*Chapter 19*

**The Entrepreneur’s Options**

Answers to Learning Objectives/

Learning Objectives Check Questions

at the Beginning and the End of the Chapter

**Note that your students can find the answers to the even-numbered *Learning Objectives Check* questions in Appendix E at the end of the text. We repeat these answers here as a convenience to you.**

**1A.** ***What advantages and disadvantages are associated with the sole proprietorship?*** A major advantage of the sole proprietorship is that the proprietor receives all of the profits. Also, it is often easier and less costly to start a sole proprietorship than to start any other kind of business. This type of business organization en­tails more flexibility than does a partnership or a corporation. A sole proprietor pays only personal income taxes on profits. Sole proprietors can establish tax-exempt retirement accounts in the form of Keogh plans.

The major disadvan­tage is that the proprietor bears the burden of any losses or liabilities incurred by the enterprise. The sole proprietorship also lacks continuity on the death of the proprietor. Another disadvantage is that the opportunity to raise capital is limited to personal funds and the funds of those who are willing to make loans.

**2A.** ***What is meant by joint and several liability? Why is this often considered to be a disadvantage of the partnership form of business?*** *Joint and several liability* means that a third party may sue any one or more of the partners without suing all of them or the partnership itself. This might be considered a disadvantage because it makes it easier for a third party to sue the firm and its partners.

**3A.** ***What advantages do limited liability partnerships offer to businesspersons that are not offered by general partnerships?*** An advantage of a limited liability partnership over a general partnership is that, depending on the applicable state statute, the liability of the partners for partnership and partners’ debts and torts can be limited to the amount of the partners’ investments. Another advantage is that partners in a limited liability partnership generally are not liable for other partners’ malpractice.

**4A.** ***What are the key differences between the rights and liabilities of general partners and those of limited partners?*** General partners, unlike limited partners, are personally liable to the partner­ship’s creditors. Limited partners enjoy this limited liability only so long as they do not participate in management, however.

**5A.** ***How are limited liability companies formed, and who decides how they will be managed and operated?*** To form an LLC, articles of organizationmust be filed with a central state agency. The articles must include—

• The name of the business.

• The principal address of the business.

• The name and address of a registered agent.

• The names of the members.

• Information on how the LLC will be managed.

Members decide how to manage and operate the business. If there is no agreement, the state LLC statute will govern the outcome, and if there is no statute on the is­sue, partnership law principles apply.

Answers to Critical Thinking Questions

**in the Features**

# Adapting the Law to the Online Environment—Critical Thinking

***Sole proprietorships, as well as other businesses, routinely seek funding for online projects. How can the individuals involved avoid personal liability?*** One way to avoid personal liability is to receive funding through the sale of an interest in the actual or proposed online business venture. While sole proprietorships can “sell” a percentage of the business in such a manner, a preferred method would be to form a limited liability partnership (LLP) or a limited liability corporation (LLC), or even a regular corporation. Afterwards, equity interest in these entities can be sold in exchange for funds needed to pursue the proposed business venture.

# Beyond Our Borders—Critical Thinking

***Clearly, limited liability is an important aspect of doing business globally. Why might a nation limit the number of member-owners in a limited liability entity?*** The intent behind such a limit might be to reduce the amount of liability that could be avoided by a single firm.

Answers to Critical Thinking Questions

**in the Cases**

**Case 19.1—Critical Thinking—Economic Consideration**

***What might the Sarks have done to avoid this dispute, as well as the loss of their home and their apparently declining business?*** As soon as the Sarks thought that they might not be able to pay their debt to Quality, they might have contacted the lender and attempted to negotiate new payment terms. Of course, they might have renegotiated payment terms with their other creditors, too. If that attempt did not yield results, the Sarks might have filed for bankruptcy. Under some parts of the Bankruptcy Code, they might have been able to continue in business while paying down as much of the debt as possible. Or, if that were not possible, they might have retained all or at least some of the value of their home.

**Case 19.2—Critical Thinking—Legal Consideration**

***How are the penalties likely to be apportioned among the three defendants? Explain.*** Whichever penalties the trial court determines to impose on remand, Valley View Enterprises, Inc., is likely to be held liable for violations of the Phase I permit, and Valley View Properties, Ltd., and Joseph Ferrara are likely to be held liable for violations of the Phase II permit.

The state charged three defendants with pollution control violations—Valley View Enterprises (a corporation), Valley View Properties (a limited partnership), and Ferrara (the owner and president of Valley View Enterprises and the sole general partner of Valley View Properties). Valley View Enterprises held the Phase I permit, which stated that any noncompliance was a violation of state law. Valley View Properties owned the property on which the development was built and held the Phase II permit. Ferrara was in charge all activities performed at the construction site. He failed to obtain the proper wetlands-fill permits and to comply with their requirements for each phase of the development.

As a corporate officer, Ferrara will likely avoid personal liability for the actions of Valley View Enterprises. But as a general partner, Ferrara is likely to be personally liable for the actions of Valley View Properties. Of course, with respect to any fine levied on the partnership, the assets of the firm may have to be exhausted before payment can be sought from Ferrara.

**Case 19.3—Critical Thinking—Economic Consideration**

***Why does the law allow—and even encourage—limits to the liability of a business organization’s owners and managers for the firm’s actions? Discuss.*** The law allows, and encourages, limits to the liability of a business organization’s owners and managers for the firm’s actions in order to facilitate business investment, which contributes to a more thriving economy. Imposing personal liability in all circumstances on the owners and operators would tend to discourage investment by providing a disincentive to going into business at all.

Of course, as noted in the court’s opinion in the *Hodge* case, there are exceptions. Particularly when a business form is used to perpetrate fraud or commit other wrongdoing, personal liability may be assessed. But in situations that do not fall within the exceptions, a party who claims injury or damage through a business firm’s actions must normally seek relief through the assets of the firm, not those of its owners and managers.

Answers to Questions in the Reviewing Feature

at the End of the Chapter

**1A.** ***LLC tax status***

This limited liability company (LLC) would be taxed as a partnership unless it opted to be taxed as a corporation. With a few exceptions, any LLC with at least two members can choose whether to be taxed as a partnership or a corporation. (A one-member LLC is taxed as a sole proprietorship unless it chooses to be taxed as a corporation.) If a firm prefers to be taxed as a corporation, it can check a box on a certain federal tax form to indicate this choice. Taxed as a partnership, an LLC would pay no taxes: its profits would be “passed through” to its members, who would however pay taxes on the profits. The corporate taxing option might be preferable to LLC members who want to reinvest the profits in the business, because corporate tax rates are often lower than personal tax rates.

**2A.** ***LLC management***

In a member-managed LLC, all members participate in management, and decisions are made by majority vote. In a manager-managed firm, the members designate managers, who may or may not be members of the firm. The LLC in this problem is a member-managed firm—the owners are the managers.

**3A.** ***Special business form***

These parties formed a joint venture.In a joint venture, two or more persons or entities combine their efforts or property for a single transaction or project or a related series of transactions or projects. The elements of a joint venture are (1) a contract to engage in a common undertaking; (2) the parties’ contributions of money, property, time, or skill to it; (3) an interest in, and mutual right to control, its property; and (4) an agreement to share its profits. The agreement between the parties in this problem and their subsequent conduct meets all of these requirements.

**4A.** ***Contractual liability***

Yes, because most courts apply the same principles to joint ventures as they apply to partnerships. A joint venturer can be held personally liable for the debts incurred on the venture’s behalf (because joint venturers share profits and losses). No, because joint ventures differ from partnerships in some significant ways. Joint venturers have less implied and apparent authority to bind their venture than partners do to bind their partnership, because the activities of a venture are more limited than the business of a partnership.

Answer to Debate This Question in the Reviewing Feature

at the End of the Chapter

***Because LLCs are essentially just partnerships with limited liability for members, all partnership laws should apply.*** While there are certainly some differences between how LLCs operate relative to how partnerships operate, the similarities are sufficiently obvious that no new laws or operating rules need be created for LLCs, except with respect to the limited liability of LLC members.  The law of partnerships has a long history, one that has created a solid body of case law that should be applied to LLCs, too.

Yes, LLCs do resemble partnerships in many respects.  But since their humble beginnings in 1997, they have become a form of business organization in their own rights.  Why shouldn’t business owners be allowed to choose from the largest array of business organizations possible?  The more that LLCs are used, the more they will gradually become increasingly distinct from partnerships. Blanket application of partnership law to LLCs would stifle their development.

Answers to Issue Spotters at the End of the Chapter

**1A.** ***Frank plans to open a sporting goods store and to hire Gogi and Hap. Frank will invest only his own funds. He expects that he will not make a profit for at least eighteen months and will make only a small profit in the three years after that. He hopes to expand eventually. Would a sole proprietorship be an appropriate form for Frank’s business? Why or why not?*** Yes.A sole proprietorship is an ap­propriate form when a business is relatively small and is not diversified, employs rela­tively few people, and has modest profits. Also, sole proprietorships are appropriate when a business is not likely to expand sig­nifi­cantly or require extensive financing in the im­me­di­ate future.

**2A.** ***Gabriel, Harry, and Ida are members of Jeweled Watches, LLC. What are their options with respect to the management of their firm?*** The members of a limited liability company (LLC) may designate a group to run their firm, in which situation the firm would be considered a manager-managed LLC. The group may include only members, only nonmembers, or members and nonmembers. If instead, all members participate in management, the firm would be a member-managed LLC. In fact, un­less the members agree otherwise, all members are considered to participate in the management of the firm.

Answers to Questions and Case Problems

**at the End of the Chapter**

**Business Scenarios and Case Problems**

**19–1A . *Limited liability companies***

Limited liability company (LLC) operating agreements typically state how prof­its will be divided. An operating agreement is not necessary for the formation of an LLC, and even if there is an operating agreement, it does need not to be in writing. Generally, though, members protect their interests by signing a writ­ten operating agreement that spells out the terms of their LLC, including a di­vi­sion of profits and losses. If there is no agreement covering how profits will be divided, the applicable state LLC statute will govern. Most LLC statutes provide that if members do not specify how profits are to be divided, they will be divided equally. If there is no operating agreement or LLC statute addressing the par­ticular issue, the principles of partnership law apply. Those principles also in­dicate that profits are divided equally among the owners of a firm unless speci­fied otherwise.

**19–2A. *Special business forms***

Although a joint stock company has characteristics of a corporation, it is usu­ally treated as a partnership. Therefore, although the joint stock company is­sues transferable shares of stock and is managed by directors and officers, the shareholders have personal liability. Unless the shareholders transfer their stock and ownership to a third party, not only are the joint stock company’s as­sets available for damages caused by a breach, but the individual shareholders’ assets are also subject to such liability.

A business trust resembles and is treated like a corporation in many respects. One is the limited liability of the beneficiaries. Unless state law treats the beneficiaries are treated as partners, making them liable to the business trust’s creditors, Faraway Corp. can look to only the business trust’s assets in the event of a breach.

**19–3A. *Quality control***

Yes, Liberty can be held liable for the statements in its franchisees’ ads. The validity of a provision permitting the franchisor to establish and enforce certain quality standards is unquestioned. The franchisor has a legitimate interest in maintaining the quality of the product or service to protect its name and reputation. If a franchisor exercises too much control over the operations of its franchisees, however, the franchisor risks potential liability. A franchisor may occasionally be held liable under the doctrine of *respondeat superior* for the tortious acts of a franchisee or the franchisees’ employees.

In this problem, Liberty’s agreement with its franchisees reserved the right to control their ads. In operations manuals, Liberty provided step-by-step instructions, directions, and limitations to its franchisees regarding their ads and retained the right to unilaterally modify the steps at any time. This seems to give the franchisor a great deal of control over its franchisees’ marketing, which under the principles stated above, points to the franchisor’s liability for the franchisees’ misleading or deceptive ads.

In the actual case on which this problem is based, the court issued a judgment in California’s favor. Liberty appealed. A state intermediate appellate court affirmed. “Liberty retained the right to control, and in fact did seek to control, its franchisees' advertising and other marketing activities beyond that necessary to protect its marks and goodwill.”

**19–4A. *Winding up***

Yes, Dan can be held liable for the amount of the debt owed to Flying Cat. Even after a partnership has been dissolved, a partner may still bind the firm by engaging in a transaction that would have bound the partnership if it had not been dissolved, provided the other party to the transaction had known of the partnership before dissolution and had no knowledge or notice of the dissolution.

In this problem, the Coles operated their business as a partnership during their marriage. The partnership was dissolved by the parties’ divorce, but Dan could be held liable under the extension of the lease entered into by Lori alone after the divorce. The lease fell within the scope of the former partnership’s business. The lease was executed with the authority that would have bound the firm if it had not been dissolved. And the landlord did not have notice that the Coles, who had held themselves out as partners during the previous lease terms, had dissolved their partnership.

In the actual case on which this problem is based, in the landlord’s suit to collect on the judgment, the court ruled in Flying Cat’s favor. Dan appealed, claiming that he was not liable. A state intermediate appellate court held that he was—although the partnership was dissolved when the couple divorced, the landlord had no notice of the dissolution.

**19–5A. *Jurisdictional requirements***

The district court does not have diversity jurisdiction. For diversity jurisdiction to exist, there must be complete diversity of citizenship, meaning that all of the plaintiffs must be from different states than all of the defendants. In this case, Mid-Atlantic is not diverse from MAG. Mid-Atlantic is a New Jersey citizen because it is a New Jersey corporation. MAG is also a New Jersey citizen because LLCs and partnerships are citizens of every state of which their members are citizens. In this instance, Robert O’Shea is a New Jersey citizen. Because O’Shea is a member of Silver Point and SPCP, they are also New Jersey citizens, and so are SP MAG and MAG itself.

**19–6A. Business Case Problem with Sample Answer*—Partnerships***

Yes, Sacco is entitled to 50 percent of the profits of Pierce Paxton Collections, PPDS, and KPD. The requirements for establishing a partnership are (1) a sharing of profits and losses, (2) a joint ownership of the business, and (3) an equal right to be involved in the management of the business.

The effort and time that Sacco expended in the business constituted a sharing of losses, and his proprietary interest in the assets of the partnership consisted of his share of the profits, which he had expressly left in the business to “grow the company” and “build sweat equity” for the future. He was involved in every aspect of the business. Although he was not paid a salary, he was reimbursed for business expenses charged to his personal credit card, which Paxton also used. These facts arguably meet the requirements for establishing a partnership.

In the actual case on which this problem is based, Sacco filed a suit in a Louisiana state court against Paxton, and the court awarded Sacco 50 percent of the profits. A state intermediate appellate court affirmed, based generally on the reasoning stated above.

**19–7A. *Quality control***

No, Domino’s Pizza, L.L.C., is not liable for negligence in the circumstances of this problem. The operation of a franchise normally is left to the franchisee. When a franchise involves the preparation of food, however, the franchise agreement often establishes certain standards for the franchisee to follow. If the agreement gives a franchisor a significant degree of control over the operation of its franchisee, the franchisor may be liable—under the doctrine of *respondeat superior*—for the tortious acts of the franchisee’s employees.

Here, Domino’s franchise agreement set out operational standards, including safety requirements, for its franchisee to follow. But the agreement also provided that each franchisee was an independent contractor, free to use its own means and methods. This included compliance on the part of the franchisee and its delivery drivers with vehicle safety requirements. MAC Pizza Management, Inc., operated a Domino’s franchise. A vehicle driven by a MAC delivery driver hydroplaned due to a bald tire and wet pavement, and struck the vehicle of Devavaram and Ruth Christopher, killing Ruth and injuring Devavaram. The delivery driver and, by vicarious liability, MAC might be liable for negligence with respect to the injury and death of the Christophers, But by the terms of the franchise agreement and the other facts in the problem, Domino’s is not.

In the actual case on which this problem is based, on behalf of Devavaram and Ruth’s estate, Raghurami Reddy filed a suit in a Texas state court against Domino's for negligence. A jury found that Balka was operating his vehicle subject to Domino’s control, and the court entered a judgment in Reddy’s favor. A state intermediate appellate court reversed this judgment, in part for the reasons stated here.

**19–8A. *Jurisdictional requirements***

No, based on the facts provided in the problem, the trial court cannot exercise diversity jurisdiction in the *Siloam* case—at least, not yet. When the parties to a suit are from different states, a federal court can exercise diversity jurisdiction if the amount in controversy exceeds $75,000. Total diversity of citizenship must exist, however. An LLC's citizenship is determined by reference to the citizenship of each and every one of its members.

Siloam Springs Hotel, LLC, operates a Hampton Inn. When Siloam’s insurer Century Surety Co. denied coverage for a certain claim, Siloam disputed the denial. Century asked a federal district court to resolve the dispute. The plaintiff asserted as the basis for jurisdiction an amount in controversy exceeding $75,000 and complete diversity of citizenship—Century is “a corporation organized under the laws of Ohio, with its principal place of business in Michigan,” and Siloam is “a corporation organized under the laws of Oklahoma, with its principal place of business in Arkansas.” The amount in controversy meets the requirement for diversity. Siloam, however, is not a corporation—it is an LLC. But the facts stated here do not reveal whether there was complete diversity between the parties.

In the actual case on which this problem is based, the court issued a summary judgment in Century’s favor. The U.S. Court of Appeals for the Tenth Circuit reversed this judgment for the reasons above. The court remanded the case for the lower court to determine whether complete diversity existed at the time of the complaint.

**19–9A. A Question of Ethics—*Dissociation***

**1.** Willensky’s dissociation occurred when he left for Florida and did not return. According to the partnership agreement, he was to supply the la­bor and oversee the construction and renovation. By effectively abandoning the project and failing to keep his side of the bargain, he breached the partner­ship agreement. Whenever a partner’s dissociation constitutes a breach of the partnership agreement, it is deemed wrongful.

**2.** Many of Willensky’s actions represented poor management of the project, and some acts were clearly unethical, if not illegal. Willensky failed to pay bills on time; did not keep Moran informed of his expenditures and the status of the partnership accounts; incurred excessive and unnecessary costs (at one point, he allegedly paid $320 for an ironing board); failed to communi­cate with Moran for long periods of time, even when she requested that she be kept apprised of certain matters; and refused to take suggestions from advisers who were experienced in renovating houses. These actions certainly reflected poor management of the project and a general carelessness with partnership funds—but they did not necessarily breach the partnership agreement. Al­though the court concluded that his conduct both before and after his depar­ture to Florida constituted a breach of contract, Willensky could probably ar­gue that Moran, by tolerating his delays and the excessive and unnecessary costs, had waived her right to claim that these actions caused a breach of con­tract. His use of partnership funds to pay for certain personal expenses, how­ever, certainly was not only unethical but also breached the agreement that the funds provided by Moran would only be used to cover expenses relating to the renovation. Also, his departure to Florida and failure to return breached the contract in that he did not fulfill his promise to provide his labor in com­pleting the renovation.

**Critical Thinking and Writing Assignments**

**19–10A. Business Law Critical Thinking Group Assignment**

**1.** Elkhatib’s refusal to offer breakfast sandwiches containing pork at his franchise locations was based on his religious beliefs. When he sought to relocate one of the franchises, Dunkin’ Doughnuts (the franchisor) notified him that it would not allow relocation and furthermore would not renew his franchise agreement. The court should grant the franchisee a remedy. Dunkin’ Doughnuts acted unfairly and wrongfully. The dietary restrictions Elkhatib observed are associated with his religion. Both Islamic and Jewish law prohibits the handling and consumption of pork.

**2.** Dunkin’ Doughnuts (the franchisor) has a right to require franchisees to offer a uniform menu to protect its name and reputation. Quality standards are particularly important in chain-style business operations. Dunkin Doughnuts acted fairly and honestly when it notified Elkhatib that it would not allow relocation and would not renew his franchise agreement. Its reasons were not arbitrary. The court should issue a judgment in the defendants’ favor.

**3.** Elkhatib’s obligations under his current franchise agreement presumably requires all franchisees to carry the full food product line of Dunkin’ Donuts. Because Elkhatib failed to carry the full line of food products, the franchisor would not ex­tend his current franchise agreement or allow the relocation of his store. In determining whether a franchisor has acted in good faith when terminating a franchise agreement, the courts generally try to balance the rights of both parties. If the court perceives that the franchisor acted arbitrarily or unfairly, the court will grant the franchisee a remedy. In this situation, the court would consider the fact that the franchisee’s refusal to offer breakfast sandwiches containing pork was based on his religious beliefs. Nonetheless, the court would balance this against the fact that the Dunkin’ Doughnuts has a right to require its franchisees to offer a uniform menu to protect its name and reputation. Dunkin’ Doughnuts acted in good faith. As for the franchisor’s refusal to allow its franchisee’s relocation, it is within a franchisor’s rights to determine the location of a franchise.