Partnership Law

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Recent Developments

The following discussion is a survey of case law pertaining to recent partnership state law decisions. The analysis is divided between general and limited partnership decisions.

General Partnerships

[] **Partners May Be Expelled for Reporting Suspected Overbilling.** In *Bohatch v. Butler & Binion,*[1] the Supreme Court of Texas addressed the issue of whether the fiduciary relationship among partners gives rise to a duty not to expel a partner who reports suspected overbilling by another partner.

In *Bohatch,* a partner in a law firm informed the firm's managing partner that she was concerned the billing partner was overbilling a client. The following day, the billing partner informed the reporting partner that he was not satisfied with her work product. This was the first time the reporting partner had ever heard criticism of her work for the client. Over the next month, the firm investigated the complaint and discussed the allegations with the client's in-house counsel. The in-house counsel responded that the client was satisfied the bills were reasonable.

A few months later, the firm's managing partner told the reporting partner that she should begin looking for other employment. After this meeting, the plaintiff received no further work assignments from the firm. The trial court held for the expelled partner on her claim that the law firm breached its fiduciary duty to her.

The supreme court reversed the trial court's judgment and ruled that the firm's only duty to the partner was not to expel her in bad faith. Finding no evidence that the firm expelled the plaintiff for self-gain, the appellate court concluded that the plaintiff could not recover for breach of fiduciary duty. Thus, the court determined that the fiduciary duty partners owe one another does not encompass a duty to remain partners, so long as the partners do not expel a partner in bad faith. The rationale of the court was that if a disagreement arises among partners over firm policy which has a profound effect on the personal confidence and trust essential to a partnership relationship so that partners find it impossible to continue to work together, partners should be able to expel a partner without a breach of a fiduciary duty.

The court also disagreed as to whether there were public policy reasons for prohibiting the expulsion of a partner who reports overbilling. Specifically, the appellate court rejected the plaintiff's argument that permitting a law firm to retaliate against a partner who in good faith reports suspected overbilling would discourage compliance with rules of professional conduct and thereby hurt clients.[2]

[] **Partner Could Not Be Expelled for Exercising Rights Under Partnership Agreement.** In *Winston & Strawn v. Nosal,*[3] a general partnership brought an action seeking a declaration that a partner's expulsion was valid under the partnership agreement and did not result in a dissolution of the partnership. The trial court granted summary judgment in favor of the partnership, and the expelled partner appealed, contending that his expulsion was void as a breach of the fiduciary duty owed to partners in a partnership.

The expelled partner became a capital partner in 1984. From 1988 until his outplacement,[4] the expelled partner made repeated requests to view the firm's financial statements, executive committee meeting minutes, and partnership compensation records by invoking a provision in the partnership agreement entitling all partners to "access to the firm's books and records." Except for receiving the firm's audited financial statements, the partner's requests were denied.

In March 1992, at a partnership meeting to discuss the outplacement of several other partners, the partner distributed a memorandum expressing his dissatisfaction with the executive committee's decision to expel partners, stating it was in violation of the partnership agreement. The partner indicated that before he would endorse such action, he would require an accounting and disclosure of all financial records regarding the partnership from 1987 to date. Eight days after his final request to inspect the partnership books, he—along with about nineteen other partners—received written notice from the firm's managing partner that they were being discharged from the firm for economic reasons. After refusing to leave the firm, the firm's capital partners voted to expel him from the partnership.

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[1] 1998 Tex. LEXIS 13 (Sup.Ct.Tx. 1998).

[2] The court explained that its refusal to create an exception to the at-will nature of partnerships in no way obviates the ethical duties of lawyers as such duties sometimes necessitate difficult decisions—for example, when a lawyer suspects overbilling by a colleague. The fact that the ethical duty to report may create an irreparable schism between partners neither excuses failure to report nor transforms expulsion as a means of resolving that schism into a tort.

[3] 664 N.E.2d 239 (1st DCA, 4th Div. Ill. 1996).

[4] In this context, outplacement means the discharge of a partner for economic reasons.

The expelled partner claimed that his expulsion was void because it was in violation of the implicit duty of good faith that exists between partners. He argued that he was expelled solely because of his persistent requests to inspect the firm's books and records, which he alleged would have revealed secretive self-dealing on the part of the executive committee and fraudulent conduct by the managing partner. The general partnership disputed these allegations and contended his expulsion was proper because it was approved by the requisite votes.

The Illinois Appellate Court agreed with the expelled partner. The court stated that the fact that his expulsion took place immediately after his ongoing requests to inspect the partnership books,[5] and just eight days after he threatened to sue if his demands were not met, raised an inference that his expulsion occurred solely because he persisted in invoking the rights belonging to him under the partnership agreement. The court then held that "regardless of the discretion conferred upon partners under a partnership agreement,[6] this does not abrogate their high duty to exercise good faith and fair dealing in the execution of such discretion." The court acknowledged that a fiduciary relationship exists among partners and each partner is bound to exercise the utmost good faith and honesty in all matters relating to the partnership business.

The decision in *Winston & Strawn* can be reconciled with the Texas Supreme Court's decision in *Bohatch*. In *Winston & Strawn*, the partners expelled the partner for self-gain, whereas the partners in *Bohatch* expelled a partner because of a disagreement over billing practices.

[5] The agreement granted all partners unrestricted access "to the books and records of the partnership."

[6] The partnership agreement placed no restriction on the expulsion of a partner other than approval by the requisite majority.

[] Expulsion Not Enforced Without Provision in Partnership Agreement. In *Beasley v. Cadwalader, Wickersham & Taft*,[7] a former partner brought an action against a general partnership, claiming he was expelled from the partnership in violation of the partnership agreement, which contained no provision for the explusion of a partner. The partnership asserted that the partner voluntarily withdrew.

The former partner joined the law firm partnership in its Palm Beach office. Even though the profits of the Palm Beach office increased after the former partner became associated with the firm, his behavior was described as "extremely disruptive," and created "severe morale problems." In connection with the partnership's annual compensation review, secret meetings were held during which the partners created lists identifying the most and least productive partners. All the Florida partners appeared on the least productive partner list. After these meetings, the firm decided to close the firm's Palm Beach office.

[7] 1996 WL 438777 (Fla. Cir. Ct., Jul. 23, 1996).

The plaintiff was initially asked to withdraw from the firm, which he declined to do. After negotiations failed to result in an agreement acceptable to both the plaintiff and the partnership, the plaintiff filed a complaint. The law firm argued that the management committee had the power to close the branch office, and that such action could not form the basis for a finding that the plaintiff was expelled. Rather, said the law firm, the partner was offered a continued partnership in New York or Washington, and his failure to accept this offer constituted a voluntary withdrawal from the partnership.

The Florida Circuit Court, however, did not agree with the law firm, and held that while the management committee had the power to close an office, they did not have the right to expel a partner absent a provision regarding expulsion in the partnership agreement. According to the court, the offer to transfer the partner to another office was not a good faith offer as he had spent his entire professional career in South Florida, and his value to the firm as a New York or Washington partner was greatly diminished since his "rainmaking abilities would be severely impaired." The court also ruled that the partner's refusal to consider the transfer did not constitute a voluntary withdrawal from the partnership.

Consistent with the Texas Supreme Court in *Bohatch* and the Illinois Appellate Court in *Winston & Strawn*, the Florida court held in the instant case that the partnership breached its fiduciary duty to the partner by expelling him for the express purpose of producing greater profits for the remaining partners.[8] The court felt that the proper way to address the problem of profitability and too many partners was to propose an amendment to the partnership agreement to expressly permit expulsion.

Finally, the court held that the fact that the partner approached three partnership associates about leaving the firm and forming their own firm did not amount to "unclean hands" which would defeat his claim. The court summed it up best when it stated: "If [the partner] had dirt under his fingernails, [the partnership] was up to its elbows in the dung heap."

[] Partnership Goodwill Not a Distributable Asset of Firm to Former Partner. In *Dawson v. White & Case*,[9] a former partner of a law firm argued that goodwill was a distributable asset of the partnership and, thus, he was entitled to his fair share of the goodwill. The partnership countered that even if a partnership might be said to possess goodwill, the courts should honor an agreement among partners which provides to the contrary.

The former partner was a partner for nearly twenty years. Sometime before 1988, the firm commenced negotiations with him to persuade him to withdraw as a partner. When

[8] Query, what would have been the result if the partnership agreement had permitted the expulsion of the partner?

[9] 88 N.Y.2d 666, 649 N.Y.S.2d 364, 672 N.E.2d 589 (Ct. App. 1996).

the talks reached an impasse, the firm voted to dissolve the partnership and re-form it without him, effective July 1, 1988.

After a hearing, a Special Referee valued the assets of the law firm partnership, and included the firm's goodwill as an asset of the partnership. The Supreme Court of New York County[10] confirmed the report and entered a judgment in favor of the former partner. The Appellate Division affirmed, concluding that the partnership possessed distributable goodwill. The New York Court of Appeals disagreed, however.

The court stated that whether goodwill is a distributable asset depends on the partnership—that is, partners can agree to exclude particular items from the class of distributable partnership property, and such an agreement will be enforced in an accounting proceeding. Therefore, the court held, even if a given partnership might be said to possess goodwill, the courts will honor an agreement among partners—express or implied—that goodwill not be considered an asset of the firm.

Accordingly, the court determined that the partners agreed by implication that goodwill was not a distributable asset because departing partners were never paid any consideration for goodwill, and goodwill was not listed as an asset in the firm's financial statements. Moreover, the partnership agreement stated that "no consideration has been or is to be paid for the firm name or any goodwill of the partnership." The court noted, though, that the holding of the case was based on the specific facts presented, and should not be construed as a prohibition against the valuation, in the appropriate case, of law firm goodwill.

[] **Summary of Expulsion Cases.** The four partnership expulsion cases discussed above provide valuable guidance to lawyers involved in drafting law firm partnership agreements. First, it is important that the partners be sure that the partnership agreement contains an explicit provision dealing with partner expulsion, rather than attempting to expel a partner indirectly by other means such as dissolution and reformation or other forms of restructuring. Second, if a firm is planning to discharge a partner, it should be careful to document the business purpose for this action, especially if there are no specific provisions pertaining to expulsion of a partner in the agreement. Finally, as *Dawson* demonstrates, a law firm partnership agreement should expressly provide whether goodwill is a distributable asset of the firm when attempting to value a former partner's interest in the partnership.

[] **Property Distributions Were Invalid Without Deed.** In *Federal Deposit Insurance Corp. v. Hish,*[11] a general partnership ran an automobile empire. Upon the founding general partner's death, his stock in the dealership corporations was distributed to his four children. However,

[10] The Supreme Court of New York County is a trial court.

[11] 76 F.3d 620 (4th Cir. 1996).

title to the property on which the dealerships were built was held by several family partnerships in which his children and a trust were partners.

When the children decided to go their separate ways, they redistributed their stock in the dealerships so that each child had a controlling interest in a dealership. For tax reasons, though, a similar exchange of the partnership interests was not possible to transfer to each child a controlling interest in the property on which the dealership controlled by that child was located.[12] Consequently, the partnership's accountants devised a two-step plan under which the partnership properties would first be distributed to the partners as tenants in common, and then, after a period of time, the undivided tenancy-in-common interests would be traded in a series of tax-free exchanges to accomplish the above ownership objectives.

In accordance with the plan, the partners agreed to dissolve the partnerships by filing final partnership tax returns, converting partnership bank accounts to accounts held by the partners as tenants in common, and acquiring business licenses identifying the property owner as a tenant in common. But no deeds were ever executed or filed to transfer legal title to the partnership properties to the partners as tenants in common.

As a result of financial difficulties, a partner borrowed $1.8 million from a bank, securing the loan with the property on which the dealership in which he had a controlling interest was located, rather than with his partnership interest. The other partners claimed that the mortgage was invalid because the partner sought to encumber the property for his own personal use, without the consent of the remaining partners, in violation of the Virginia Uniform Partnership Act (VUPA).[13] Furthermore, VUPA prevents a partner from assigning his interest in partnership property.[14]

The bank argued that the partners distributed the partnership property to themselves as tenants in common when they agreed to place the partnership in dissolution, and because the partner had an undivided 22.5 percent interest in the property when he executed the mortgage, the mortgage was valid.

The district court granted the bank's motion for summary judgment on the ground that the property had been distributed to the partners as tenants in common and, thus, the partners were free to encumber their own interest in property. The Fourth Circuit disagreed and held that the mortgage did not

[12] I.R.C. Section 1031 specifically excludes partnership interests from the type of property eligible for like-kind exchange treatment.

[13] A partner has an equal right with his partners to possess specific partnership property for partnership purposes, but he has no right to possess such property for any other purpose without the consent of his partners. Va. Code Ann. § 50-25(B)(1).

[14] A partner's right in specific partnership property is not assignable except in connection with the assignment of the rights of all the partners in the same property. Va. Code Ann. § 50-25(B)(2).

validly convey an interest in the property because no deed was executed to convey the property to the partners as tenants in common. The appellate court based its holding on Virginia law, which provides that legal title to property can be conveyed only by deed or will. In this case, however, no deed had ever been executed to transfer legal title to the partners, and thus the partnership still had record ownership of the property. This case is an example of the difference between the more formalistic nature of partnership state law and the substance-over-form approach of partnership tax law under Subchapter K.

Limited Partnerships

[] Fraudulent Partnership Was Not Enforced. In *Sender v. Simon,*[15] a trustee in bankruptcy brought an action against limited partners to recover money they received in excess of contributions to a failed Ponzi scheme.[16] The limited partners took the position that because the partnership was illegal, the agreement was null and void.

In the late 1970s, a corporation was formed for the purpose of operating an investment fund. When an individual agreed to invest in the fund, he was sold a limited partnership interest in one of three limited partnerships. While the invested amounts resulted in net profits in a few of the years, in most years the investment fund had net losses, and in all of the years the fund's performance was overstated. From 1982 onward the fund was insolvent and, to prevent investors from discovering the fund's poor performance, false high earnings were reported.

The defendant limited partners invested in the operation through a limited partnership formed under the Colorado Uniform Limited Partnership Act (CULPA) of 1981. Their relationship with the fund ended in 1989, however, when they each received lump-sum checks in excess of their investments.

The operation went into bankruptcy in the summer of 1990. In 1992, the trustee brought suits in Colorado District Court against the limited partners to recover the distributions they received in "excess of their contribution" in violation of Colorado law.[17] The district court granted summary judgment in favor of the limited partners after determining that the partnership agreements were not enforceable.

The trustee claimed the defendants received payments in violation of the partnership agreement and in violation of section 608(2) of CULPA, which provides:

> If a partner has received the return of any part of his contribution in violation of the partnership agreement or this article, he is liable to the limited partnership for a period of six years thereafter for the amount of the contribution wrongfully returned.

The Tenth Circuit agreed with the defendant limited partners and held that the partnership agreement was an illegal contract, and therefore unenforceable. The court stated that even though the partnerships were not illegal per se, they were created and operated in furtherance of a fraudulent and illegal investment scheme. It is not the job of the courts, said the Tenth Circuit, to aid the effort of a fraudulent entity that used the "trappings of legal formality to lure its victims and then turn around and try to hold its victims accountable under those same legal formalities."

[] Agent's Fiduciary Duties Owed Primarily to Limited Partnership, Not to Limited Partners. In *Life Care Centers of America, Inc. v. Charles Town Associates Limited Partnership,*[18] a management company brought suit against a limited partnership, charging it with breach of contract and wrongful termination. The limited partnership and its partners raised an affirmative defense that the management company violated its fiduciary duty by soliciting the limited partners to replace the managing general partner. The management company challenged this defense by asserting that it owed a fiduciary duty only to the partnership, not to the limited partners.

The district court agreed. The defendants asked the district court to reconsider its decision on the issue of whether an agent of a limited partnership owes a fiduciary duty solely to the partnership, or whether it owes the duty to the limited partners as well.

The Sixth Circuit reasoned that if the management company's principals were the individual partners, then its fiduciary duties flowed to each of them under the aggregate theory of partnership law. On the other hand, if the management company's principal was the limited partnership, then it owed a fiduciary duty to the partnership under the entity theory of partnership law. Hence, the primary issue was to whom the management company owed a fiduciary duty.[19]

The Sixth Circuit held that, although a limited partnership does have certain aggregate theory aspects (such as personal liability of general partners), it has a strong entity character in that its identity and existence are separate and apart from individual partners whose participation is minimal. It is this entity character that requires the management of the limited partnership to be placed in a "quasi-corporate light and subject to special constraints." Accordingly, the court held that while fiduciary duties do flow to the individual partners of a

[15] 84 F.3d 1299 (10th Cir. 1996).

[16] A Ponzi scheme is a fraudulent investment scheme in which profits to investors are not created by the success of the underlying business venture, but instead are derived from the capital contributions of subsequently recruited investors.

[17] Section 608(2) of the Colorado Uniform Limited Partnership Act (CULPA) of 1981.

[18] 79 F.3d 496 (6th Cir. 1996).

[19] The Sixth Circuit acknowledged there was no authority discussing who the principal is in the context of a limited partnership. The court stated that in the case of a general partnership, there is considerable authority which holds that an agent to a general partnership owes fiduciary duties to the partnership as well as to the partners.

limited partnership, it is appropriate to subordinate such interests to those of the entity when a conflict of interest arises.

[] **Defectively Formed Limited Partnership Still Has Capacity to Sue.** In *American Alternative Energy Partners II v. Windridge, Inc.,*[20] a limited partnership that allegedly owned certain machinery brought an action against the other alleged owner, claiming that he had converted the limited partnership's machinery to his own use. The other alleged owner moved to dismiss the complaint on the ground the limited partnership failed to timely file a certificate of limited partnership and, thus, was without capacity to maintain its action.

The trial court granted the motion to dismiss. The trial court reasoned that because the alleged tortious acts occurred in January 1990 and the certificate of limited partnership was not filed until 1994, the three-year statute of limitations had expired by the time the limited partnership had capacity to sue.

The California Appellate Court, however, framed the issue as not whether the limited partnership had capacity to sue as a limited partnership, but whether it had capacity to sue as an entity other than a limited partnership. The appellate court held that it did, and the partnership's failure to file the certificate of limited partnership rendered it a general partnership with capacity to sue at the time it filed its complaint.[21] The court's rationale was that if a limited partnership is not formed because of noncompliance with the recordation requirement, the partnership is a general partnership. Moreover, if the legislature had meant to deprive the partnership of its capacity to sue, in addition to rendering it a general partnership, the "legislature would have said so."

[] **General Partners Do Not Have Implied Power to Advance Legal Expenses.** In *Christman v. Brauvin Realty Advisors, Inc.,*[22] four limited partners challenged a proposed transaction in which the assets of four limited partnerships would be acquired either by sale to, or by merger with, a real estate limited liability company (LLC). The defendants were the corporate general partners of each partnership. The four limited partners alleged that the defendant general partners were unlawfully advancing partnership funds to defend themselves in this litigation. The defendants argued the funds were lawfully advanced to pay legal expenses. The

[20] 49 Cal. Rptr. 2d 686 (5th DCA Ca. 1996).

[21] The court relied on several provisions of California's Uniform Limited Partnership Act. Section 15044 states: "Every partnership that is not formed in accordance with the law concerning limited partnerships, is a general partnership." Section 15621 states: "In order to form a limited partnership the general partners shall . . . file a certificate of limited partnership and, either before or after the filing . . . the partners shall have entered into a partnership agreement."

[22] 1997 U.S. Dist. LEXIS 19563 (N.D. Ill. Dec. 2, 1997).

partnership agreements did not contain any provisions regarding advancements. The plaintiffs contended that advancements were not permitted, absent the express agreement of the parties.

In the only Delaware case concerning advancement of legal expenses by a limited partnership, *Delphi Easter Partners Ltd. Partnership v. Spectacular Partners, Inc.,*[23] the court noted that Delaware law defers completely to the contracting parties to create and limit rights and obligations with respect to the advancement of expenses. The language in *Delphi* strongly suggests that the right to advancement exists only if it is provided for in the partnership agreement. The issue was not directly before the court there, however, because the partnership agreement in *Delphi* specifically provided for the right to advance legal expenses.

The defendants in the instant case claimed that the authority given the general partner in the partnership agreements to do acts "necessary, desirable, proper and advantageous for the administration of the Partnership" empowered general partners to advance themselves expenses for lawsuits. But the court was not convinced that the power of the general partners to perform such acts should be construed so broadly as to permit advancements of legal fees. The court held that it is difficult to view the general partners' decision to advance themselves legal expenses as merely exercising their discretion to manage the partnership. When the general partners themselves are the target of the lawsuit, the court cannot ignore the potential conflict between the interests of the general partners and the interests of the partnerships. The court noted that if the general partners want to have the authority to advance themselves partnership funds for litigation expenses, they must explicitly provide for such authority in the partnership agreement.

[23] 1993 Del. Ch. Lexis 159.