnership paperwork with the state. A contributed $100,000, B contributed $50,000 and her technical expertise and C contributed his services as a salesperson. They distributed the work amongst themselves. Although the facts do not state that they shared in the profits, it can be assumed that they shared in the profits because ABC becomes successful. Thus, because no formal paperwork was filed, all three members contributed money or services and share in the profits, there is a presumption that ABC operated as a general partnership.

Characteristics of a General Partnership

General Liability

In a general partnership, all partnerships share equally in liability and are personally liable for the debts of of the other partners and the partnership. Although A stated that he wanted to limit his liability, there are no facts to support that this was actually accomplished through an agreement, contract or that the partnership filed for a limited liability partnership. The only way that A could limit his liability would be to become a limited partnership, but that can only be done if the proper paperwork is filed with the state; there is at least one limited partner and at least one general partner. Because there is an absence of the necessary components of a limited liability partnership, A's liability will not be limited.

Each Partner is a Fiduciary and Agent to the General Partners and Partnership

Each partner is a fiduciary and agent to the general partnership and general partners. Thus, the laws of agency apply to the partners when acting in furtherance of and conducting business for the partnership.

Default Rules for General Partnership

In absence of an agreement governing the partnership, the default rules of partnership will be applied by the court. Here, A, B, C only had an oral agreement about how to run the business and not formal structure or governing documents for the partnership. Thus, the default rules will be applied.

Several of the key default rules that are applicable in the present situation include: Each partner has equal power to manage the partnership; when there are profits they are shared equally and losses are shared like profits.

Dissolution of General Partnership

Upon dissolution of a general partnership, there is a specific order in which assets must be distributed. First, creditors must be paid and general partners who loaned money to the partnership. Second in line to [be] paid are general partners who made capital contributions. Lastly, any surplus or profits will go to the general partners or the general partners may be personally liable for existing debt of a dissolved corporation. Partners who contributed capital contributions and made loans to the company should receive their money back if it is possible upon dissolution.

Here, ABC went [out] of business and owed its creditors over $500,000. It is unclear how much profit was made or the assets of the partnership at the time it went out of business. Assuming the partnership went out of business due to lack of profits or funds, then the creditors are to [be] paid all that was left of the partnership's assets and each general partner will be personally liable for the remaining that is owed to the creditors. As discussed above, although A wanted to limit his liability, that is not done properly, so each partner will be equally liable for the debt after all partnership assets have been used to pay the creditors and there remains a debt stilled owed to the creditors.

2.) Is Deco likely to Succeed in Lawsuit against ABC?

Here, B as a general partner of ABC entered into a written sales contract with Deco, Inc. The contract was extremely favorable to Deco and not ABC. Deco was owned by B's sister. When A and C learned of the agreement with Deco they informed Deco that B had no authority to enter into sales contracts and that ABC could not profit if it sold computers at that price. ABC refused to deliver the computers and Deco sued. The issues are whether B can bind the partnership and whether A and C can cancel the contract that B made.

B's Authority to Enter Into Agreements that Bind the General Partnership

Absent an agreement, the default rules of partnership state that each general partner has an equal right to manage the partnership and act as agents for the partnership in the usual course of business. This means that the general partners have authority to enter into contracts that bind the corporation as long as the contracts are in the regular course of business of the partnership. The other partners do not need to assent to know about the agreement, but will become liable on any agreement that is validly entered into by one of the other partners in the course of business. Here, A, B, and C agreed that B would be responsible for designing computers and C alone would handle computer sales. Although they delegated responsibility for tasks, there is no agreement that limited authority of any of the partners; thus the default rules apply (although one could argue that their delegations of tasks was akin to agreement to limit authority, but the mere oral agreement is not sufficient to rise to a degree of limited partnership rights). Therefore, B can enter into contracts in the regular course of business the bind the general partnership without the knowledge or consent of either A or C. Thus, it was proper for B to use her authority as a general partner to enter into an agreement with Deco to sell computers to Deco.

B's Fiduciary Duties of General Partners and Partnership

However, every general partner owes a duty to the partnership and general partners. Each partner must act as a fiduciary, owing a duty of care and loyalty to the general partnership. Each partner has a duty of lolyalty to the corporation to do [sic] not compete with the partnership, usurp the partnership's opportunities or engage in any

self-dealing where the paratner receives a benefit to the detriment of the corporation. Here, B entered into a contract with Deco, which was owned by her sister. Inherently, there is nothing outrightly wrong with entering into an agreement with a family member. However, the contract that B entered into with her sister was extremely favorable to her sister and would actually cause ABC not to profit. Thus, the agreement was extremely beneficial to Deco, and B's sister, to the detriment of the partnership. Therefore, B's actions can be characterized as self-dealing because her sister received a benefit to the detriment of the partnership. Thus, B breached her duty of loyalty to the partnership.

When a partner breaches a duty of loyalty, the profits can be disgorged and the contract can be revoked or rescinded. Here, because B breached her duty of loyalty to the partnership in forming the contract with her sister, the contract can be revoked. Further, a court would likely allow the contract to be revoked. Because B's sister was a wrongdoer because [she] was well aware of B's positon and responsibility/duty to the general partnership, B's sister cannot claim that she was innocent and did not know that her sister owed a fiduciary duty to the corporation.

Thus, although B had authority to enter into the contract with Deco, because B breached her duty of loyalty to ABC, ABC can refuse to deliver the computers under the contract and hold B personally liable for damages.

3.) Is Zeta likely to Succeed in Lawsuit against ABC?

Here, A contacted Zeta, Inc., a supplier of components for ABC, and told the President to not allow C to order components because that was B's job. Then C placed an order with Zeta and ABC refused to pay for components. Zeta, Inc. then sued ABC. The issues are whether A can limit C's power and whether after informing Zeta that C should not be allowed to place orders, whether ABC can refuse to pay for the components ordered by C.

A's Authority to Revoke C's Authority

As discussed above, in absence of an agreement the default partnership rules apply. In the present case, ABC has no formal agreement and thus each partner will share equally in the management duties. Additionally, each manager has the authority to bind

the partnership. Here, A and C have equal management power and power to bind the coporation. The issue is whether A has the authority to revoke C's power and authority absent any agreeement.

A does not have authority to revoke C's power and authority to enter into contracts simply because he is concerned about how B and C were managing the corporation. There was no agreement as to what A was responsible for. In light of the fact that no partner was given a power similar to that of a CEO or oversight or management of the entire partnership and other partners' action, A had no authority to revoke C's authority.

Further if A was under the impression that he was [a] limited partner, he would not be allowed to engage in managing the partnership under the traditional limited liability partnership model. Under the traditional limited liability partnership model, limited partners have limited liability and cannot engage in management of the partnership. If limited partners engage in management of the partnership, then they forfeit their limited liability status. However, under the newly revised Uniform Partnership Code, if it applies in this jx, limited partners may retain their liability and manage the partnership.

Although A had no power to revoke C's authority, the president of Zeta was put on notice that A did not want C to have the ability to bind the partnership due to how management powers/oversight was delegated. Thus, the president of Zeta should have thought twice before entering into an agreement with C, because at the very minimum with such informtion Zeta's president should have known that there was some conflict over management powers or personal issues between C and A. It was irresponsible of Zeta's president to enter into the contract with C after receiving such information from A.

C had authority to enter into the agreement with Zeta because C's authority was not limited in any way. Thus, although Zeta was aware that he could potentially have problems with the contract, the contract was validly entered into by C (assuming all contract formalties were met). Thus, the partnership and all the partners will be personally liable for breach of contract to Zeta.