THE ACCIDENTAL AGENT

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When parties agree to share profits and control of a business venture, they are deemed under law to have formed a partnership even if the parties have never expressly provided for such a result. As a consequence, the accidental partners are subject to the default rules of partnership law, including the sharing of partnership losses and liability to third parties. While a case can be made that the sharing of losses may be intended by parties who have agreed to share profits, this is not certain. In any case, the extension of loss sharing beyond indemnification between the parties to liability owed a third-party consensual lender cannot be justified by the intent of the parties, at least where the partner sought by the lender was hidden from the lender at the time it extended credit. It is an open question whether other considerations, such as the minimization of transaction costs, justify a hidden partner's liability, but it is a question that judges and legislators should carefully consider.

Parties who agree to share profits of and control over an enterprise are considered partners and agents of the partnership under the law, even in the absence of an express partnership agreement. This is a sensible outcome with respect to some features of partnership law, but perhaps not with respect to other features. For example, in a dispute over an enterprise opportunity, it follows naturally that parties who agree to share profits and control should also share the opportunity since this was likely the bargain that the parties intended. In a dispute over a debt owed to a third-party consensual creditor of one of the parties, however, it is less clear that an agreement to share profits and control should always mean shared liability to the third party, even if the relationship does imply an indemnification obligation between the partners.

Part I of this essay describes routine explicit and implicit intended partnerships. Part II addresses an unusual partnership—one I refer to as an accidental partnership—where shared profits and control between parties trigger a principal-agent relationship and thus joint liability to

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third parties, even while the parties envisioned and manifested an association between an investor and an independent business. Part III of the essay discusses and critiques potential justifications for the determination that an accidental agency can impose partnership liability on a hidden partner even where the beneficiary of such liability is a consensual creditor. Finally, Part IV offers the conclusion that the law on this topic is less than sensible.

I. INTENDED PARTNERSHIP

Business co-venturers can intentionally form a partnership in one of two ways. First, they may expressly invoke partnership law with an agreement that labels their relationship a partnership. Second, they may manifest agreement, expressly or implicitly, to be bound by the substance of partnership law without expressly invoking that body of law. In either case, it is reasonable for the law to consider the parties' venture a partnership and to apply partnership rules. The following hypothetical cases illustrate each kind of intended partnership.

In the first hypothetical, Isabel and Benjamin, each a certified arborist, tire of their work as employees of a large landscaping firm and branch out on their own. Each consults a lawyer and the former co-workers expressly form a general partnership, one that they explicitly agree will be governed by applicable partnership law.

If the partnership between Isabel and Benjamin is governed by the Uniform Partnership Act (UPA),[1] as adopted in the relevant jurisdiction, the two co-venturers will be subject to a set of off-the-rack rules, also known as default rules, that control absent contrary agreement.[2] The guiding principle of these default rules is equality; Isabel and Benjamin will have equal say in the control of their business,[3] will own equal shares of any business assets net of liabilities, also known as profits and surplus,[4] and will be equally responsible for any business losses.[5]

The equality principle that underlies the default rules of partnership law allows a court to resolve quickly many common disputes. So, for instance, if, while engaged in the landscaping business, Isabel is offered a lucrative opportunity to design a movie star's garden, she must not exploit that opportunity for her personal benefit because the opportunity is an asset of the partnership. Instead, she must share it with Benjamin. A

1. UNIF. P'SHIP ACT (1914), 6 U.L.A. (pt. I) 1 (2001) [hereinafter UPA]. The Uniform Partnership Act is not the only relevant uniform act. There is also the Revised Uniform Partnership Act. UNIF. P'SHIP ACT (1997), 6 U.L.A. (pt. I) 275 (2001). The point of this essay, however, is based on general partnership-law principle and does not turn on distinctions between these uniform acts or among the partnership laws as adopted by the states.

2. *See, e.g.*, UPA § 18.

3. *See* UPA § 18(e).

4. *See* UPA § 18(a).

5. *See id.*

valuable opportunity is, after all, a profit that the partners have agreed to share. This is, more or less, the holding of the celebrated opinion by Justice Cardozo in *Meinhard v. Salmon*.[6] Similarly, if Benjamin borrows money on behalf of the business and the business assets run dry, Isabel and Benjamin are responsible equally for repayment of the loan.

Now consider the facts of the hypothetical above but with a variation. Just as before, Isabel and Benjamin form a new landscaping business. This time, however, neither consults a lawyer or explicitly agrees to form a partnership. Instead, their working understanding is that they will operate the business jointly and share the proceeds of their efforts. As it turns out, the absence of an express agreement may have little or no consequence. The law likely will infer that Isabel and Benjamin have formed a partnership just as if they had done so explicitly because the UPA defines a partnership as "an association of two or more persons to carry on as co-owners a business for profit."[7] When Isabel and Benjamin decided to start a business and share ownership and control, they formed a partnership even though they never discussed the terms of their informal agreement. The landscaping business formed by Isabel and Benjamin carries with it the attributes of an explicit partnership.

Thus, pursuant to *Meinhard*, even if in the formation of a business the parties do not address the possibility that a business opportunity might be presented to a particular partner or partners, the obligation to share that opportunity exists just as if there had been an express partnership. Similarly, if the parties do not explicitly determine who bears the debt liability for business expenses, the loan taken out on behalf of the business by one partner becomes equally the liability of each of the partners.

These results are not controversial. When parties create a business and establish themselves as similarly situated co-owners without any explicit agreement as to how to divide gains and losses, it is extraordinarily likely that they intend to adopt the equality principles of the partnership default rules just as they do when they expressly adopt those rules. If an alternative arrangement were intended, such as a greater allocation of profits to one party or a greater burden of loss to the other, one would expect them to have expressly provided for this alternative.

Obscured somewhat in the above hypothetical examples is the fact that shared liability has two distinct aspects. A party's shared liability for partnership obligations means that he must reimburse his partner should the partner satisfy a disproportionate amount of those obligations.[8] This is, in essence, an obligation to indemnify. Shared liability also means

6. 164 N.E. 545, 549 (N.Y. 1928).

7. UPA § 6(1); *see also* UPA § 7(4). For an application of the UPA to formation of an informal partnership under circumstances similar to those described in the text, see, e.g., *Vohland v. Sweet*, 433 N.E.2d 860 (Ind. Ct. App. 1982).

8. *See* UPA §§ 9(1), 18(a)–(b).

that if a partner is unable to satisfy his share of the partnership obligations, the other is responsible to make up the difference.[9] This is a liability to third parties. Even this, however, is not controversial in a simple case, such as those illustrated so far, where the partners jointly conduct partnership business, sharing alike, and holding themselves out to the world as responsible parties for the joint venture. As explained next, more complicated partnerships present more difficult issues.

II. AN ACCIDENTAL PARTNERSHIP

The discussion above illustrates how routine express and implied partnerships work. In each case, the UPA performed admirably. In the case of the express partnership, the UPA provided a set of default rules of which the parties explicitly availed themselves. In the case of the implicit partnership, each of the pertinent rules from the UPA apparently matched the parties' implicit understanding of how a matter between them would be resolved.

Not every business association is routine, however. Consider the following version of the above illustrations. Isabel is not a landscaper but an investor. Benjamin is a landscaper with connections to potential customers. Isabel agrees to lend Benjamin a significant sum of money at a favorable interest rate. In return, Benjamin promises not only to repay the loan, but also to give Isabel veto rights over any customer account Benjamin takes on and to give Isabel half of any profits from the landscaping business. Benjamin purchases equipment with the money borrowed from Isabel and begins to serve customers. But the business does not go well. Benjamin applies for a bank loan and pledges all of the landscaping equipment in support of the loan. Benjamin provides the bank with a full description of this equipment as well as an accurate description of his personal assets. Benjamin does not mention Isabel or her involvement with the landscaping business nor does the bank learn of Isabel or her involvement before approving the loan. Despite his best efforts, the landscaping business eventually fails entirely. The bank forecloses on the landscaping equipment and acquires all of Benjamin's other assets but is still owed a sizeable deficiency. At the foreclosure, the bank discovers Isabel's role in the landscaping business. The bank does not contend that Isabel exercised control over the business in any way that may have harmed the bank, but it still sues Isabel on the ground that she is a partner in the business and is thus liable for the partnership's obligations.[10]

9. *See* UPA § 15.

10. The fact that the bank did not serve itself at the expense of the debtor or the debtor's other creditors distinguishes the case from a lender-liability claim based on creditor misconduct. A court might find a creditor liable to a debtor or its creditors under the rubric of "lender liability" merely because the creditor exercised such control over the debtor as to be principal or a co-venturer, but in such a case the distinction between a finding of lender liability and that of a partnership is merely se-

These facts are a stylized (and simplified) version of those in *Minute Maid v. United Foods*.[11] In *Minute Maid*, United Foods Corporation (United Foods) purchased produce from Minute Maid on credit.[12] When United Foods could not pay, Minute Maid discovered that U.S. Cold Storage Corporation (Cold Storage) not only lent money to United Foods, but also exercised some control over United Foods and stood to profit, beyond repayment of its loan, from United Foods' relationship with Minute Maid.[13] Though *Minute Maid* was not formally decided under the UPA, the court defined partnership in essentially the same language used by the UPA. The court determined that "those persons are partners who contribute either property or money to carry a joint business for their common benefit, and who own and share the profits thereof in certain proportions."[14] The court proceeded to spell out the consequences of a partnership formed by a decision of two parties to carry on a business as co-owners for profit:

> If they do this, the incidents or consequences follow that the acts of one in conducting the partnership business are the acts of all, that each is agent for the firm and for the other partners, that each receives part of the profits as profits, and takes part of the fund to which the creditors of the partnership have a right to look for the payment of their debts, that all are liable as partners upon contracts made by any of them with third persons within the scope of the partnership business.[15]

In *Minute Maid*, Cold Storage, who played the same role as Isabel in the above illustration, attempted to deny that it was a partner by insisting that it was a creditor. The court responded that Cold Storage may have been a creditor, but because it exercised control and shared in profits, it was also a partner and as a partner was liable for debts incurred by the partnership business.[16] In the illustration, Isabel, similarly, would be liable. It did not matter to the court in *Minute Maid* that the third party was unaware of the partnership, and it would not matter in Isabel's case either.

A seemingly powerful argument in favor of Isabel is that hers is an atypical setting for a partnership and that it is, therefore, unreasonable to assume the parties intended to share losses merely because they intended to share control and profits. Put another way, Isabel might argue that, in essence, she is a creditor with special privileges, a counterpart to Benjamin, a debtor with special burdens, rather than an equal co-venturer who

mantic. *See*, *e.g.*, John C. Englander & Richard A. Oetheimer, *Lender Liability*, *in* BUSINESS TORTS IN MASSACHUSETTS, ¶12.4.4 (2002).

11. 291 F.2d 577 (5th Cir. 1961).
12. *Id.* at 578.
13. *Id.* at 581.
14. *Id.* at 582 (quoting Meehan v. Valentine, 145 U.S. 611, 623 (1892)).
15. *Id.*
16. *Id.* at 582–83; *see also, e.g.*, Warner v. Modano, 164 N.E.2d 904, 906 (Mass. 1960) (holding that a secret partner was liable as an undisclosed principal to one who sold goods to the partnership).

would expect to share benefits and burdens. In *Minute Maid*, Cold Storage made such an argument but was met with indifference by a court that woodenly applied the definition of partnership and then brought to bear the accompanying set of default rules.[17]

There is, however, an even stronger argument that Isabel can make. She can argue that it is irrelevant whether she and Benjamin agreed to share losses. If one assumes such an agreement, Isabel might be liable to Benjamin as she would thus have effectively agreed to indemnify him for losses he suffered beyond his share. It is unreasonable, however, to assume that an agreement between Isabel and Benjamin would make Isabel liable for a debt owed a third party, such as the bank in the illustration. Recall that the bank did not know of Isabel at the time it made the loan. Consequently, the terms of the loan made to Benjamin reflected only Benjamin's credit worthiness, which was enhanced by the equipment that Benjamin pledged and against which the bank collected. If Isabel and Benjamin had intended for Isabel to be held liable, they surely would have identified her to the bank at the time of the loan because access to her assets could only have improved the terms of the loan. The fact that Isabel's role in the business remained undisclosed to the bank suggests that neither Isabel nor Benjamin intended for Isabel to be liable.

The point can be made more generally. When two parties act in concert it is never in their mutual interest to agree with one another that there will be expanded liability for an obligation owed a third party. To be sure, it may be in the parties' joint interest that each of them offer to be liable, but such an offer would be made and accepted in an agreement with the third party and not between the two parties acting in concert. Where the third party has not extracted an agreement of liability, explicitly or implicitly, either directly or as a third-party beneficiary of an agreement with one of the parties, it is difficult to imagine the contractual source of such liability.

This argument, powerful though it may seem, is not reflected in the UPA or cases such as *Minute Maid*. Rather, the holding in *Minute Maid* would likely survive Isabel's challenge that the parties intended to preclude her from being liable. Indeed, the *Minute Maid* court quotes, as dictum, an early U.S. Supreme Court case, *Meehan v. Valentine*,[18] which states: "[E]ven an express stipulation between [partners] that one shall not be so liable, though good between themselves, is ineffectual as against third persons."[19]

The conclusion from *Meehan* that an agreement between the parties is not the source of a partner's liability to a third party is odd, to say the least, where applied absent any express or implicit agreement with the third party. Nevertheless, this conclusion is supported by the UPA. Re-

17. *Minute Maid*, 291 F.2d at 583.
18. 145 U.S. 611 (1892).
19. *Id*. at 623.

call that the UPA defines partnership by reference to shared profit and control and establishes liability to third parties by virtue of the partnership thus established and not as a result of any independent agreement on liability.[20] Contrast *Minute Maid* with more reasonable applications of the UPA where liability of the partners to one another and to third parties seemed sensible, based on express or implicit agreement among the partners and the third party.[21] Where agreement is not the source of a partner's liability to a third party, what, if anything, justifies such liability? Part III of this essay addresses this question.

III. QUESTIONABLE JUSTIFICATION

An ostensibly appealing justification for liability of even a hidden partner for partnership debts is that one who controls an enterprise and seeks to profit from it should also bear the costs of the venture rather than impose them on a third party. When the third party is a nonconsensual creditor, such as a tort victim, this logic is compelling. Without liability to a third party, those in control of a business would externalize the cost of doing business and thus engage in too much activity. In the *Minute Maid* scenario, however, the third party in question was a consensual creditor that relied on only the apparent partnership assets and the creditworthiness of the partner with whom it dealt.[22] The hidden partner was just that—hidden—and the terms of the third party's loan reflected only the limited apparent asset pool.[23] Presumably, the more limited that pool, the higher the interest rate on the third party's loan. The higher interest rate, in turn, would cause the partnership to internalize the costs of doing business, and it becomes unclear why the third party should receive what would seem to be a windfall by recovering from the hidden partner.

In *Nichols v. Arthur Murray, Inc*,[24] a case celebrated in business associations classrooms, a franchisee held itself out as an Arthur Murray dance studio.[25] A creditor of the franchisee sought payment from the franchisor, Arthur Murray, and won on the ground that the franchisor principal was responsible for the debts of its franchisee agent.[26] Although the holding in *Nichols* emphasized the franchisor's control over the franchisee, it is noteworthy that Arthur Murray, the principal, had permitted its agent to use its name and thus implicitly held itself out as responsible for the agent's obligations.[27] In the last illustration above,

20. *See* UPA §§ 6(1), 15.
21. *See supra* text accompanying notes 1–9.
22. *See Minute Maid*, 291 F.2d at 583.
23. *See id.* at 579–81.
24. 56 Cal. Rptr. 728 (Cal. Ct. App. 1967).
25. *Id.* at 730.
26. *Id.* at 730, 734.
27. *Id.* at 730.

Isabel, like Cold Storage in *Minute Maid*, made no such implicit representation, and the bank creditor was unaware of Isabel's existence at the time it extended its loan.[28] Moreover, the fact that Isabel was a creditor should not in itself matter. A consensual creditor who does not seek any guaranty that its debtor will borrow from no one else and does not require the debtor to promise disclosure of other creditors frequently faces competition from hidden claims. The prospect of such competition would be reflected in the terms of the loan, and competing creditors are not typically liable to one another for a debtor's obligations.[29]

Still, there is the matter of control itself. One might imagine that even a hidden partner who exercises control over an enterprise might do so to the detriment of the enterprise's creditors and should thus be held responsible for any liability that results; the logic of this outcome is not clear, however. Shareholders typically control corporations directly or indirectly, yet such control in the absence of some form of misconduct will not subject the shareholders to liability for corporate debts. A creditor who lends to a corporation and does not obtain personal guarantees from the shareholders knows that its recovery ordinarily will be limited to corporate assets even though the shareholders have control over those assets. This is the bargain. It is not obvious that a loan made to a visible partner should not similarly leave a hidden partner unaffected even though the hidden partner has exercised some control over the debtor.

Perhaps a reason for the hidden partner's liability lies in the fact that the partner *is hidden* and has control. The concern might be that a hidden partner may exercise control in a way unexpected by the third-party creditor. The hidden partner's liability to the third party would perhaps insulate the third party from skullduggery. Still, it is hard to imagine how the hidden partner's liability to a third party would cause the partner to behave any better toward the third party save that the partner would have an incentive to take fewer risks with partnership assets because the hidden partner would bear the consequences of failure. An incentive for fewer risks may seem desirable, but risk is sometimes rewarded by return, and when a third party contracts with a visible partner for access to a limited pool of assets, the inherent risk profile of the (apparent) enterprise is a factor that affects the terms of the loan. Again, the third party would receive an apparent windfall if the terms of the loan reflected significant risk while the actual incentives of the partnership were to take few risks.

All this said, sophisticated parties react to legal rules, so no one should shed any tears for a hidden partner saddled with liability. There

28. *See supra* Part III.

29. Lender liability will sometimes attach where a creditor exercises control over the debtor in a self-serving manner to the detriment of other creditors. The question here, however, is whether a creditor who is also a partner should be held liable even absent any allegation that the creditor affirmatively injured the other creditors. *See supra* note 10.

need not be any windfall for the third-party creditor or unfavorable loan terms since a hidden partner can reveal or protect herself at the time the visible partner contracts with the third party.[30] In the above illustration, therefore, one might expect that Isabel would announce herself to the bank and either get the bank to release her from any liability on its loan to Benjamin or to lower the interest rate on the loan. (Or, if Isabel sought a release, she might have Benjamin get the bank to disclaim liability of any hidden partner.) Alternatively, Isabel and Benjamin might form a corporation and have the corporation borrow from the bank with Benjamin, but not Isabel, issuing a personal guaranty for the loan. In any case, all parties would get the bargain they made.

The question remains, however, whether it makes sense to impose on a hidden partner the transaction costs of obtaining a waiver or forming a corporation where the hidden party does not wish to guarantee a loan. In *Minute Maid*, for example, the relationship between Cold Storage and United Foods might have been one of many between Cold Storage and produce purchasers. Would it make sense for the law to impose on Cold Storage an obligation to form a corporation for every purchaser with whom it deals or to seek a waiver (or have United Foods or other purchasers seek a waiver) of liability from every one of United Foods' suppliers and those of other purchasers with whom Cold Storage transacts? The transaction costs of such incorporations or waivers could become sizeable particularly as Cold Storage ends or modifies its relationships with some purchasers and creates new ones with others. If such transaction costs are significant enough, investors such as Cold Storage, or Isabel, might choose not to bear them, but instead to alter their business relationships, ceding either control or profits to their counterpart, even if it is in the parties' mutual interest to share both control and profits rather than endure a more traditional creditor-debtor relationship.

Against these transaction costs from the UPA rule as represented by *Minute Maid*, one must weigh the costs of an alternative rule, one under which a hidden partner would not be liable to a third party for partnership debts. So far, I have not identified any such costs, but there may be some. Consider, for example, yet another version of the above illustration. As before, a bank loans money to Benjamin and seeks to collect the equipment that Benjamin pledges in support of the loan. Isabel intervenes and claims that some of the equipment belongs to her, not to Benjamin or their partnership. One should not worry too much that Isabel would be able easily to perpetrate a fraud. Even if the general rule permitted Isabel to evade personal liability for partnership debts, the bank could argue that Isabel allowed Benjamin, her agent, to offer the

30. Larry Ribstein and Peter Letsou have argued that a benefit of partner liability to a third party is that a hidden partner will have an incentive to reveal itself. *See* LARRY E. RIBSTEIN & PETER V. LETSOU, BUSINESS ASSOCIATIONS § 2.02 (4th ed. 2003). This essay questions the benefits of such revelation.

equipment and thus should be bound by Benjamin's pledge. The bank would prevail as it relies on standard agency principles. Still, there could be a cost in separating Isabel's committed assets from her reserved assets because it might not be apparent at the time of dispute precisely which assets Benjamin had pledged to the bank. This would be an even greater concern if Benjamin did not formally, with full documentation, pledge Isabel's assets as security for a loan but instead merely represented some of them as his own.

A related, but more subtle, problem might arise if the bank comes upon Benjamin's well-appointed place of business and concludes that the proprietor of the business must be a person of substantial wealth. The bank might base the terms of its loan on this conclusion. The signal of proprietor wealth is one Isabel sent by setting Benjamin up in business. If the default rule did not provide for her liability to the bank, the bank would be misled unless it undertook to investigate the true source of Benjamin's apparent wealth. The need for such investigation is a cost that the bank might not have to bear under the UPA rule of hidden-partner liability.

One might be skeptical that these costs would be properly attributed to a default rule of no hidden-partner liability. As earlier noted, under the UPA rule, which holds a hidden partner liable even to a consensual third party, one might expect hidden partners to reveal themselves and disclaim liability either through formation of a corporation or waiver by the third party. After the formation of a corporation or a waiver, however, a third-party creditor would encounter problems quite similar to those it would face if the default rule did not provide for hidden-partner liability. Which assets belong to the corporation (or the liable partner) and which to its shareholders (or the released partner)? Is the corporation (or the liable partner) wealthy or are its shareholders (or the released partner) wealthy?

Despite these misgivings, it is possible that a default rule of hidden-partner liability is valuable because it pushes the liability issue to the forefront where a third party can consider questions of debtor creditworthiness. A bank, or in a different setting a less sophisticated third party, might not consider whether apparent assets truly belong to the visible partner, but might begin to ask questions if its debtor were a corporation or if its debtor or the debtor's emerged partner asked for a waiver. The potential for forgone scrutiny counts against a rule that would allow a hidden partner to avoid liability. It is not certain, however, that this is enough to justify the UPA rule and its inherent costs.

IV. DECOUPLING AND RATIONALIZING PARTNER LIABILITY

The foregoing establishes that it may be possible to justify the UPA's broad hidden-partner liability for partnership obligations.

Whether this rule can in fact be justified depends on a balance of costs that a hidden partner must bear under the rule and the costs that even a consensual third-party creditor might encounter were the rule otherwise.

What is troubling about the UPA rule and the case law under the UPA, as exemplified by the cases discussed here, is that there is no evidence of any attempt to balance the costs and benefits of alternative rules. Rather, the UPA and the courts have either coupled an arguably reasonable rule of shared profits and losses between partners with a questionable and undefended rule of shared liability to third parties, or have concluded, inappositely and without explanation, that an agreement between the parties does not determine liability to a third party. A better analysis would decouple these issues and permit conclusions that are not only independent, but reasoned.