

HYBRID

Business Organizations I (Agency and Partnership)

Fall 2023 Exam

Professor: P. Stirling

Instructions:

Time Allotted: Three (3) Hours

Allocate your time according to the points for each question:

Question 1: 125 points

Question 2: 125 points

Question 3: 50 points

**Question 1: 125 points**

Derwood has a landscape design and garden tool repair shop, Moonscapes. He is the sole owner and the business is a sole proprietorship. He hires Gomer and the employment agreement states that Gomer will work in the shop to both talk to customers about designs and to repair garden tools, as well as manage the general operations when Derwood is traveling (there are maintenance workers that need to be paid). As Derwood is also a rodeo clown, he travels often. In order to keep the business running, he provides Gomer with a power of attorney that allows Gomer to act on Derwood's behalf and to "enter into and execute any contract for the purchase of goods or merchandise as needed for the operation of the current business of Moonscapes, or to sign any credit or promissory note in connection with the operation of the current business of Moonscapes on my behalf."

While Derwood is performing at the world rodeo finals in Manaus, Brazil, Gomer comes up with an idea for selling specialty personalized flower baskets. He goes to the bank and tells them he has power of attorney from Derwood "to run the business." The bank manager knows Derwood and does not bother to look at the power of attorney. Gomer signs a promissory note for \$50,000 to purchase the baskets from Bertha's Basketville. Gomer takes delivery of the baskets and decides he could make more money personalizing them himself and selling them online. That evening, he leaves the store closed and locked (he is the only employee with a key so no other staff can enter) and flies to Cambria, Wales to create his online business. When Derwood returns one week later, the store is still locked, and he receives notice that the bank has not been repaid and no employees paid so they all quit.

What would you advise Derwood regarding his position with the bank, Gomer's actions, and the legal recourse (if any) he can take against Gomer?

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**Question 2: 125 points**

Ragnar, Lagartha, and Floki orally agreed to start RLF (“RLF”), a business to manufacture and sell Pickled Herring. Ragnar contributed \$100,000 to RLF, stating to Lagartha and Floki that he wanted to limit his personal liability to that amount.

Lagartha, who had technical expertise at pickling fish, contributed \$50,000 to RLF. Floki contributed no money to RLF but agreed to act as salesperson. Ragnar, Lagartha, and Floki agreed that Lagartha would be responsible for pickling herrings, and that Floki alone would handle all fish sales.

RLF opened and quickly became successful, primarily due to Floki’s effective sales techniques. Subsequently, without the knowledge or consent of Ragnar or Floki, Lagartha entered into a written sales contract in RLF’s name with Bjorn, Inc. (“Bjorn”) to sell Pickled herrings manufactured by RLF at a price that was extremely favorable to Bjorn. Lagartha’s sister owned Bjorn. When Ragnar and Floki became aware of the contract, they contacted Bjorn and informed it that Lagartha had no authority to enter into sales contracts, and that RLF could not sell Pickled herrings profitably at the price agreed to by Lagartha. RLF refused to deliver the Pickled herrings, and Bjorn sued RLF for breach of contract.

Thereafter, Ragnar became concerned about how Lagartha and Floki were managing RLF. He contacted Zeta, Inc. (“Zeta”), RLF’s fish supplier. He told Zeta’s president, “Don’t allow Floki to order fish; he’s not our technical person. That’s Lagartha’s job.” Floki later placed an order for several expensive amounts of fish (including some fish other than herring such as Colombian dogfish) with Zeta. RLF refused to pay for the fish, and Zeta sued RLF for breach of contract. Not long afterwards, RLF went out of business, owing its creditors over \$500,000.

1. How should RLF’s debt be allocated? Discuss.
2. Is Bjorn likely to succeed in its lawsuit against RLF? Discuss.
3. Is Zeta likely to succeed in its lawsuit against RLF? Discuss.

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**Question 3: 50 points**

Before Ragnar, Lagartha and Floki begin their partnership, they ask you to draft a simple partnership agreement (they plan to be a general partnership). Please provide a minimum of 10 clauses you will include in the agreement. Please provide full sentences.

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## ANSWER 1 (OUTLINE)

**20% Organization (Similar headings – boldfaced below)**

**20% Issue (Spot all issues)**

**20% Rules (Name all rules – underlined below)**

**20% Analysis (Apply law to facts – all non-underlined, non-italicized font below)**

**20% Conclusions (Get correct conclusions – as *italicized* below)**

### Introduction

Nature of the business: No facts indicate that there are any other owners of Moonscapes, nor that it is incorporated, so this would be a sole proprietorship owned by Derwood.

### Nature of the relationship

- An agency relationship exists when one party, the agent, consents to act on behalf of, and under the control of another, the principal.
- In this case, Gomer agreed to employment by Moonscapes and to act on behalf of Derwood. *Accordingly, Gomer is an agent of the principal, Derwood.*
- As an agent, Gomer owes particular duties to the principal, including fiduciary duties such as a duty of loyalty, a duty of care and a duty to obey or follow instructions.

### Does Derwood have any recourse with regard to the loan payable to the bank?

- Derwood expressly empowered Gomer to act on his behalf by providing a power of attorney that included the signing of promissory notes.
  - The power of attorney was limited, however, to the business of the shop, which did not include purchasing and selling baskets.
- *As such, Gomer violated his fiduciary duty to Derwood by entering into a transaction for which he had no authority.*
- Be that as it may, a principal is responsible for the act of the agent taken in the course of employment. As such, it would appear that Derwood is responsible for the loan signed on his behalf by Gomer.
  - The bank manager may argue that Gomer had apparent authority to sign the loan document. Apparent authority arises when a principal holds an agent out as having a certain level of authority. Derwood may argue, however, that Gomer's authority was not apparent, but rather express by way of the power of attorney. The manager did not read the power of attorney which would have informed the bank that Gomer was not authorized to obtain the loan unrelated to the business of Moonscapes, and thus the loan agreement itself was invalid. *Derwood can therefore argue that he is not responsible for the loan as it was invalid.*

### Does Derwood have any legal recourse against Gomer?

- An agent has various fiduciary and other duties to the principal, such as the duties of care, loyalty and to follow instructions.

- In this case, Gomer was empowered to sign promissory notes, but only related to the business of the shop which did not include baskets.
- Gomer would not be able to argue that he had implied authority to obtain the loan and purchase baskets. Implied authority includes ancillary actions that the agent may logically conclude are within his/her power as part of the overall authority. Had Gomer signed the loan to purchase repair parts, implied authority may have been present. In this case, however, the shop did not sell baskets, nor was the loan related to necessary parts.
- *Accordingly, Gomer violated his fiduciary duty of care and acted outside of the course of his employment, and thus Derwood would not be responsible for the purchase of the baskets.*
  - Secondly, Gomer was responsible for running the shop in Derwood's absence which included opening and closing the shop and managing the other employees. As such Gomer violated his fiduciary duty of care to Derwood to keep the business running. Gomer may have a legal complaint for loss of business for the days the shop was not operating.
  - Thirdly, Gomer decided to take the baskets and start his own business. Such an action would be a violation of his duty of loyalty to Derwood. It should be noted, however, that Gomer may argue that Moonscapes was not in the business of selling baskets so there would be no violation of a duty of loyalty. Regardless, Gomer was an employee and has absconded with the baskets that were the property of the shop, and in doing so has not only committed criminal theft, but also a violation of his duty of loyalty to the principal.
  - Finally, with regard to the question of whether Derwood can succeed in pursuing legal action against Gomer for the above noted issues, the facts indicate that Gomer has left the country. Unless Gomer returns, any legal action may be procedurally challenging.
- *In summary, Derwood should argue that he is not responsible for the loan as it was an invalid transaction for which he gave no express approval. Derwood does have legal recourse for the lost revenue for the days Gomer failed to open the shop.*

## **ANSWER 2 (OUTLINE)**

**20% Organization (Similar headings – boldfaced below)**

**20% Issue (Spot all issues)**

**20% Rules (Name all rules – underlined below)**

**20% Analysis (Apply law to facts – all non-underlined, non-italicized font below)**

**20% Conclusions (Get correct conclusions – as *italicized* below)**

### **Introduction**

1. Nature of Organization
2. RLF is a general partnership under definition
3. Partnerships are business for profit and if no agreement, profits are split

### **1. How should RLF's Debt be Allocated?**

1. Just like profits, without agreement, debts are split equally.
2. R wanted to limit his liability. However, absent a formal agreement, R is going to be considered a general partner.
  - a. Also R has active management (general managerial position, apparent equal voting rights), R was the one to call Zeta (Z) and tell them not to accept orders from F.
  - b. Limited partners, those with limited liability, generally have no managerial functions.
  - c. Under agency law, any contract or tortious action entered into in the scope of the partnership is deemed to be partnership debt, and all partners are jointly and severally liable.
3. Therefore, any contracts that were properly entered into and authorized by a partner having authority are partnership debts that R, L, and F will be jointly and severally liable for as individuals.
4. ***Therefore, the order of payment is: (1) all debt creditors, (2) all capital contributions from each partner, which would be \$100,000 to R and \$50,000 to L and zero to F since partners generally have no right to salary or compensation for services; (3) any remaining profits equally to R, L, F.***

## **2. Is Bjorn likely to Succeed in its Lawsuit against RLF?**

1. Validity of the Agreement: Bjorn (B) must show that EL was authorized to enter the contract.
  - a. All partners are authorized agents of the partnership but the nature of authority may vary.
  - b. Express authority exists when the arrangement expressly states what an agent may do, but sales were expressly reserved to F so L doesn't have express authorities.
  - 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 objection, or 3) normal custom for someone with the position of the agent. Sales are not necessary to L's technical design responsibilities, and she has never sold before.
  - d. Apparent authority 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 RLF held L out to be a sales representative in the first instance. There was likely no good basis that B had to rely on any authority from RLF. However, given that L herself is a managing partner, B likely could argue that L'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 RLF.
2. ***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.***
  3. Breach of Duty of Good Faith and Loyalty
    - a. Partners have fiduciary duties to each other that are described as the utmost duty of good faith and loyalty.
    - b. Duty of Loyalty means a partner must not engage in self-dealing, usurping business opportunities, or competing against the company. In this instance, L engaged in a transaction with her sister who owned B. The terms were apparently very favorable

to B. This could be viewed as self-dealing because it promoted L's familial interest with her sister and was not in the best interest of the company.

- c. Duty of Good Faith requires that partners act in a way that solely benefits and is advantageous to the partnership. Again, L's deal with B 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 L informed her partners. The other partners have a very strong argument to bring a claim against L for these breaches of duty.

**4. Therefore, the entire liability for the breached contract would be on L, which would deviate from the normal liability scheme described above, and B could only succeed against B.**

### **3. Is Zeta likely to Succeed in its Lawsuit against RLF?**

#### 1. Validity of the Agreement

- Zeta's (Z) claim on this contract again hinges on the authority of F to enter into it. In this instance, F has the express authority to enter into sales contracts. However, this contract was for components being purchased by F, which is outside his express authority.
- Implied authority: Z may argue that components are necessary to production and later sales, which gives F implied authority to enter into contracts. Plus, it is reasonable to assume that a partner who can sell can also buy. This reasonable assumption lends credence to a claim of apparent authority.
- Apparent authority: Z will argue that RLF has held F out as a person whose sole responsibility is to contract, and it reasonably relied on that representation. Z will argue, therefore, that any resulting contract liability would be distributed among the partnership and R, L and F.

#### 2. Actual notice to Z of Lack of F's authority

- Z's main issue is that R called and gave actual notice that F could not enter into this contract. This would destroy any reasonable reliance that Z had. R told Z that L was the technical person, not F. As such, Z should have seen that this was outside the scope of F's authority. But F is still a general partner in the company.
- 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. R alone tried to limit what F could do. Z may argue that it knew this wasn't a proper action by R and more reasonably relied on F.
- RLF will argue that Z at least should have investigated further once given notice that F may not have authority and failure to follow through made their reliance on his apparent authority unreasonable. RLF will argue that this contract is invalid and will not bind RLF for this persuasive reason.

#### 3. Effect of R's Notice on F's Duties

- R might also claim that F's activities outside his scope of duty were not in good faith.

- The argument is that acting in an area in which F knows nothing about shows a lack of obedience to his agency limits and lack of good faith in honoring partnership agreements on authority.
- But R didn't act with the consent of E. As such, there is no indication that the majority of management is at odds with F's decision to enter the contract. This appears to be solely the reservation of D with E and F.
- ***In the end, there was likely no breach of duty and any potential liability from this contract would flow to all, not just F.***

### **Answer 3**

1. Name of the partnership
2. Purpose and type of the partnership
3. Partners identified
4. Contributions by each partner.
5. Liability (joint and several)
6. Meeting frequency
7. Powers of partner 1
8. Powers of partner 2
9. Powers of partner 3
10. Impact of one partner leaving.