Choosing an organizational form for entrepreneurial ventures: A partnership gone wrong

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ABSTRACT

Alexander and Jude were lifelong friends and had enjoyed success in their respective business careers. Both had reached the stage in their lives where they desired to start their own businesses and during a conversation, they began to explore possible joint projects. Each brought unique resources and expertise to the table, creating the basis for their entrepreneurial journey, and determined to establish their company as a general partnership. This case study explores key lessons learned by Alexander and Jude as they navigated the complexities of starting and ending their joint business endeavor with a particular focus on the challenges and liabilities associated with the partnership form of organization. The case is appropriate for courses in small business management, entrepreneurship, legal environment of business, and business ethics. Teaching Notes are available from the lead author.

Keywords: partnership, entrepreneur, business partnership, business ethics, organizational forms, entrepreneurship, liability, limited liability

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INTRODUCTION

Failure rates for new business startups are often over estimated and reported (including such examples as sole proprietorships that transition to another organizational form, and the death of an owner in either a sole proprietorship or partnership that had been a long successful firm). The U. S. Small Business Administration reports that 80% of employer businesses survive the first year, 70% survive at least two years, 50% survive at least five years, 30% survive at least ten years, and 25% survive at least fifteen years—much higher than the "frequently cited myth" that 50% fail in their first year (Commerce Institute, 2022). The challenges facing a new entrepreneur are legion. From classic factors of poor planning, inadequate capital, growth mismanagement, to black swan events such as COVID-19, business failure is a reality that is heavily researched (Amankwah-Amoah, Khan, & Wood, 2021; Amankwah-Amoah & Syllias, 2020; Kucher, Mayr, Mitter, Duller, & Feldbauer-Durstmuller, 2020). While risk is inherent in a free market system, as many factors as possible should be taken to mitigate those risks.

From assistance provided through the U. S. Small Business Administration, free online resources, and college courses dedicated to entrepreneurship, to mentoring programs for small business owners and entrepreneurs, there is a plethora of resources available (Clough, Fang, Vissa & Wu 2019; Orzechowsk 2023; Whitlock, Hampton, & Campbell 2023; Yi 2021). But, too often, new business owners move quickly into new ventures without adequately researching the market, understanding the complexities of a given industry, or having sufficient financial resources. Ignorance of accounting principles and legal ramifications can be disastrous even in seemingly simple matters such as choosing the organizational form. Selecting an organizational form without fully considering the advantages and disadvantages of each option has caused grief. Misunderstandings, broken relationships, and financial ruin have often resulted from poorly considered or poorly drafted agreements. Nowhere is the anecdotal evidence for this stronger than in the cases of partnerships gone wrong. Such is the case with two best friends who established a partnership called Brotherhood Garage Doors.

BACKGROUND

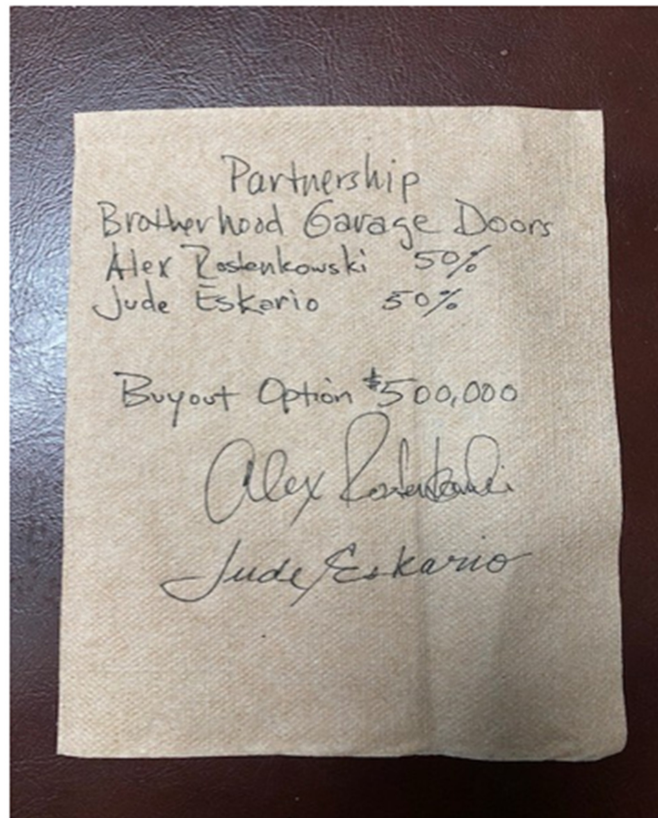
Alexander and Jude were lifelong friends and had enjoyed success in their respective business careers. Both had reached the stage in their lives where they desired to start their own businesses and during a conversation, they began to explore possible joint projects.

Alexander and Jude were determined to forge their lifelong friendship into a business partnership. Each brought different aspects to contribute to the new adventure. Alexander brought the financial means, while Jude brought the contractor connections and a marketing perspective. Alexander's financial resources were used to launch the business as he procured all necessary machinery and established the essential operating funds through a joint bank account. Conversely, Jude's extensive network of contractors provided crucial connections that proved instrumental for the partnership. He was willing to leverage his connections with contractors and customers from his previous experience.

With excitement, the two best friends wrote out the basis of their agreement on the back of a napkin, both initialed and shook hands. They were partners, 50-50. Both of their names were on the business letterhead, both names were on the joint bank account in their company name as Brotherhood Garage Doors launched with a local Chamber of Commerce ribbon-cutting

ceremony. They framed their napkin agreement and hung it in the office area of a warehouse they leased. See Exhibit A.

EXHIBIT A



After one year, Brotherhood Garage Doors grossed $1.1 million, and was projecting more than $2 million in contracts for their second year. The partnership was a success. Except that Alexander noted two months into their second year what he perceived as discrepancies in the bank account. Alexander questioned Jude about the irregularities, and Jude openly admitted to occasionally withdrawing funds for personal expenses but said he had noted the withdrawals in the petty cash drawer. Alexander looked and there were several notes written on papers torn from a spiral notebook indicating numerous withdrawals. This revelation led to a disagreement between the two partners with Alexander insisting on clearing any future withdrawals and insisting that such actions were not appropriate.

When Alexander noticed yet another discrepancy the very next month, a heated argument ensued with Jude shrugging off his actions as inconsequential and simply a perk of ownership. Facing a breach of trust and what he considered unethical conduct within their partnership, Alexander sought legal counsel, emphasizing the escalating severity of the situation and the need for a structured resolution process. After hearing the situation, the attorney briefed him and followed up the next morning with a formal letter outlining the legal situation. See Exhibit B for the letter from his attorney, Corey Bogaro. The letter was bad news, indicating that Jude had the authority to withdraw funds without explicit consent from Alexander. This added to Alexander's frustration, and Jude's unapologetic stance further exacerbated the situation.

Exhibit B

RE: Brotherhood Garage Doors Partnership

Dear Mr. Rostenkowski:

I am writing in regard to your query about how to stop your partner from taking money from the business. Believe it or not, this is one of the most common questions I get concerning partnership disagreements. Unfortunately, absent a specific clause prohibiting this behavior in your partnership agreement, there is little you can do to force Jude to stop taking funds. Very rarely, a court will issue an injunction to remove a partner's name from a bank account, but this is usually because the agreement was in place constraining such practices.

As long as Jude is documenting the transactions, and they can in any way be related to the business, including keeping his current standard of living stable so that he can have peace of mind and contribute to the business's success, these withdrawals are legal. We would have a cause of action if he were secretly stealing from the partnership or embezzling, because that rises to the level of criminal activity.

You can try to get him to sign an agreement stating that you are both limited to only taking so much per month, but he is of course free to refuse the limitation. I know this is not what you wanted to hear. I am sorry.

Sincerely,

Corey Bogaro, Senior Partner

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Meanwhile, Alexander did some reading on the different forms of organizations, sincerely wishing he had done this before entering the partnership with his friend. He discovered that different forms have different advantages and disadvantages.

Sole Proprietorship

A business owned and managed by one person, the sole proprietorship is the oldest and most common organizational form, making up a majority of all business forms (Whitlock, 2007). The sole proprietor retains exclusive control over the business, which terminates upon the owner's demise or decision to cease operations. Like the Partnership, the Sole Proprietorship has unlimited liability for the owner. Many business owners, however, prefer an organizational form that limits personal liability (Matheson, 2002).

Partnership

A partnership is a relationship in which two or more individuals (or a legal entity such as a corporation) work together as partners (Whitlock, 2007; Kiss, 2020). The two most common types of partnerships are General Partnerships and Limited Partnerships, but there is also a Master Limited Partnership—MLP (Whitlock, 2007). In general partnerships, all partners take on unlimited liability. They are personally responsible (liable) for the actions, debts, decisions of the other general partners. Partners share both profits and liabilities, with each partner bearing personal responsibility for the partnership's debts and obligations.

In a partnership at will, dissolution can happen anytime, either by choice or court order, leading to a winding-up process involving debt settlement and asset distribution. While an agreement cannot prevent dissolution, it can aid in managing the aftermath, allowing partners to decide whether to continue the partnership post-dissolution (Matheson, 2002). Only in Limited Partnerships or MLPs can some partners be exempt from this unlimited liability.

Limited Partnership

A limited partnership is a type of partnership with two or more individuals (or legal entity) but requiring at least one individual as a general partner (with unlimited liability). Additional limited partners are typically liable only for their capital contributions, contingent on their silence. In other words, limited partners are not active in management (Whitlock, 2007). Despite offering certain protective measures for limited partners, limited partnerships are less common outside investment fund and family contexts due to their restrictive management framework (Matheson, 2002).

Corporation

A Corporation is an organization chartered by the state as a legal entity—an artificial person. As such it can enter into agreements, contracts, even invest in and own shares of stock in a business. The business itself has liability separate from the owners. It has a perpetual live meaning it does not cease to exist with the death of any owner (shareholder), and the transfer or termination of ownership basically just requires the selling of one's shares of ownership. Termination of the corporation can be difficult and expensive, and the corporation is subject to taxes as are the owners (resulting in double taxation). But the limited liability of the owners, and the ability to raise capital by issue stock is a significant advantage (Whitlock, 2007; Matheson, 2002).

The Subchapter S Corporation—S Corp—is also perpetual, and given some restrictions allows a company to operate with limited liability but enjoy the tax benefits of other organizational forms like the sole proprietorship, partnership, and the Limited Liability Company.

Limited Liability Company

A Limited Liability Company (LLC) is a legal organization that offers the same benefits as an S Corp, but which is much easier to form. All 50 states recognized the LLC. The length of life is determined by the life of or withdrawal of the owners. While the LLC cannot sell stock, it does offer limited liability to all owners. But it also offers the advantages of no corporate tax rates; only the owners pay taxes on their personal earnings (Whitlock, 2007).

Typically, an LLC can be established by one or more organizers, with the option for single-member or multi-member ownership comprising corporations, partnerships, trusts, or individuals (Matheson, 2002). To establish LLC status, the submission of “Articles of Organization” to the Secretary of State. Maintaining LLC statues requires annual registration (Matheson, 2002).

As he read, he came across a set of notes tucked into a textbook at the library comparing organizational forms and the various factors. See Table 1. As he scanned the table someone had prepared, he realized that there had been much better options for his business.

Table 1
Comparison of Organizational Form Factors[1]

Factor	Corporation	General Partnership	Sole Proprietor	Limited Liability Company
Relative ease of formation.		✓	✓	✓
Personal tax returns can be used to report profits and losses.		✓	✓	✓
No required annual meeting.		✓	✓	✓
Length of life can be perpetual.	✓			✓
Limited liability protection for owners.	✓			✓
Created by state level registration.	✓			✓
Can be owned by another business.	✓			✓
Can elect to be taxed as an S-Corp.	✓			✓
Can issue stock to raise capital.	✓			✓

[1] Adapted from Whitlock, *Opportunity: Introducing Free Enterprise and Business* (2007). Wipf & Stock, Eugene, Oregon, pp 38-42.

THE DILEMMA

Alexander is faced with a multifaceted challenge as he struggles with Jude's reckless withdrawals from the business bank account. There is a breach of trust and his partner's unethical conduct that directly impacts the foundation of their partnership. Likewise, the financial stability of the business is at risk due to the irregular and unaccounted-for withdrawals of his partner that jeopardizes the operational and investment capabilities of the business, potentially leading to instability and reduced growth prospects. Moreover, the lack of a structured approach to financial management can lead to legal repercussions and damage the business' reputation.

Alexander is confronted with crucial decisions about how to navigate the current predicament. Should he dissolve the partnership, opting for a $500,000 buyout agreement (which he does not have at his disposal)? Should he continue operating as is in hopes of recuperating some of his funds and attempt to address the issue of his partner's behavior and financial mismanagement over time? Or should he cease all business activities and divide the assets, resulting in a significant financial loss for him, though an inconsequential if any loss by his partner.

When Alexander approached Jude with his concerns and with the attorney's recommendation, Jude exploded. He demanded Alexander immediately buy him out for $500,000. When Alexander explained he had already invested his life savings of $125,000 into the business and just wanted to ensure that Jude quit using the checking account as a personal account, Jude laughed. "I know you don't understand, but part of owning your own business is being able to buy things when you want." He nodded outside to a brand-new Harley Davidson Electra Glide Ultra Limited.

"When did you get that?" Alexander asked.

"Yesterday. And thanks, by the way."

Now Alexander was beside himself. His lifelong friend had become someone he felt as if he did not even know. He got up to get the company checkbook.

"Looking for this?" Jude tossed the checkbook to Alexander's chair.

Alexander looked inside. A stub for $30,000 had been recorded for a check to the local Harley Davidson dealer.

"Can you believe it?" asked Jude. "After the extras and the helmet, it came out to an even thirty! As far as our company goes, you've got two choices. Buy me out now for $500,000, or we split everything down the middle, and I take half of our inventory, half of our tools. And don't forget, there is only one thing we didn't both sign on. Only you signed the five-year lease on this warehouse and office space. But count on this. We stay in business together and I'm going to do as I please and enjoy the accoutrements of ownership!"

"Jude, what's gotten into you? Is there no other way of working this out?"

"Not if you can't buy me out?"

"You know I can't."

Jude responded that he intended to leave Alexander with the warehouse and office lease, take his supplier and customer database and initiate a new venture. With that, he walked out of the office, mounted his new Harley, revved it, saluted Alexander, and rode away.

CONCLUSION

Challenges faced by entrepreneurs and small business owners are diverse, ranging from financial constraints to unexpected events like a general partner absconding with assets and using the business as a personal cash till—as illustrated in this case. Alexander's and Jude's story serves as a warning for would-be business owners. Entrepreneurs and new business owners must investigate and comprehend the intricacies of the various business organizational forms.

Partnerships are perhaps the most difficult forms to manage relative to personal relationships and have often resulted in severed relationships as well as business dissolutions and bankruptcies. Carefully evaluating the advantages and disadvantages of each option and establishing clearly defined roles, responsibilities, and buyout/dissolution clauses are critical. Especially in a General Partnership, there should be a formal document outlining these agreements to avoid conflict and financial turmoil.

Moreover, ignorance of key accounting and legal principles, coupled with inadequate research and planning, can result in devastating consequences. Such is the case with Brotherhood Garage Doors. The business was shuttered. Alexander was left bankrupted. Jude was left with debts of less than $1,000, currently owns Garage Doors and Construction Services with another partner, and enjoys long trips on his Harley.

Questions

1. Should Alexander and Jude have generated a formal contract before starting the partnership?

2. Should a contract have been generated for the dissolution of the partnership?

3. What are Alexander's legal liabilities in this case? List the known liabilities.

4. If Alexander separated from Jude, which business entity should he choose?

5. What should Alexander do in this case?

JBCA

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