Sole Proprietorships
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Although there are many ways to structure your business, starting a sole proprietorship is probably the easiest and cheapest. There are both benefits and drawbacks to starting a sole proprietorship; below are some of the most questions regarding how sole proprietorships work.

What is a sole proprietorship?

A sole proprietorship is a company with only one owner and is not registered with the state, unlike a limited liability company (LLC) or corporation. Starting a sole proprietorship requires no paperwork - all you do to create a sole proprietorship is simply go into business. Although you do not have to file paperwork to set up a sole proprietorship, you do still have to acquire business licenses and permits, just like with any other form of business. Most people use the term "DBA" which stands for "doing business as" to indicate a sole proprietorship.

How does a sole proprietorship differ from other company forms?

A sole proprietorship differs from other forms of business in several ways. The chief ways a sole proprietorship is different include:

- Sole proprietorships are the least complex and cheapest form of doing business
- Sole proprietorships require no formal paperwork to set up and don't need to be registered with the state
- Sole proprietorships do not shield individuals from liability for their business debts (see below)
- Sole proprietorships are treated as simple income for tax purposes, and do not need to have separate taxes prepared (see below)

How are sole proprietorships treated for tax purposes?

Unlike corporations, sole proprietorships are not treated separately by the IRS. This means that any profit derived from your sole proprietorship is treated as your personal income and is accounted for on your individual tax return. Any such income is taxed to you in the year it was received.

Am I personally liable for my business under a sole proprietorship?

Yes. Unlike other forms of incorporation, you are personally liable for any of your sole proprietorship's debts or legal judgments against your business. This means that in order to satisfy debts owed by your business, debt collectors can come after your personal assets --
homes, cars, etc. For this reason alone, you should be extremely cautious about setting up a sole proprietorship.

Closing a Sole Proprietorship

For years, Jane's friend's told her that she should sell her delicious blue cheese salad dressing. Once Jane learned how to use her computer and "surf the net," she realized that she could market, sell, and distribute her salad dressing over the Internet. She set everything up -- she was required by state law to apply for a Certificate of Trade Name and give notice of her intent to do business as "Salad Goddess." She also obtained a sales tax permit from her state tax authority and had her kitchen licensed. Jane and her husband did all of the work and she reported Salad Goddess profits and losses on her and her husband's jointly filed income tax return.

After five years in business, Jane became tired of always smelling like blue cheese and decided to close down her business. Because all states have different requirements for closing businesses, Jane checked with the Small Business Administration office in her area to determine whether she needed to notify the secretary of state, local tax authorities, or licensing entities of her decision to close her business. She found out that she is required to send a letter to the secretary of state discontinuing the Salad Goddess trade name. She also had to notify the state tax authority and the licensing entity. That completed, it was time to dismantle her business:

- She filled her final orders.
- She closed her website in two stages - she initially posted a message about closing her business and no longer taking orders and removed the order-taking pages from the site. She planned a complete shutdown of the site a number of months later, when it seemed that enough customers had seen the message.
- She notified her creditors and debtors that she was closing and told them to submit final bills or payments.
- She paid all of her outstanding bills.
- She made sure that her suppliers knew that she was no longer in business.
- She donated the balance of her stock to food shelters.
- She sold her equipment.
- She put aside an appropriate amount of money for taxes and unknown creditors.
- She notified her commercial liability carrier of her closure.
- She kept detailed records of each transaction in anticipation of completing her income taxes.

Can a Sole Proprietorship Stay in Operation After the Death of the Owner?

The business format an entrepreneur chooses can have significant impacts on both the business clientele and the owner’s heirs and successors if the owner dies. From a business standpoint, the death of an owner in a corporate business entity is not as significant as the death of an
owner of a sole proprietorship. The corporate entity would be unaffected, while the sole proprietorship would technically expire upon the owner’s death.

Sole proprietorships are the most basic form of business. Legally, there is no distinction between the sole proprietorship and the owner himself; they are one entity. Sole proprietorships have only one owner. A business with more than one owner is a partnership, unless the business has elected to operate as something different, such as a limited liability company. When the sole proprietor dies, the business technically dies also.

Partnerships: General Characteristics and Formation

Learning Objectives

After reading this chapter, you should understand the following:

1. The importance of partnership and the present status of partnership law
2. The extent to which a partnership is an entity
3. The tests that determine whether a partnership exists
4. Partnership by estoppel
5. Partnership formation

18.1 Introduction to Partnerships and Entity Theory

Learning Objectives

1. Describe the importance of partnership.
2. Understand partnership history.
3. Identify the entity characteristics of partnerships.

Importance of Partnership Law

It would be difficult to conceive of a complex society that did not operate its businesses through organizations. In this chapter we study partnerships, limited partnerships, and limited liability companies, and we touch on joint ventures and business trusts.

When two or more people form their own business or professional practice, they usually consider becoming partners. Partnership law defines a partnership as “the association of two or more persons to carry on as co-owners a business for profit...whether or not the persons intend to form a partnership.” [1] In 2011, there were more than three million business firms in the United States as partnerships (see Table 18.1 "Selected Data: Number of US Partnerships, Limited Partnerships, and Limited Liability Companies", showing data to 2006), and partnerships are a common form of organization among accountants, lawyers, doctors, and other professionals. When we use the word partnership, we are referring to the general business partnership. There are also limited partnerships and limited liability partnerships, which are discussed in Chapter 20 "Hybrid Business Forms".
Table 18.1 Selected Data: Number of US Partnerships, Limited Partnerships, and Limited Liability Companies

<table>
<thead>
<tr>
<th></th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
<th>2006</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total number of active partnerships</td>
<td>2,375,375</td>
<td>2,546,877</td>
<td>2,763,625</td>
<td>2,947,116</td>
</tr>
<tr>
<td>Number of partners</td>
<td>14,108,458</td>
<td>15,556,553</td>
<td>16,211,908</td>
<td>16,727,803</td>
</tr>
<tr>
<td>Number of limited partnerships</td>
<td>378,921</td>
<td>402,238</td>
<td>413,712</td>
<td>432,550</td>
</tr>
<tr>
<td>Number of partners</td>
<td>6,262,103</td>
<td>7,023,921</td>
<td>6,946,986</td>
<td>6,738,737</td>
</tr>
<tr>
<td>Number of limited liability companies</td>
<td>1,091,502</td>
<td>1,270,236</td>
<td>1,465,223</td>
<td>1,630,161</td>
</tr>
<tr>
<td>Number of partners</td>
<td>4,226,099</td>
<td>4,949,808</td>
<td>5,640,146</td>
<td>6,361,958</td>
</tr>
</tbody>
</table>


Partnerships are also popular as investment vehicles. Partnership law and tax law permit an investor to put capital into a limited partnership and realize tax benefits without liability for the acts of the general partners.

Even if you do not plan to work within a partnership, it can be important to understand the law that governs it. Why? Because it is possible to become someone’s partner without intending to or even realizing that a partnership has been created. Knowledge of the law can help you avoid partnership liability.

**History of Partnership Law**

**Through the Twentieth Century**

Partnership is an ancient form of business enterprise, and special laws governing partnerships date as far back as 2300 BC, when the Code of Hammurabi explicitly regulated the relations between partners.

Partnership was an important part of Roman law, and it played a significant role in the law merchant, the international commercial law of the Middle Ages.

In the nineteenth century, in both England and the United States, partnership was a popular vehicle for business enterprise. But the law governing it was jumbled. Common-law principles were mixed with equitable standards, and the result was considerable confusion. Parliament moved to reduce the uncertainty by adopting the Partnership Act of 1890, but codification took longer in the United States. The Commissioners on Uniform State Laws undertook the task at the turn of the twentieth century. The Uniform Partnership Act (UPA), completed in 1914, and the Uniform Limited Partnership Act (ULPA),
completed in 1916, were the basis of partnership law for many decades. UPA and ULPA were adopted by all states except Louisiana.

**The Current State of Partnership Law**

Despite its name, UPA was not enacted uniformly among the states; moreover, it had some shortcomings. So the states tinkered with it, and by the 1980s, the National Conference of Commissioners on Uniform Laws (NCCUL) determined that a revised version was in order. An amended UPA appeared in 1992, and further amendments were promulgated in 1993, 1994, 1996, and 1997. The NCCUL reports that thirty-nine states have adopted some version of the revised act. This chapter will discuss the Revised Uniform Partnership Act (RUPA) as promulgated in 1997, but because not all jurisdictions have not adopted it, where RUPA makes significant changes, the original 1914 UPA will also be considered. [2] The NCCUL observes in its “prefatory note” to the 1997 act: “The Revised Act is largely a series of ‘default rules’ that govern the relations among partners in situations they have not addressed in a partnership agreement. The primary focus of RUPA is the small, often informal, partnership. Larger partnerships generally have a partnership agreement addressing, and often modifying, many of the provisions of the partnership act.” [3]

**Entity Theory**

**Meaning of “Legal Entity”**

A significant difference between a partnership and most other kinds of business organization relates to whether, and the extent to which, the business is a legal entity. A legal entity is a person or group that the law recognizes as having legal rights, such as the right to own and dispose of property, to sue and be sued, and to enter into contracts; the entity theory is the concept of a business firm as a legal person, with existence and accountability separate from its owners. When individuals carry out a common enterprise as partners, a threshold legal question is whether the partnership is a legal entity. The common law said no. In other words, under the common-law theory, a partnership was but a convenient name for an aggregate of individuals, and the rights and duties recognized and imposed by law are those of the individual partners. By contrast, the mercantile theory of the law merchant held that a partnership is a legal entity that can have rights and duties independent of those of its members. During the drafting of the 1914 UPA, a debate raged over which theory to adopt. The drafters resolved the debate through a compromise. In Section 6(1), UPA provides a neutral definition of partnership (“an
association of two or more persons to carry on as co-owners a business for profit”) and retained the common-law theory that a partnership is an aggregation of individuals—the aggregate theory.

RUPA moved more toward making partnerships entities. According to the NCCUL, “The Revised Act enhances the entity treatment of partnerships to achieve simplicity for state law purposes, particularly in matters concerning title to partnership property. RUPA does not, however, relentlessly apply the entity approach. The aggregate approach is retained for some purposes, such as partners’ joint and several liability.”[4] Section 201(a) provides, “A partnership is an entity distinct from its partners.” [5]

Entity Characteristics of a Partnership

Under RUPA, then, a partnership has entity characteristics, but the partners remain guarantors of partnership obligations, as always—that is the partners’ joint and several liability noted in the previous paragraph (and discussed further in Chapter 19 "Partnership Operation and Termination"). This is a very important point and a primary weakness of the partnership form: all partners are, and each one of them is, ultimately personally liable for the obligations of the partnership, without limit, which includes personal and unlimited liability. This personal liability is very distasteful, and it has been abolished, subject to some exceptions, with limited partnerships and limited liability companies, as discussed in Chapter 20 "Hybrid Business Forms". And, of course, the owners of corporations are also not generally liable for the corporation’s obligations, which is a major reason for the corporate form’s popularity.

For Accounting Purposes

Under both versions of the law, the partnership may keep business records as if it were a separate entity, and its accountants may treat it as such for purposes of preparing income statements and balance sheets.

For Purposes of Taxation

Under both versions of the law, partnerships are not taxable entities, so they do not pay income taxes. Instead, each partner’s distributive share, which includes income or other gain, loss, deductions, and credits, must be included in the partner’s personal income tax return, whether or not the share is actually distributed.

For Purposes of Litigation

In litigation, the aggregate theory causes some inconvenience in naming and serving partnership defendants: under UPA, lawsuits to enforce a partnership contract or some other right must be filed in the name of all the partners. Similarly, to sue a partnership, the plaintiff must name and sue each of the
partners. This cumbersome procedure was modified in many states, which enacted special statutes expressly permitting suits by and against partnerships in the firm name. In suits on a claim in federal court, a partnership may sue and be sued in its common name. The move by RUPA to make partnerships entities changed very little. Certainly it provides that “a partnership may sue and be sued in the name of the partnership”—that’s handy where the plaintiff hopes for a judgment against the partnership, without recourse to the individual partners’ personal assets. But a plaintiff must still name the partnership and the partners individually to have access to both estates, the partnership and the individuals’: “A judgment against a partnership is not by itself a judgment against a partner. A judgment against a partnership may not be satisfied from a partner’s assets unless there is also a judgment against the partner.”

For Purposes of Owning Real Estate

Aggregate theory concepts bedeviled property co-ownership issues, so UPA finessed the issue by stating that partnership property, real or personal, could be held in the name of the partners as “tenants in partnership”—a type of co-ownership—or it could be held in the name of the partnership. Under RUPA, “property acquired by the partnership is property of the partnership and not of the partners.” But RUPA is no different from UPA in practical effect. The latter provides that “property originally brought into the partnership stock or subsequently acquired by purchase...on account of the partnership, is partnership property.” Under either law, a partner may bring onto the partnership premises her own property, not acquired in the name of the partnership or with its credit, and it remains her separate property. Under neither law can a partner unilaterally dispose of partnership property, however labeled, for the obvious reason that one cannot dispose of another’s property or property rights without permission. And keep in mind that partnership law is the default: partners are free to make up partnership agreements as they like, subject to some limitations. They are free to set up property ownership rules as they like.

For Purposes of Bankruptcy

Under federal bankruptcy law—state partnership law is preempted—a partnership is an entity that may voluntarily seek the haven of a bankruptcy court or that may involuntarily be thrust into a bankruptcy proceeding by its creditors. The partnership cannot discharge its debts in a liquidation proceeding under Chapter 7 of the bankruptcy law, but it can be rehabilitated under Chapter 11 (see Chapter 13 "Bankruptcy").
Partnership law is very important because it is the way most small businesses are organized and because it is possible for a person to become a partner without intending to. Partnership law goes back a long way, but in the United States, most states—but not all—have adopted the Revised Uniform Partnership Act (RUPA, 1997) over the previous Uniform Partnership Act, originally promulgated in 1914. One salient change made by RUPA is to directly announce that a partnership is an entity: it is like a person for purposes of accounting, litigation, bankruptcy, and owning real estate. Partnerships do not pay taxes; the individual partners do. But in practical terms, what RUPA does is codify already-existing state law on these matters, and partners are free to organize their relationship as they like in the partnership agreement.

**EXERCISES**

1. When was UPA set out for states to adopt? When was RUPA promulgated for state adoption?
2. What does it mean to say that the partnership act is the “default position”? For what types of partnership is UPA (or RUPA) likely to be of most importance?
3. What is the aggregate theory of partnership? The entity theory?

[5] RUPA, Section 201(a).
18.2 Partnership Formation

LEARNING OBJECTIVES

1. Describe the creation of an express partnership.
2. Describe the creation of an implied partnership.
3. Identify tests of partnership existence.
4. Understand partnership by estoppel.

Creation of an Express Partnership

Creation in General

The most common way of forming a partnership is expressly—that is, in words, orally or in writing. Such a partnership is called an express partnership. If parties have an express partnership with no partnership agreement, the relevant law—the Uniform Partnership Act (UPA) or the Revised Uniform Partnership Act (RUPA)—applies the governing rules.

Assume that three persons have decided to form a partnership to run a car dealership. Able contributes $250,000. Baker contributes the building and space in which the business will operate. Carr contributes his services; he will manage the dealership.

The first question is whether Able, Baker, and Carr must have a partnership agreement. As should be clear from the foregoing discussion, no agreement is necessary as long as the tests of partnership are met. However, they ought to have an agreement in order to spell out their rights and duties among themselves.

The agreement itself is a contract and should follow the principles and rules spelled out in Chapter 8 "Contracts" of this book. Because it is intended to govern the relations of the partners toward themselves and their business, every partnership contract should set forth clearly the following terms: (1) the name under which the partners will do business; (2) the names of the partners; (3) the nature, scope, and
location of the business; (4) the capital contributions of each partner; (5) how profits and losses are to be divided; (6) how salaries, if any, are to be determined; (7) the responsibilities of each partner for managing the business; (8) limitations on the power of each partner to bind the firm; (9) the method by which a given partner may withdraw from the partnership; (10) continuation of the firm in the event of a partner’s death and the formula for paying a partnership interest to his heirs; and (11) method of dissolution.

**Specific Issues of Concern**

In forming a partnership, three of these items merit special attention. And note again that if the parties do not provide for these in their agreement, RUPA will do it for them as the default.

**Who Can Be a Partner?**

As discussed earlier in this chapter, a partnership is not limited to a direct association between human beings but may also include an association between other entities, such as corporations or even partnerships themselves. \[^1\] Family members can be partners, and partnerships between parents and minor children are lawful, although a partner who is a minor may disaffirm the agreement.

**Written versus Oral Agreements**

If the business cannot be performed within one year from the time that the agreement is entered into, the partnership agreement should be in writing to avoid invalidation under the Statute of Frauds. Most partnerships have no fixed term, however, and are partnerships “at will” and therefore not covered by the Statute of Frauds.

**Validity of the Partnership Name**

Able, Baker, and Carr decide that it makes good business sense to choose an imposing, catchy, and well-known name for their dealership—General Motors Corporation. There are two reasons why they cannot do so. First, their business is a partnership, not a corporation, and should not be described as one. Second, the name is deceptive because it is the name of an existing business. Furthermore, if not registered, the name would violate the assumed or fictitious name statutes of most states. These require that anyone doing business under a name other than his real name register the name, together with the names and addresses of the proprietors, in some public office. (Often, the statutes require the proprietors to publish this information in the newspapers when the business is started.) As *Loomis v.*
Whitehead in Section 18.3.2 "Creation of a Partnership: Registering the Name" shows, if a business fails to comply with the statute, it could find that it will be unable to file suit to enforce its contracts.

**Creation of Implied Partnership**

An implied partnership exists when in fact there are two or more persons carrying on a business as co-owners for profit. For example, Carlos decides to paint houses during his summer break. He gathers some materials and gets several jobs. He hires Wally as a helper. Wally is very good, and pretty soon both of them are deciding what jobs to do and how much to charge, and they are splitting the profits. They have an implied partnership, without intending to create a partnership at all.

**Tests of Partnership Existence**

But how do we know whether an implied partnership has been created? Obviously, we know if there is an express agreement. But partnerships can come into existence quite informally, indeed, without any formality—they can be created accidentally. In contrast to the corporation, which is the creature of statute, partnership is a catchall term for a large variety of working relationships, and frequently, uncertainties arise about whether or not a particular relationship is that of partnership. The law can reduce the uncertainty in advance only at the price of severely restricting the flexibility of people to associate. As the chief drafter of the Uniform Partnership Act (UPA, 1914) explained,

> All other business associations are statutory in origin. They are formed by the happening of an event designated in a statute as necessary to their formation. In corporations this act may be the issuing of a charter by the proper officer of the state; in limited partnerships, the filing by the associates of a specified document in a public office. On the other hand, an infinite number of combinations of circumstances may result in co-ownership of a business. Partnership is the residuum, including all forms of co-ownership, of a business except those business associations organized under a specific statute. [2]

*Figure 18.1 Partnership Tests*
Because it is frequently important to know whether a partnership exists (as when a creditor has dealt with only one party but wishes to also hold others liable by claiming they were partners, see Section 18.3.1 "Tests of Partnership Existence", Chaiken v. Employment Security Commission), a number of tests have been established that are clues to the existence of a partnership (see Figure 18.1 "Partnership Tests"). We return to the definition of a partnership: “the association of two or more persons to carry on as co-owners a business for profit[.]” The three elements are (1) the association of persons, (2) as co-owners, (3) for profit.

**Association of Persons**

This element is pretty obvious. A partnership is a contractual agreement among persons, so the persons involved need to have *capacity* to contract. But RUPA does not provide that only *natural* persons can be partners; it defines *person* as follows: “‘Person’ means an individual, corporation, business trust, estate, trust, partnership, association, joint venture, government, governmental subdivision, agency, or instrumentality, or any other legal or commercial entity.” Thus unless state law precludes it, a corporation can be a partner in a partnership. The same is true under UPA.

**Co-owners of a Business**

If what two or more people own is clearly a business—including capital assets, contracts with employees or agents, an income stream, and debts incurred on behalf of the operation—a partnership exists. A tougher question arises when two or more persons co-own property. Do they automatically become partners? The answer can be important: if one of the owners while doing business pertinent to the property injures a stranger, the latter could sue the other owners if there is a partnership.

Co-ownership comes in many guises. The four most common are joint tenancy, tenancy in common, tenancy by the entireties, and community property. In joint tenancy, the owners hold the property under a
single instrument, such as a deed, and if one dies, the others automatically become owners of the deceased’s share, which does not descend to his heirs. Tenancy in common has the reverse rule: the survivor tenants do not take the deceased’s share. Each tenant in common has a distinct estate in the property. The tenancy by the entirety and community property (in community-property states) forms of ownership are limited to spouses, and their effects are similar to that of joint tenancy. These concepts are discussed in more detail in relation to real property in Chapter 31 "The Transfer of Real Estate by Sale".

Suppose a husband and wife who own their home as tenants by the entirety (or community property) decide to spend the summer at the seashore and rent their home for three months. Is their co-ownership sufficient to establish that they are partners? The answer is no. By UPA Section 7(2) and RUPA Section 202(b)(1), the various forms of joint ownership by themselves do not establish partnership, whether or not the co-owners share profits made by the use of the property. To establish a partnership, the ownership must be of a business, not merely of property.

**Sharing of Profits**

There are two aspects to consider with regard to profits: first, whether the business is for-profit, and second, whether there is a sharing of the profit.

**Business for Profit**

Unincorporated nonprofit organizations (UNAs) cannot be partnerships. The paucity of coherent law governing these organizations gave rise in 2005 to the National Conference of Commissioners of Uniform Laws’ promulgation of the Revised Uniform Unincorporated Nonprofit Association Act (RUUNAA). The prefatory note to this act says, “RUUNAA was drafted with small informal associations in mind. These informal organizations are likely to have no legal advice and so fail to consider legal and organizational questions, including whether to incorporate. The act provides better answers than the common law for a limited number of legal problems...There are probably hundreds of thousands of UNAs in the United States including unincorporated nonprofit philanthropic, educational, scientific and literary clubs, sporting organizations, unions, trade associations, political organizations, churches, hospitals, and condominium and neighborhood associations.” [4] At least twelve states have adopted RUUNAA or its predecessor.

**Sharing the Profit**
While co-ownership does not establish a partnership unless there is a business, a business by itself is not a partnership unless co-ownership is present. Of the tests used by courts to determine co-ownership, perhaps the most important is sharing of profits. Section 202(c) of RUPA provides that “a person who receives a share of the profits of a business is presumed to be a partner in the business,” but this presumption can be rebutted by showing that the share of the profits paid out was (1) to repay a debt; (2) wages or compensation to an independent contractor; (3) rent; (4) an annuity, retirement, or health benefit to a representative of a deceased or retired partner; (5) interest on a loan, or rights to income, proceeds, or increase in value from collateral; or (5) for the sale of the goodwill of a business or other property. Section 7(4) of UPA is to the same effect.

Other Factors

Courts are not limited to the profit-sharing test; they also look at these factors, among others: the right to participate in decision making, the duty to share liabilities, and the manner in which the business is operated. Section 18.3.1 "Tests of Partnership Existence", Chaiken v. Employment Security Commission, illustrates how these factors are weighed in court.

Creation of Partnership by Estoppel

Ordinarily, if two people are not legally partners, then third parties cannot so regard them. For example, Mr. Tot and Mr. Tut own equal shares of a house that they rent but do not regard it as a business and are not in fact partners. They do have a loose “understanding” that since Mr. Tot is mechanically adept, he will make necessary repairs whenever the tenants call. On his way to the house one day to fix its boiler, Mr. Tot injures a pedestrian, who sues both Mr. Tot and Mr. Tut. Since they are not partners, the pedestrian cannot sue them as if they were; hence Mr. Tut has no partnership liability.

Suppose that Mr. Tot and Mr. Tut happened to go to a lumberyard together to purchase materials that Mr. Tot intended to use to add a room to the house. Short of cash, Mr. Tot looks around and espies Mr. Tat, who greets his two friends heartily by saying within earshot of the salesman who is debating whether to extend credit, “Well, how are my two partners this morning?” Messrs. Tot and Tut say nothing but smile faintly at the salesman, who mistakenly but reasonably believes that the two are acknowledging the partnership. The salesman knows Mr. Tat well and assumes that since Mr. Tat is rich, extending credit to the “partnership” is a “sure thing.” Messrs. Tot and Tut fail to pay. The lumberyard is entitled to collect from Mr. Tat, even though he may have forgotten completely about the incident by the time suit is filed.
Under Uniform Partnership Act Section 16(1), Mr. Tat would be liable for the debt as being part of a partnership by estoppel. The Revised Uniform Partnership Act is to the same effect:

Section 308. Liability of Purported Partner.
(a) If a person, by words or conduct, purports to be a partner, or consents to being represented by another as a partner, in a partnership or with one or more persons not partners, the purported partner is liable to a person to whom the representation is made, if that person, relying on the representation, enters into a transaction with the actual or purported partnership.

Partnership by estoppel has two elements: (1) a representation to a third party that there is in fact a partnership and (2) reliance by the third party on the representation. See Section 18.3.3 "Partnership by Estoppel", Chavers v. Epsco, Inc., for an example of partnership by estoppel.

**KEY TAKEAWAY**

A partnership is any two or more persons—including corporate persons—carrying on a business as co-owners for profit. A primary test of whether a partnership exists is whether there is a sharing of profits, though other factors such as sharing decision making, sharing liabilities, and how the business is operated are also examined.

Most partnerships are expressly created. Several factors become important in the partnership agreement, whether written or oral. These include the name of the business, the capital contributions of each partner, profit sharing, and decision making. But a partnership can also arise by implication or by estoppel, where one has held herself as a partner and another has relied on that representation.

**EXERCISES**

1. Why is it necessary—or at least useful—to have tests to determine whether a partnership exists?
2. What elements of the business organization are examined to make this determination?
3. Jacob rents farmland from Davis and pays Davis a part of the profits from the crop in rent. Is Davis a partner? What if Davis offers suggestions on what to plant and when? Now is he a partner?
4. What elements should be included in a written partnership agreement?
5. What is an implied partnership?
6. What is a partnership by estoppel, and why are its “partners” estopped to deny its existence?
A joint venture—sometimes known as a joint adventure, coadventure, joint enterprise, joint undertaking, syndicate, group, or pool—is an association of persons to carry on a particular task until completed. In essence, a joint venture is a “temporary partnership.” In the United States, the use of joint ventures began with the railroads in the late 1800s. Throughout the middle part of the twentieth century joint ventures were common in the manufacturing sector. By the late 1980s, they increasingly appeared in both manufacturing and service industries as businesses looked for new, competitive strategies. They are aggressively promoted on the Internet: “Joint Ventures are in, and if you’re not utilizing this strategic weapon, chances are your competition is, or will soon be, using this to their advantage….possibly against you!” (Scott Allen, “Joint Venturing 101,” About.com Entrepreneurs, http://entrepreneurs.about.com/od/beyondstartup/a/jointventures.htm). As a risk-avoiding device, the joint venture allows two or more firms to pool their differing expertise so that neither needs to “learn the ropes” from the beginning; neither needs the entire capital to start the enterprise. Partnership rules generally apply, although the relationship of the joint venturers is closer to that of special than general agency as discussed in Chapter 14 "Relationships between Principal and Agent". Joint venturers are fiduciaries toward one another. Although no formality is necessary, the associates will usually sign an agreement. The joint venture need have no group name, though it may have one. Property may be owned jointly. Profits and losses will be shared, as in a partnership, and each associate has the right to participate in management. Liability is unlimited. Sometimes two or more businesses will form a joint venture to carry out a specific task—prospecting for oil, building a nuclear reactor, doing basic scientific research—and will incorporate the joint venture. In that case, the resulting business—known as a “joint venture corporation”—is governed by corporation law, not the law of partnership, and is not a joint venture in the sense described here. Increasingly, companies are forming joint ventures to do business abroad; foreign investors or governments own significant interests in these joint ventures. For example, in 1984 General Motors entered into a joint venture with Toyota to revive GM’s shuttered Fremont, California, assembly plant to create New United Motor Manufacturing, Inc. (NUMMI). For GM the joint venture was an opportunity to learn about lean manufacturing from the Japanese company, while Toyota gained its first manufacturing base in North America and a chance to test its production system in an American labor environment. Until May 2010, when the copartnership ended and the plant closed, NUMMI built an average of six thousand vehicles a week, or nearly eight million cars and trucks. These vehicles were the Chevrolet Nova (1984–88), the Geo Prizm (1989–97), the Chevrolet Prizm (1998–2002), and the Hilux (1991–95, predecessor of the Tacoma), as well as the Toyota Voltz, the Japanese right-hand-drive version of the Pontiac Vibe. The latter two


### 18.3 Cases

#### Tests of Partnership Existence

*Chaiken v. Employment Security Commission*

274 A.2d 707 (Del. 1971)

STOREY, J.

The Employment Security Commission, hereinafter referred to as the Commission, levied an involuntary assessment against Richard K. Chaiken, complainant, hereinafter referred to as Chaiken, for not filing his unemployment security assessment report. Pursuant to the same statutory section, a hearing was held and a determination made by the Commission that Chaiken was the employer of two barbers in his barber shop and that he should be assessed as an employer for his share of unemployment compensation contributions. Chaiken appealed the Commission’s decision....

Both in the administrative hearing and in his appeal brief Chaiken argues that he had entered into partnership agreements with each of his barbers and, therefore, was and is not subject to unemployment compensation assessment. The burden is upon the individual assessed to show that he is outside the ambit of the statutory sections requiring assessment. If Chaiken’s partnership argument fails he has no secondary position and he fails to meet his burden.

Chaiken contends that he and his “partners”:

1. properly registered the partnership name and names of partners in the prothonotary’s office, in accordance with [the relevant statute], [1]

2. properly filed federal partnership information returns and paid federal taxes quarterly on an estimated basis, and
3. duly executed partnership agreements.

Of the three factors, the last is most important. Agreements of “partnership” were executed between Chaiken and Mr. Strazella, a barber in the shop, and between Chaiken and Mr. Spitzer, similarly situated. The agreements were nearly identical. The first paragraph declared the creation of a partnership and the location of business. The second provided that Chaiken would provide barber chair, supplies, and licenses, while the other partner would provide tools of the trade. The paragraph also declared that upon dissolution of the partnership, ownership of items would revert to the party providing them. The third paragraph declared that the income of the partnership would be divided 30% for Chaiken, 70% for Strazella; 20% for Chaiken and 80% for Spitzer. The fourth paragraph declared that all partnership policy would be decided by Chaiken, whose decision was final. The fifth paragraph forbade assignment of the agreement without permission of Chaiken. The sixth paragraph required Chaiken to hold and distribute all receipts. The final paragraph stated hours of work for Strazella and Spitzer and holidays.

The mere existence of an agreement labeled “partnership” agreement and the characterization of signatories as “partners” docs not conclusively prove the existence of a partnership. Rather, the intention of the parties, as explained by the wording of the agreement, is paramount.

A partnership is defined as an association of two or more persons to carry on as co-owners a business for profit. As co-owners of a business, partners have an equal right in the decision making process. But this right may be abrogated by agreement of the parties without destroying the partnership concept, provided other partnership elements are present.

Thus, while paragraph four reserves for Chaiken all right to determine partnership policy, it is not standing alone, fatal to the partnership concept. Co-owners should also contribute valuable consideration for the creation of the business. Under paragraph two, however, Chaiken provides the barber chair (and implicitly the barber shop itself), mirror, licenses and linen, while the other partners merely provide their tools and labor—nothing more than any barber-employee would furnish. Standing alone, however, mere contribution of work and skill can be valuable consideration for a partnership agreement.

Partnership interests may be assignable, although it is not a violation of partnership law to prohibit assignment in a partnership agreement. Therefore, paragraph five on assignment of partnership interests does not violate the partnership concept. On the other hand, distribution of partnership assets to the partners upon dissolution is only allowed after all partnership liabilities are satisfied. But paragraph two
of the agreement, in stating the ground rules for dissolution, makes no declaration that the partnership assets will be utilized to pay partnership expenses before reversion to their original owners. This deficiency militates against a finding in favor of partnership intent since it is assumed Chaiken would have inserted such provision had he thought his lesser partners would accept such liability. Partners do accept such liability, employees do not.

Most importantly, co-owners carry on “a business for profit.” The phrase has been interpreted to mean that partners share in the profits and the losses of the business. The intent to divide the profits is an indispensable requisite of partnership. Paragraph three of the agreement declares that each partner shall share in the income of the business. There is no sharing of the profits, and as the agreement is drafted, there are no profits. Merely sharing the gross returns does not establish a partnership. Nor is the sharing of profits prima facie evidence of a partnership where the profits received are in payment of wages. The failure to share profits, therefore, is fatal to the partnership concept here.

Evaluating Chaiken’s agreement in light of the elements implicit in a partnership, no partnership intent can be found. The absence of the important right of decision making or the important duty to share liabilities upon dissolution individually may not be fatal to a partnership. But when both are absent, coupled with the absence of profit sharing, they become strong factors in discrediting the partnership argument. Such weighing of the elements against a partnership finding compares favorably with Fenwick v. Unemployment Compensation Commission, which decided against the partnership theory on similar facts, including the filing of partnership income tax forms.

In addition, the total circumstances of the case taken together indicate the employer-employee relationship between Chaiken and his barbers. The agreement set forth the hours of work and days off—unusual subjects for partnership agreements. The barbers brought into the relationship only the equipment required of all barber shop operators. And each barber had his own individual “partnership” with Chaiken. Furthermore, Chaiken conducted all transactions with suppliers, and purchased licenses, insurance, and the lease for the business property in his own name. Finally, the name “Richard’s Barber Shop” continued to be used after the execution of the so-called partnership agreements. [The Commission’s decision is affirmed.]

**CASE QUESTIONS**

1. Why did the unemployment board sue Chaiken?
2. Why did Chaiken set up this “partnership”?
3. What factors did the court examine to determine whether there was a partnership here? Which one was the most important?
4. Why would it be unusual in a partnership agreement to set forth the hours of work and days off?

Creation of a Partnership: Registering the Name (omitted)

Partnership by Estoppel

Chavers v. Epsco, Inc.

98 S.W.3d 421 (Ark. 2003)

Hannah, J.

Appellants Reggie Chavers and Mark Chavers appeal a judgment entered against them by the Craighead County Circuit Court. Reggie and Mark argue that the trial court erred in holding them liable for a company debt based upon partnership by estoppel because the proof was vague and insufficient and there was no detrimental reliance on the part of a creditor. We hold that the trial court was not clearly erroneous in finding liability based upon partnership by estoppel. Accordingly, we affirm.

Facts

Gary Chavers operated Chavers Welding and Construction (“CWC”), a construction and welding business, in Jonesboro. Gary’s sons Reggie Chavers and Mark Chavers joined their father in the business after graduating from high school. Gary, Mark, and Reggie maintain that CWC was a sole proprietorship owned by Gary, and that Reggie and Mark served only as CWC employees, not as CWC partners.

In February 1999, CWC entered into an agreement with Epsco, Inc. (“Epsco”), a staffing service, to provide payroll and employee services for CWC. Initially, Epsco collected payments for its services on a weekly basis, but later, Epsco extended credit to CWC. Melton Clegg, President of Epsco, stated that his decision to extend credit to CWC was based, in part, on his belief that CWC was a partnership.

CWC’s account with Epsco became delinquent, and Epsco filed a complaint against Gary, Reggie, and Mark, individually, and doing business as CWC, to recover payment for the past due account. Gary discharged a portion of his obligation to Epsco due to his filing for bankruptcy. Epsco sought to recover CWC’s remaining debt from Reggie and Mark. After a hearing on March 7, 2002, the trial court issued a letter opinion, finding that Reggie and Mark “represented themselves to [Epsco] as partners in an existing
partnership and operated in such a fashion to give creditors in general, and Epsco in particular, the impression that such creditors/potential creditors were doing business with a partnership....” On May 21, 2002, the trial court entered an order stating that Reggie and Mark were partners by estoppel as relates to Epsco. The trial court found that Reggie and Mark were jointly and severally liable for the debt of CWC in the amount of $80,360.92. In addition, the trial court awarded Epsco pre-judgment interest at the rate of six percent, post-judgment interest at the rate of ten percent, and attorney’s fees in the amount of $8,036.92.

[The relevant Arkansas statute provides]:

(1) When a person, by words spoken or written or by conduct, represents himself, or consents to another representing him to any one, as a partner in an existing partnership or with one (1) or more persons not actual partners, he is liable to any person to whom such representation has been made, who has, on the faith of such representation, given credit to the actual or apparent partnership, and if he has made such representation or consented to its being made in a public manner, he is liable to that person, whether the representation has or has not been made or communicated to that person so giving credit by or with the knowledge of the apparent partner making the representation or consenting to it being made.

(a) When a partnership liability results, he is liable as though he were an actual member of the partnership.

We have long recognized the doctrine of partnership by estoppel. [Citation, 1840], the court stated that they who hold themselves out to the world as partners in business or trade, are to be so regarded as to creditors and third persons; and the partnership may be established by any evidence showing that they so hold themselves out to the public, and were so regarded by the trading community.

Further, we have stated that “[p]artnerships may be proved by circumstantial evidence; and evidence will sometimes fix a joint liability, where persons are charged as partners, in a suit by a third person, when they are not, in fact, partners as between themselves.” [Citation, 1843.]

In [Citation, 1906], the court noted that
[a] person who holds himself out as a partner of a firm is estopped to deny such representation, not only as to those as to whom the representation was directly made, but as to all others who had knowledge of such holding out and in reliance thereon sold goods to the firm....

In addition, “if the party himself puts out the report that he is a partner, he will be liable to all those selling goods to the firm on the faith and credit of such report.” [Citation] When a person holds himself out as a member of partnership, any one dealing with the firm on the faith of such representation is entitled to assume the relation continues until notice of some kind is given of its discontinuance.

[Citations]

In [Citation, 1944], the court wrote:

It is a thoroughly well-settled rule that persons who are not as between themselves partners, or as between whom there is in fact no legal partnership, may nevertheless become subject to the liabilities of partners, either by holding themselves out as partners to the public and the world generally or to particular individuals, or by knowingly or negligently permitting another person to do so. All persons who hold themselves out, or knowingly permit others to hold them out, to the public as partners, although they are not in partnership, become bound as partners to all who deal with them in their apparent relation.

The liability as a partner of a person who holds himself out as a partner, or permits others to do so, is predicated on the doctrine of estoppel and on the policy of the law seeking to prevent frauds on those who lend their money on the apparent credit of those who are held out as partners. One holding himself out as a partner or knowingly permitting himself to be so held out is estopped from denying liability as a partner to one who has extended credit in reliance thereon, although no partnership has in fact existed.

In the present case, the trial court cited specific examples of representations made by Reggie and Mark indicating that they were partners of CWC, including correspondence to Epsco, checks written to Epsco, business cards distributed to the public, and credit applications. We will discuss each in turn.

**The Faxed Credit References**

Epsco argues that Plaintiff’s Exhibit # 1, a faxed list of credit references, clearly indicates that Gary was the owner and that Reggie and Mark were partners in the business. The fax lists four credit references, and it includes CWC’s contact information. The contact information lists CWC’s telephone number, fax
number, and federal tax number. The last two lines of the contact information state: “Gary Chavers Owner” and “Reggie Chavers and Mark Chavers Partners.”

Gary testified that he did not know that the list of credit references was faxed to Epsco. In addition, he testified that his signature was not at the bottom of the fax. He testified that his former secretary might have signed his name to the fax; however, he stated that he did not authorize his secretary to sign or fax a list of credit references to Epsco. Moreover, Gary testified that the first time he saw the list of credit references was at the bench trial.

This court gives deference to the superior position of the trial judge to determine the credibility of the witnesses and the weight to be accorded their testimony. [Citations] Though there was a dispute concerning whether Gary faxed the list to Epsco, the trial court found that Epsco received the faxed credit references from CWC and relied on CWC's statement that Reggie and Mark were partners. The trial court's finding is not clearly erroneous.

**The Fax Cover Sheet**

At trial, Epsco introduced Plaintiff's Exhibit # 2, a fax cover sheet from “Chavers Construction” to Epsco. The fax cover sheet was dated July 19, 2000. The fax cover sheet contained the address, telephone number, and fax number of the business. Listed under this information was “Gary, Reggie, or Mark Chavers.” Epsco argues that Gary, Reggie, and Mark are all listed on the fax cover sheet, and that this indicates that they were holding themselves out to the public as partners of the business. The trial court's finding that the fax cover sheet indicated that Reggie and Mark were holding themselves out as partners of CWC is not clearly erroneous.

**The Epsco Personnel Credit Application**

Epsco introduced Plaintiff's Exhibit # 9, a personnel credit application, which was received from CWC. Adams testified that the exhibit represented a completed credit application that she received from CWC. The type of business checked on the credit application is “partnership.” Adams testified that the application showed the company to be a partnership, and that this information was relied upon in extending credit. Clegg testified that he viewed the credit application which indicated that CWC was a partnership, and that his decision to extend credit to CWC was based, in part, on his belief that CWC was a partnership. Gary denied filling out the credit application form.
It was within the trial court’s discretion to find Adams’s and Clegg’s testimony more credible than Gary’s testimony and to determine that Epsco relied on the statement of partnership on the credit application before extending credit to CWC. The trial court’s finding concerning the credit application is not clearly erroneous.

**The Checks to Epsco**

Epsco argues that Plaintiff’s Exhibit # 3 and Plaintiff’s Exhibit # 11, checks written to Epsco showing the CWC account to be in the name of “Gary A. or Reggie J. Chavers,” indicates that Reggie was holding himself out to be a partner of CWC. Plaintiff’s Exhibit # 3 was signed by Gary, and Plaintiff’s Exhibit # 11 was signed by Reggie. The checks are evidence that Reggie was holding himself out to the public as a partner of CWC, and Epsco could have detrimentally relied on the checks before extending credit to CWC. The trial court was not clearly erroneous in finding that the checks supported a finding of partnership by estoppel.

**The Business Card**

Epsco introduced Plaintiff’s Exhibit # 4, a business card that states “Chavers Welding, Construction & Crane Service.” Listed on the card as “owners” are Gary Chavers and Reggie Chavers. Gary testified that the business cards were printed incorrectly, and that Reggie’s name should not have been included as an owner. He also testified that some of the cards might have been handed out, and that it was possible that he might have given one of the cards to a business listed as one of CWC’s credit references on Plaintiff’s Exhibit # 1.

The business card listing Reggie as an owner indicates that Reggie was holding himself out as a partner. As we stated in [Citation] when a person holds himself out as a member of partnership, any one dealing with the firm on the faith of such representation is entitled to assume the relation continues until notice of some kind is given of its discontinuance. There is no indication that Reggie ever informed any person who received a business card that the business relationship listed on the card was incorrect or had been discontinued. The trial court’s finding concerning the business card is not clearly erroneous.

**The Dealership Application**

Epsco introduced Plaintiff’s Exhibit # 5, an application form from “Chavers Welding,” signed by Reggie, seeking a dealership from Sukup Manufacturing. The application, dated January 23, 1997, lists “Gary & Reggie Chavers” as owners of “Chavers Welding.” The application is signed by Reggie. Reggie admits that
he signed the dealership application and represented that he was an owner of “Chavers Welding,” but he dismisses his statement of ownership as mere “puffery” on his part. Epsco argues that instead, the application shows that Reggie was holding himself out to the public as being a partner. The trial court’s determination that Reggie’s dealership application supports a finding of partnership by estoppel is not clearly erroneous.

In sum, the trial court was not clearly erroneous in finding that Reggie and Mark held themselves out as partners of CWC and that Epsco detrimentally relied on the existence of the partnership before extending credit to CWC. The appellants argue that even if we find Reggie liable based upon partnership by estoppel, there was scant proof of Mark being liable based upon partnership by estoppel. We disagree. We are aware that some examples of holding out cited in the trial court’s order pertain only to Reggie. However, the representations attributed to both Reggie and Mark are sufficient proof to support the trial court’s finding that both Reggie and Mark are estopped from denying liability to Epsco.

Affirmed.

CASE QUESTIONS

1. What is the rationale for the doctrine of partnership by estoppel?
2. Gary and Reggie claimed the evidence brought forth to show the existence of a partnership was unconvincing. How credible were their claims?

[1] The word prothonotary means first notary of the court. The prothonotary is the keeper of the civil records for the court system. The office is responsible for the creation, maintenance, and certification of matters pending or determined by the court. The office is also responsible for certain reporting and collection duties to state agencies.

[2] NRS 602.010(1): “Every person doing business in this state under an assumed or fictitious name that is in any way different from the legal name of each person who owns an interest in the business must file with the county clerk of each county in which the business is being conducted a certificate containing the information required by NRS 602.020.”

[3] NRS 602.070: “No action may be commenced or maintained by any person...upon or on account of any contract made or transaction had under the assumed or fictitious name, or upon or on account of any cause of action arising or growing out of the business conducted under that name, unless before the commencement of the action the certificate required by NRS 602.010 has been filed.”
18.4 Summary and Exercises

Summary

The basic law of partnership is found in the Uniform Partnership Act and Revised Uniform Partnership Act. The latter has been adopted by thirty-five states. At common law, a partnership was not a legal entity and could not sue or be sued in the partnership name. Partnership law defines a partnership as “an association of two or more persons to carry on as co-owners a business for profit.” The Uniform Partnership Act (UPA) assumes that a partnership is an aggregation of individuals, but it also applies a number of rules characteristic of the legal entity theory. The Revised Uniform Partnership Act (RUPA) assumes a partnership is an entity, but it applies one crucial rule characteristic of the aggregate theory: the partners are ultimately liable for the partnership’s obligations. Thus a partnership may keep business records as if it were a legal entity, may hold real estate in the partnership name, and may sue and be sued in federal court and in many state courts in the partnership name.

Partnerships may be created informally. Among the clues to the existence of a partnership are (1) co-ownership of a business, (2) sharing of profits, (3) right to participate in decision making, (4) duty to share liabilities, and (5) manner in which the business is operated. A partnership may also be formed by implication; it may be formed by estoppel when a third party reasonably relies on a representation that a partnership in fact exists.

No special rules govern the partnership agreement. As a practical matter, it should sufficiently spell out who the partners are, under what name they will conduct their business, the nature and scope of the business, capital contributions of each partner, how profits are to be divided, and similar pertinent provisions. An oral agreement to form a partnership is valid unless the business cannot be performed wholly within one year from the time that the agreement is made. However, most partnerships have no fixed terms and hence are “at-will” partnerships not subject to the Statute of Frauds.

Exercises

1. Able, Baker, and Carr own, as partners, a warehouse. The income from the warehouse during the current year is $300,000, two-thirds of which goes to Able. Who must file a tax return listing this as income, the partnership or Able? Who pays the tax, the partnership or Able?

2. The Havana Club operated in Salt Lake City under a lease running to defendant Dale Bowen, who owned the equipment, furnishings, and inventory. He did not himself work in operating the club. He made an oral
agreement with Frances Cutler, who had been working for him as a bartender, that she take over the management of the club. She was to have the authority and the responsibility for the entire active management and operation: to purchase the supplies, pay the bills, keep the books, hire and fire employees, and do whatever else was necessary to run the business. As compensation, the arrangement was for a down-the-middle split; each was to receive $300 per week plus one half of the net profits. This went on for four years until the city took over the building for a redevelopment project. The city offered Bowen $30,000 as compensation for loss of business while a new location was found for the club. Failing to find a suitable location, the parties decided to terminate the business. Bowen then contended he was entitled to the entire $30,000 as the owner, Cutler being an employee only. She sued to recover half as a partner. What was the result? Decide and discuss.

3. Raul, a business student, decided to lease and operate an ice cream stand during his summer vacation. Because he could not afford rent payments, his lessor agreed to take 30 percent of the profits as rent and provide the stand and the parcel of real estate on which it stood. Are the two partners?

4. Able, Baker, and Carr formed the ABC Partnership in 2001. In 2002 Able gave her three sons, Duncan, Eldon, and Frederick, a gift of her 41 percent interest in the partnership to provide money to pay for their college expenses. The sons reported income from the partnership on their individual tax returns, and the partnership reported the payment to them on its information return. The sons were listed as partners on unaudited balance sheets in 2003, and the 2004 income statement listed them as partners. The sons never requested information about the management of the firm, never attended any meetings or voted, and never attempted to withdraw the firm’s money or even speak with the other partners about the firm. Two of the sons didn’t know where the firm was located, but they all once received “management fees” totaling $3,000, without any showing of what the “fees” were for. In 2005, the partnership incurred liability for pension-fund contributions to an employee, and a trustee for the fund asserted that Able’s sons were personally liable under federal law for the money owing because they were partners. The sons moved for summary judgment denying liability. How should the court rule?

5. The Volkmans wanted to build a house and contacted David McNamee for construction advice. He told them that he was doing business with Phillip Carroll. Later the Volkmans got a letter from McNamee on stationery that read “DP Associates,” which they assumed was derived from the first names of David and Phillip. At the DP Associates office McNamee introduced Mr. Volkman to Carroll, who said to Volkman, “I
hope we’ll be working together.” At one point during the signing process a question arose and McNamee said, “I will ask Phil.” He returned with the answer to the question. After the contract was signed but before construction began, Mr. Volkman visited the DP Associates office where the two men chatted; Carroll said to him, “I am happy that we will be working with you.” The Volkmans never saw Carroll on the construction site and knew of no other construction supervised by Carroll. They understood they were purchasing Carroll’s services and construction expertise through DP Associates. During construction, Mr. Volkman visited the DP offices several times and saw Carroll there. During one visit, Mr. Volkman expressed concerns about delays and expressed the same to Carroll, who replied, “Don’t worry. David will take care of it.” But David did not, and the Volkmans sued DP Associates, McNamee, and Carroll. Carroll asserted he could not be liable because he and McNamee were not partners. The trial court dismissed Carroll on summary judgment; the Volkmans appealed. How should the court rule on appeal?

6. Wilson and VanBeek want to form a partnership. Wilson is seventeen and VanBeek is twenty-two. May they form a partnership? Explain.

7. Diane and Rachel operate a restaurant at the county fair every year to raise money for the local 4-H Club. They decide together what to serve, what hours to operate, and generally how to run the business. Do they have a partnership?
Chapter 19
Partnership Operation and Termination

LEARNING OBJECTIVES

After reading this chapter, you should understand the following:

1. The operation of a partnership, including the relations among partners and relations between partners and third parties
2. The dissolution and winding up of a partnership

19.1 Operation: Relations among Partners

LEARNING OBJECTIVES

1. Recognize the duties partners owe each other: duties of service, loyalty, care, obedience, information, and accounting.
2. Identify the rights that partners have, including the rights to distributions of money, to management, to choice of copartners, to property of the partnership, to assign partnership interest, and to enforce duties and rights.

Most of the rules discussed in this section apply unless otherwise agreed, and they are really intended for the small firm. The Uniform Partnership Act (UPA) and the Revised Uniform Partnership Act (RUPA) do not dictate what the relations among partners must be; the acts supply rules in the event that the partners have not done so for themselves. In this area, it is especially important for the partners to elaborate their agreement in writing. If the partners should happen to continue their business beyond the term fixed for it in their agreement, the terms of the agreement continue to apply.

Duties Partners Owe Each Other

Among the duties partners owe each other, six may be called out here: (1) the duty to serve, (2) the duty of loyalty, (3) the duty of care, (4) the duty of obedience, (5) the duty to inform copartners, and (6) the duty to account to the partnership. These are all very similar to the duty owed by an agent to the principal, as partnership law is based on agency concepts.

Duty to Serve

Unless otherwise agreed, expressly or impliedly, a partner is expected to work for the firm. The partnership, after all, is a profit-making co-venture, and it would not do for one to loaf about and still
expect to get paid. For example, suppose Joan takes her two-week vacation from the horse-stable partnership she operates with Sarah and Sandra. Then she does not return for four months because she has gone horseback riding in the Southwest. She might end up having to pay if the partnership hired a substitute to do her work.

**Duty of Loyalty**

In general, this requires partners to put the firm’s interests ahead of their own. Partners are *fiduciaries* as to each other and as to the partnership, and as such, they owe a fiduciary duty to each other and the partnership. Judge Benjamin Cardozo, in an often-quoted phrase, called the fiduciary duty “something stricter than the morals of the market place. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior.” [3] Breach of the fiduciary duty gives rise to a claim for compensatory, consequential, and incidental damages; recoupment of compensation; and—rarely—punitive damages. See Section 19.4.1 "Breach of Partnership Fiduciary Duty", *Gilroy v. Conway*, for an example of breach of fiduciary duty.

**Application of the Fiduciary Standard to Partnership Law**

Under UPA, all partners are fiduciaries of each other—they are all principals and agents of each other—though the word *fiduciary* was not used except in the *heading* to Section 21. The section reads, “Every partner must account to the partnership for any benefit, and hold as trustee for it any profits derived by him without the consent of the other partners from any transaction connected with the formation, conduct, or liquidation of the partnership or from any use by him of its property.”

Section 404 of RUPA specifically provides that a partner has a fiduciary duty to the partnership and other partners. It imposes the fiduciary standard on the duty of loyalty in three circumstances:

1. to account to the partnership and hold as trustee for it any property, profit, or benefit derived by the partner in the conduct and winding up of the partnership business or derived from a use by the partner of partnership property, including the appropriation of a partnership opportunity;
2. to refrain from dealing with the partnership in the conduct or winding up of the partnership business as or on behalf of a party having an interest adverse to the partnership; and
3. to refrain from competing with the partnership in the conduct of the partnership business before the dissolution of the partnership.
Limits on the Reach of the Fiduciary Duty

This sets out a fairly limited scope for application of the fiduciary standard, which is reasonable because partners do not delegate open-ended control to their copartners. Further, there are some specific limits on how far the fiduciary duty reaches (which means parties are held to the lower standard of “good faith”). Here are two examples. First, RUPA—unlike UPA—does not extend to the formation of the partnership; Comment 2 to RUPA Section 404 says that would be inappropriate because then the parties are “really dealing at arm’s length.” Second, fiduciary duty doesn’t apply to a dissociated partner (one who leaves the firm—discussed in Section 19 “Dissociation”) who can immediately begin competing without the others’ consent; and it doesn’t apply if a partner violates the standard “merely because the partner’s conduct furthers the partner’s own interest.” Moreover, the partnership agreement may eliminate the duty of loyalty so long as that is not “manifestly unreasonable.”

Activities Affected by the Duty of Loyalty

The duty of loyalty means, again, that partners must put the firm’s interest above their own. Thus it is held that a partner

- may not compete with the partnership,
- may not make a secret profit while doing partnership business,
- must maintain the confidentiality of partnership information.

This is certainly not a comprehensive list, and courts will determine on a case-by-case basis whether the duty of loyalty has been breached.

Duty of Care

Stemming from its roots in agency law, partnership law also imposes a duty of care on partners. Partners are to faithfully serve to the best of their ability. Section 404 of RUPA imposes the fiduciary standard on the duty of care, but rather confusingly: how does the “punctilio of an honor the most sensitive”—as Judge Cardozo described that standard—apply when under RUPA Section 404(c) the “the duty of care...is limited to refraining from engaging in grossly negligent or reckless conduct, intentional misconduct, or a knowing violation of law”? Recognize that a person can attend to business both loyally and negligently. For example, Alice Able, a partner in a law firm who is not very familiar with the firm’s computerized bookkeeping system, attempts to trace a missing check and in so doing erases a month’s worth of records. She has not breached her duty of care: maybe she was negligent, but not grossly negligent under RUPA.
Section 404(c). The partnership agreement may reduce the duty of care so long as it is not “unreasonably reduce[d]”; it may increase the standard too. [6]

**Duty of Obedience**

The partnership is a contractual relationship among the partners; they are all agents and principals of each other. Expressly or impliedly that means no partner can disobey the partnership agreement or fail to follow any properly made partnership decision. This includes the duty to act within the authority expressly or impliedly given in the partnership agreement, and a partner is responsible to the other partners for damages or losses arising from unauthorized activities.

**Duty to Inform Copartners**

As in the agency relationship, a partner is expected to inform copartners of notices and matters coming to her attention that would be of interest to the partnership.

**Duty to Account**

The partnership—and necessarily the partners—have a duty to allow copartners and their agents access to the partnership’s books and records and to provide “any information concerning the partnership’s business and affairs reasonably required for the proper exercise of the partner’s rights and duties under the partnership agreement [or this Act].” [7] The fiduciary standard is imposed upon the duty to account for “it any property, profit, or benefit derived by [a] partner,” as noted in RUPA Section 404. [8]

**The Rights That Partners Have in a Partnership**

Necessarily, for every duty owed there is a correlative right. So, for example, if a partner has a duty to account, the other partners and the partnership have a right to an accounting. Beyond that, partners have recognized rights affecting the operation of the partnership.

Here we may call out the following salient rights: (1) to distributions of money, (2) to management, (3) to choose copartners, (4) to property of the partnership, (5) to assign partnership interest, and (6) to enforce duties and rights.

**Rights to Distributions**

The purpose of a partnership is ultimately to distribute “money or other property from a partnership to a partner in the partner’s capacity.” [9] There are, however, various types of money distributions, including profits (and losses), indemnification, capital, and compensation.

**Right to Profits (and Losses)**
Profits and losses may be shared according to any formula on which the partners agree. For example, the partnership agreement may provide that two senior partners are entitled to 35 percent each of the profit from the year and the two junior partners are entitled to 15 percent each. The next year the percentages will be adjusted based on such things as number of new clients garnered, number of billable hours, or amount of income generated. Eventually, the senior partners might retire and each be entitled to 2 percent of the firm’s income, and the previous junior partners become senior, with new junior partners admitted.

If no provision is stated, then under RUPA Section 401(b), “each partner is entitled to an equal share of the partnership profits and is chargeable with a share of the partnership losses in proportion to the partner’s share of the profits.” Section 18(a) of the Uniform Partnership Act is to the same effect. The right to share in the profits is the reason people want to “make partner”: a partner will reap the benefits of other partners’ successes (and pay for their failures too). A person working for the firm who is not a partner is an associate and usually only gets only a salary.

**Right to Indemnification**

A partner who incurs liabilities in the normal course of business or to preserve its business or property is entitled to indemnification (UPA Section 18(b), RUPA Section 401(c)). The liability is a loan owing to the partner by the firm.

**Right to Return of Capital Contribution**

When a partner joins a partnership, she is expected to make a capital contribution to the firm; this may be deducted from her share of the distributed profit and banked by the firm in its capital account. The law provides that “the partnership must reimburse a partner for an advance of funds beyond the amount of the partner’s agreed capital contribution, thereby treating the advance as a loan.” [10] A partner may get a return of capital under UPA after creditors are paid off if the business is wound down and terminated. [11]

**Right to Compensation**

Section 401(d) of RUPA provides that “a partner is not entitled to remuneration for services performed for the partnership, except for reasonable compensation for services rendered in winding up the business of the partnership”; UPA Section 18(f) is to the same effect. A partner gets his money from the firm by sharing the profits, not by a salary or wages.

**Right to Management**
All partners are entitled to share equally in the management and conduct of the business, unless the partnership agreement provides otherwise. The partnership agreement could be structured to delegate more decision-making power to one class of partners (senior partners) than to others (junior partners), or it may give more voting weight to certain individuals. For example, perhaps those with the most experience will, for the first four years after a new partner is admitted, have more voting weight than the new partner.

**Right to Choose Partners**

A business partnership is often analogized to a marriage partnership. In both there is a relationship of trust and confidence between (or among) the parties; in both the poor judgment, negligence, or dishonesty of one can create liabilities on the other(s). In a good marriage or good partnership, the partners are friends, whatever else the legal relationship imposes. Thus no one is compelled to accept a partner against his or her will. Section 401(i) of RUPA provides, “A person may become a partner only with the consent of all of the partners.” UPA Section 18(g) is to the same effect; the doctrine is called delectus personae. The freedom to select new partners, however, is not absolute. In 1984, the Supreme Court held that Title VII of the Civil Rights Act of 1964—which prohibits discrimination in employment based on race, religion, national origin, or sex—applies to partnerships.

**Right to Property of the Partnership**

Partners are the owners of the partnership, which might not include any physical property; that is, one partner could contribute the building, furnishings, and equipment and rent those to the partnership (or those could count as her partnership capital contribution and become the partnership’s). But partnership property consists of all property originally advanced or contributed to the partnership or subsequently acquired by purchase or contribution. Unless a contrary intention can be shown, property acquired with partnership funds is partnership property, not an individual partner’s: “Property acquired by a partnership is property of the partnership and not of the partners individually.”

**Rights in Specific Partnership Property: UPA Approach**

Suppose that Able, who contributed the building and grounds on which the partnership business is conducted, suddenly dies. Who is entitled to her share of the specific property, such as inventory, the building, and the money in the cash register—her husband and children, or the other partners, Baker and Carr? Section 25(1) of UPA declares that the partners hold the partnership property.
as tenants in partnership. As spelled out in Section 25(2), the specific property interest of a tenant in partnership vests in the surviving partners, not in the heirs. But the heirs are entitled to the deceased partner’s interest in the partnership itself, so that while Baker and Carr may use the partnership property for the benefit of the partnership without consulting Able’s heirs, they must account to her heirs for her proper share of the partnership’s profits.

**Rights in Specific Property: RUPA Approach**

Section 501 of RUPA provides, “A partner is not a co-owner of partnership property and has no interest in partnership property which can be transferred, either voluntarily or involuntarily.” Partnership property is owned by the entity; UPA’s concept of tenants in partnership is abolished in favor of adoption of the entity theory. The result, however, is not different.

**Right to Assign Partnership Interest**

One of the hallmarks of the capitalistic system is that people should be able to dispose of their property interests more or less as they see fit. Partnership interests may be assigned to some extent.

**Voluntary Assignment**

At common law, assignment of a partner’s interest in the business—for example, as a mortgage in return for a loan—would result in a legal dissolution of the partnership. Thus in the absence of UPA, which changed the law, Baker’s decision to mortgage his interest in the car dealership in return for a $20,000 loan from his bank would mean that the three—Able, Baker, and Carr—were no longer partners. Section 27 of UPA declares that assignment of an interest in the partnership neither dissolves the partnership nor entitles the assignee “to interfere in the management or administration of the partnership business or affairs, or to require any information or account of partnership transactions, or to inspect the partnership books.” The assignment merely entitles the assignee to receive whatever profits the assignor would have received—this is the assignor’s transferable interest. Under UPA, this interest is assignable. Under RUPA, the same distinction is made between a partner’s interest in the partnership and a partner’s transferable interest. The Official Comment to Section 101 reads as follows: “‘Partnership interest’ or ‘partner’s interest in the partnership’ is defined to mean all of a partner’s interests in the partnership, including the partner’s transferable interest and all management and other rights. A partner’s ‘transferable interest’ is a more limited concept and means only his share of the profits and losses and right to receive distributions, that is, the partner’s economic interests.”
This transferable interest is assignable under RUPA 503 (unless the partners agree to restrict transfers, Section 103(a)). It does not, by itself, cause the dissolution of the partnership; it does not entitle the transferee to access to firm information, to participate in running the firm, or to inspect or copy the books. The transferee is entitled to whatever distributions the transferor partner would have been entitled to, including, upon dissolution of the firm, the net amounts the transferor would have received had there been no assignment.

RUPA Section 101(b)(3) confers standing on a transferee to seek a judicial dissolution and winding up of the partnership business as provided in Section 801(6), thus continuing the rule of UPA Section 32(2). But under RUPA 601(4)(ii), the other partners may by unanimous vote expel a partner who has made “a transfer of all or substantially all of that partner’s transferable interest in the partnership, other than a transfer for security purposes [as for a loan].” Upon a creditor foreclosure of the security interest, though, the partner may be expelled.

**Involuntary Assignment**

It may be a misnomer to describe an involuntary assignment as a “right”; it might better be thought of as a consequence of the right to own property. In any event, if a partner is sued in his personal capacity and a judgment is rendered against him, the question arises: may the judgment creditor seize partnership property? Section 28 of UPA and RUPA Section 504 permit a judgment creditor to obtain a charging order, which charges the partner’s interest in the partnership with obligation to satisfy the judgment. The court may appoint a receiver to ensure that partnership proceeds are paid to the judgment creditor. But the creditor is not entitled to specific partnership property. The partner may always pay off the debt and redeem his interest in the partnership. If the partner does not pay off the debt, the holder of the charging order may acquire legal ownership of the partner’s interest. That confers upon the judgment creditor an important power: he may, if the partnership is one at will, dissolve the partnership and claim the partner’s share of the assets. For that reason, the copartners might wish to redeem the interest—pay off the creditor—in order to preserve the partnership. As with the voluntary assignment, the assignee of an involuntary assignment does not become a partner. See Figure 19.1 "Property Rights".

*Figure 19.1 Property Rights*
Right to Enforce Partnership Rights

The rights and duties imposed by partnership law are, of course, valueless unless they can be enforced. Partners and partnerships have mechanisms under the law to enforce them.

Right to Information and Inspection of Books

We noted in Section 19.1.1 "Duties Partners Owe Each Other" of this chapter that partners have a duty to account; the corollary right is the right to access books and records, which is usually very important in determining partnership rights. Section 403(b) of RUPA provides, “A partnership shall provide partners and their agents and attorneys access to its books and records. It shall provide former partners and their agents and attorneys access to books and records pertaining to the period during which they were partners. The right of access provides the opportunity to inspect and copy books and records during ordinary business hours. A partnership may impose a reasonable charge, covering the costs of labor and material, for copies of documents furnished.” [18]

Section 19 of UPA is basically in accord. This means that without demand—and for any purpose—the partnership must provide any information concerning its business and affairs reasonably required for the proper exercise of the partner’s rights and duties under the partnership agreement or the act; and on demand, it must provide any other information concerning the partnership’s business and affairs, unless the demand is unreasonable or improper. [19] Generally, the partnership agreement cannot deny the right to inspection.

The duty to account mentioned in Section 19.1.1 "Duties Partners Owe Each Other" of this chapter normally means that the partners and the partnership should keep reasonable records so everyone can tell what is going on. A formal accounting under UPA is different.

Under UPA Section 22, any partner is entitled to a formal account (or accounting) of the partnership affairs under the following conditions:
1. If he is wrongfully excluded from the partnership business or possession of its property by his copartners;
2. If the right exists under the terms of any agreement;
3. If a partner profits in violation of his fiduciary duty (as per UPA 22); and
4. Whenever it is otherwise just and reasonable.

At common law, partners could not obtain an accounting except in the event of dissolution. But from an early date, equity courts would appoint a referee, auditor, or special master to investigate the books of a business when one of the partners had grounds to complain, and UPA broadened considerably the right to an accounting. The court has plenary power to investigate all facets of the business, evaluate claims, declare legal rights among the parties, and order money judgments against any partner in the wrong.

Under RUPA Section 405, this “accounting” business is somewhat modified. Reflecting the entity theory, the partnership can sue a partner for wrongdoing, which is not allowed under UPA. Moreover, to quote from the Official Comment, RUPA “provides that, during the term of the partnership, partners may maintain a variety of legal or equitable actions, including an action for an accounting, as well as a final action for an accounting upon dissolution and winding up. It reflects a new policy choice that partners should have access to the courts during the term of the partnership to resolve claims against the partnership and the other partners, leaving broad judicial discretion to fashion appropriate remedies[, and] an accounting is not a prerequisite to the availability of the other remedies a partner may have against the partnership or the other partners.”

**KEY TAKEAWAY**

Partners have important duties in a partnership, including (1) the duty to serve—that is, to devote herself to the work of the partnership; (2) the duty of loyalty, which is informed by the fiduciary standard: the obligation to act always in the best interest of the partnership and not in one’s own best interest; (3) the duty of care—that is, to act as a reasonably prudent partner would; (4) the duty of obedience not to breach any aspect of the agreement or act without authority; (5) the duty to inform copartners; and (6) the duty to account to the partnership.

Partners also have rights. These include the rights (1) to distributions of money, including profits (and losses), indemnification, and return of capital contribution (but not a right to compensation); (2) to management; (3) to choose copartners; (4) to property of the partnership, and no partner has any rights to
specific property; (5) to assign (voluntarily or involuntarily) the partnership interest; and (6) to enforce
duties and rights by suits in law or equity. (Under RUPA, a formal accounting is not first required.)

**EXERCISES**

1. What is the “fiduciary duty,” and why is it imposed on some partners’ actions with the partnership?
2. Distinguish between ownership of partnership property under UPA as opposed to under RUPA.
3. Carlos obtained a judgment against Pauline, a partner in a partnership, for negligently crashing her car into Carlos’s while she was not in the scope of partnership business. Carlos wants to satisfy the judgment from her employer. How can Carlos do that?
4. What is the difference between the duty to account and a formal partnership accounting?
5. What does it mean to say a partnership interest has been involuntarily assigned?


[2] Revised Uniform Partnership Act, Section 404, Comment 3: “Indeed, the law of partnership reflects the broader law of principal and agent, under which every agent is a fiduciary.”


[4] RUPA, Section 503(b)(2); RUPA, Section 404(e).


[6] RUPA, Section 103(2)(d); RUPA, Section 103.

[7] UPA, Sections 19 and 20; RUPA, Section 403.

[8] RUPA, Section 404(1).


[10] UPA, Section 18(c); RUPA, Section 401(d).

[11] UPA, Section 40(b); RUPA, Section 807(b).

[12] UPA, Section 18(e); RUPA, Section 401(f).


[14] RUPA, Section 203; UPA, Sections 8(1) and 25.

19.2 Operation: The Partnership and Third Parties

LEARNING OBJECTIVES

1. Understand the partners’ and partnership’s contract liability.
2. Understand the partners’ and partnership’s tort and criminal liability.
3. Describe the partners’ and partnership’s tax liability.

By express terms, the law of agency applies to partnership law. Every partner is an agent of the partnership for the purpose of its business. Consequently, the following discussion will be a review of agency law, covered in Chapter 18 "Partnerships: General Characteristics and Formation" as it applies to partnerships. The Revised Uniform Partnership Act (RUPA) adds a few new wrinkles to the liability issue.

Contract Liability

Liability of the Partnership

Recall that an agent can make contracts on behalf of a principal under three types of authority: express, implied, and apparent. Express authority is that explicitly delegated to the agent, implied authority is that necessary to the carrying out of the express authority, and apparent authority is that which a third party is led to believe has been conferred by the principal on the agent, even though in fact it was not or it was revoked. When a partner has authority, the partnership is bound by contracts the partner makes on its behalf. Section 19.4.2 "Partnership Authority, Express or Apparent", Hodge v. Garrett, discusses all three types of authority.

The General Rule

Section 305 of RUPA restates agency law: “A partnership is liable for loss or injury, or for a penalty incurred, as a result of a wrongful act or omission, or other actionable conduct, of a partner acting in the ordinary course” ([1]) of partnership business or with its authority. The ability of a partner to bind the
Partnership to contract liability is problematic, especially where the authority is apparent: the firm denies liability, lawsuits ensue, and unhappiness generally follows.

But the firm is not liable for an act not apparently in the ordinary course of business, unless the act was authorized by the others. Section 401(j) of RUPA requires the unanimous consent of the partners for a grant of authority outside the ordinary course of business, unless the partnership agreement provides otherwise.

Under the Uniform Partnership Act (UPA) Section 9(3), the firm is not liable for five actions that no single partner has implied or apparent authority to do, because they are not “in the ordinary course of partnership.” These actions are: (1) assignment of partnership property for the benefit of creditors, (2) disposing of the firm’s goodwill (selling the right to do business with the firm’s clients to another business), (3) actions that make it impossible to carry on the business, (4) confessing a judgment against the partnership, and (5) submitting a partnership claim or liability. RUPA omits that section, leaving it to the courts to decide the outer limits of the agency power of a partner. In any event, unauthorized actions by a partner may be ratified by the partnership.

**Partnership “Statements”**

New under RUPA is the ability of partnerships, partners, or even nonpartners to issue and file “statements” that announce to the world the establishment or denial of authority. The goal here is to control the reach of apparent authority. There are several kinds of statements authorized.

A statement of partnership authority is allowed by RUPA Section 303. It specifies the names of the partners authorized, or not authorized, to enter into transactions on behalf of the partnership and any other matters. The most important goal of the statement of authority is to facilitate the transfer of real property held in the name of the partnership. A statement must specify the names of the partners authorized to execute an instrument transferring that property.

A statement of denial, RUPA Section 304, operates to allow partners (and persons named as partners) an opportunity to deny any fact asserted in a statement of partnership authority.

A statement of dissociation, RUPA Section 704, may be filed by a partnership or a dissociated partner, informing the world that the person is no longer a partner. This tells the world that the named person is no longer in the partnership.
There are three other statements authorized: a statement of qualification establishes that the partnership has satisfied all conditions precedent to the qualification of the partnership as a limited liability partnership; a statement of foreign qualification means a limited liability partnership is qualified and registered to do business in a state other than that in which it is originally registered; and a statement of amendment or cancellation of any of the foregoing. Limited liability partnerships are taken up in Chapter 20 "Hybrid Business Forms".

Generally, RUPA Section 105 allows partnerships to file these statements with the state secretary of state’s office; those affecting real estate need to be filed with (or also with) the local county land recorder’s office. The notices bind those who know about them right away, and they are constructive notice to the world after ninety days as to authority to transfer real property in the partnership’s name, as to dissociation, and as to dissolution. However, as to other grants or limitations of authority, “only a third party who knows or has received a notification of a partner’s lack of authority in an ordinary course transaction is bound.” Since RUPA is mostly intended to provide the rules for the small, unsophisticated partnership, it is questionable whether these arcane “statements” are very often employed.

**Personal Liability of Partners, in General**

It is clear that the partnership is liable for contracts by authorized partners, as discussed in the preceding paragraphs. The bad thing about the partnership as a form of business organization is that it imposes liability on the partners personally and without limit. Section 306 of RUPA provides that “all partners are liable jointly and severally for all obligations of the partnership unless otherwise agreed by the claimant or provided by law.” Section 13 of UPA is in accord.

**Liability of Existing Partners**

Contract liability is joint and several: that is, all partners are liable (“joint”) and each is “several.” (We usually do not use several in modern English to mean “each”; it’s an archaic usage.) But—and here’s the intrusion of entity theory—generally RUPA requires the judgment creditor to exhaust the partnership’s assets before going after the separate assets of a partner. Thus under RUPA the partners are guarantors of the partnership’s liabilities.

Under UPA, contract liability is joint only, not also several. This means the partners must be sued in a joint action brought against them all. A partner who is not named cannot later be sued by a creditor in a
separate proceeding, though the ones who were named could see a proportionate contribution from the ones who were not.

**Liability of Incoming Partners**

Under RUPA Section 306(b), a new partner has no personal liability to existing creditors of the partnership, and only her capital investment in the firm is at risk for the satisfaction of existing partnership debts. Sections 17 and 41(7) of UPA are in accord. But, again, under either statute a new partner’s personal assets are at risk with respect to partnership liabilities incurred after her admission as a partner. This is a daunting prospect, and it is the reason for the invention of hybrid forms of business organization: limited partnerships, limited liability companies, and limited liability partnerships. The corporate form, of course, also (usually) obviates the owners’ personal liability.

**Tort and Criminal Liability**

**Partnership Liability for Torts**

The rules affecting partners’ tort liability (discussed in Section 19.2.1 "Contract Liability") and those affecting contract liability are the same. Section 13 of UPA says the partnership is liable for “any wrongful act or omission of any partner acting in the ordinary course of the business of the partnership or with the authority of his co-partners.” \[7\] A civil “wrongful act” is necessarily either a tort or a breach of contract, so no distinction is made between them. (Section 305 of RUPA changed the phraseology slightly by adding after *any wrongful act or omission* the words *or other actionable conduct*; this makes the partnership liable for its partner’s no-fault torts.) That the principal should be liable for its agents’ wrongdoings is of course basic agency law. RUPA does expand liability by allowing a partner to sue during the term of the partnership without first having to get out of it, as is required under UPA.

For tortious acts, the partners are said to be jointly and severally liable under both UPA and RUPA, and the plaintiff may separately sue one or more partners. Even after winning a judgment, the plaintiff may sue other partners unnamed in the original action. Each and every partner is separately liable for the entire amount of the debt, although the plaintiff is not entitled to recover more than the total of his damages. The practical effect of the rules making partners personally liable for partnership contracts and torts can be huge. In his classic textbook Economics, Professor Paul Samuelson observed that unlimited liability "reveals why partnerships tend to be confined to small, personal enterprises....When it becomes a question of placing their personal fortunes in jeopardy, people are reluctant to put their capital into
complex ventures over which they can exercise little control....In the field of investment banking, concerns like JPMorgan Chase used to advertise proudly ‘not incorporated’ so that their creditors could have extra assurance. But even these concerns have converted themselves into corporate entities.” [8]

**Partners’ Personal Liability for Torts**

Of course, a person is always liable for his own torts. All partners are also liable for any partner’s tort committed in the scope of partnership business under agency law, and this liability is—again—personal and unlimited, subject to RUPA’s requirement that the judgment creditor exhaust the partnership’s assets before going after the separate assets of the partners. The partner who commits a tort or breach of trust must indemnify the partnership for losses paid to the third party. [9]

**Liability for Crimes**

Criminal liability is generally personal to the miscreant. Nonparticipating copartners are ordinarily not liable for crimes if guilty intent is an element. When guilty intent is not an element, as in certain regulatory offenses, all partners may be guilty of an act committed by a partner in the course of the business.

**Liability for Taxes**

Corporate income gets taxed twice under federal law: once to the corporation and again to the shareholders who receive income as dividends. However, the partnership’s income “passes through” the partnership and is distributed to the partners under the conduit theory. When partners get income from the firm they have to pay tax on it, but the partnership pays no tax (it files an information return). This is perceived to be a significant advantage of the partnership form.

**KEY TAKEAWAY**

The partnership is generally liable for any contract made by a partner with authority express, implied, or apparent. Under RUPA the firm, partners, or even nonpartners may to some extent limit their liability by filing “statements” with the appropriate state registrar; such statements only affect those who know of them, except that a notice affecting the right of a partner to sell real estate or regarding dissociation or dissolution is effective against the world after ninety days.

All partners are liable for contracts entered into and torts committed by any partner acting in or apparently in the normal course of business. This liability is personal and unlimited, joint and several (although under UPA contract liability it is only joint). Incoming partners are not liable, in contract or in
tort, for activities predating their arrival, but their capital contribution is at risk. Criminal liability is generally personal unless the crime requires no intention.

**EXERCISES**

1. What is the partnership’s liability for contracts entered into by its partners?
2. What is the personal liability of partners for breach of a contract made by one of the partnership’s members?
3. Why would people feel more comfortable knowing that JPMorgan Bank—Morgan was at one time the richest man in the United States—was a partnership and not a corporation?
4. What is the point of RUPA’s “statements”? How can they be of use to a partner who has, for example, retired and is no longer involved in the firm?
5. Under what circumstances is the partnership liable for crimes committed by its partners?
6. How is a partnership taxed more favorably than a corporation?

[1] RUPA Section 305.
[2] RUPA, Section 301(2); UPA, Section 9(2).
[3] RUPA, Section 1001(d); RUPA, Section 1102.
[9] RUPA, Section 405(a).

### 19.3 Dissolution and Winding Up

**LEARNING OBJECTIVES**

1. Understand the dissolution of general partnerships under the Uniform Partnership Act (UPA).
2. Understand the dissociation and dissolution of general partnerships under the Revised Uniform Partnership Act (RUPA).
3. Explain the winding up of partnerships under UPA and RUPA.

It is said that a partnership is like a marriage, and that extends to its ending too. It’s easier to get into a partnership than it is to get out of it because legal entanglements continue after a person is no longer a partner. The rules governing “getting out” of a partnership are different under the Revised Uniform Partnership Act (RUPA) than under the Uniform Partnership Act (UPA). We take up UPA first.

**Dissolution of Partnerships under UPA**

_Dissolution_, in the most general sense, means a separation into component parts.

**Meaning of Dissolution under UPA**

People in business are sometimes confused about the meaning of dissolution. It does not mean the termination of a business. It has a precise legal definition, given in UPA Section 29: “The dissolution of a partnership is the change in the relation of the partners caused by any partner ceasing to be associated in the carrying on as distinguished from the winding up of the business.” The partnership is not necessarily terminated on dissolution; rather, it continues until the winding up of partnership affairs is completed, and the remaining partners may choose to continue on as a new partnership if they want. But, again, under UPA the partnership dissolves upon the withdrawal of any partner.

**Causes of Dissolution**

Partnerships can dissolve for a number of reasons.

**In Accordance with the Agreement**

The term of the partnership agreement may have expired or the partnership may be at will and one of the partners desires to leave it. All the partners may decide that it is preferable to dissolve rather than to continue. One of the partners may have been expelled in accordance with a provision in the agreement. In none of these circumstances is the agreement violated, though its spirit surely might have been. Professor Samuelson calls to mind the example of William Dean Howells’s Silas Lapham, who forces his partner to sell out by offering him an ultimatum: “You may buy me out or I’ll buy you out.” The ultimatum was given at a time when the partner could not afford to buy Lapham out, so the partner had no choice.

**In Violation of the Agreement**

Dissolution may also result from violation of the agreement, as when the partners decide to discharge a partner though no provision permits them to do so, or as when a partner decides to quit in violation of a term agreement. In the former case, the remaining partners are liable for damages for wrongful
dissolution, and in the latter case, the withdrawing partner is liable to the remaining partners the same way.

**By Operation of Law**

A third reason for dissolution is the occurrence of some event, such as enactment of a statute, that makes it unlawful to continue the business. Or a partner may die or one or more partners or the entire partnership may become bankrupt. Dissolution under these circumstances is said to be by operation of law. [3]

**By Court Order**

Finally, dissolution may be by court order. Courts are empowered to dissolve partnerships when “on application by or for a partner” a partner is shown to be a lunatic, of unsound mind, incapable of performing his part of the agreement, “guilty of such conduct as tends to affect prejudicially the carrying on of the business,” or otherwise behaves in such a way that “it is not reasonably practicable to carry on the business in partnership with him.” A court may also order dissolution if the business can only be carried on at a loss or whenever equitable. In some circumstances, a court will order dissolution upon the application of a purchaser of a partner’s interest. [4]

**Effect of Dissolution on Authority**

For the most part, dissolution terminates the authority of the partners to act for the partnership. The only significant exceptions are for acts necessary to wind up partnership affairs or to complete transactions begun but not finished at the time of dissolution. [5] Notwithstanding the latter exception, no partner can bind the partnership if it has dissolved because it has become unlawful to carry on the business or if the partner seeking to exercise authority has become bankrupt.

**After Dissolution**

After a partnership has dissolved, it can follow one of two paths. It can carry on business as a new partnership, or it can wind up the business and cease operating (see Figure 19.2 "Alternatives Following UPA Dissolution").

*Figure 19.2 Alternatives Following UPA Dissolution*
Forming a New Partnership

In order to carry on the business as a new partnership, there must be an agreement—preferably as part of the original partnership agreement but maybe only after dissolution (and maybe oral)—that upon dissolution (e.g., if a partner dies, retires, or quits) the others will regroup and carry on. Under UPA the remaining partners have the right to carry on when (1) the dissolution was in contravention of the agreement, (2) a partner was expelled according to the partnership agreement, or (3) all partners agree to carry on.\textsuperscript{6}

Whether the former partner dies or otherwise quits the firm, the noncontinuing one or his, her, or its legal representative is entitled to an accounting and to be paid the value of the partnership interest, less damages for wrongful dissolution.\textsuperscript{7} The firm may need to borrow money to pay the former partner or her estate; or, in the case of a deceased partner, the money to pay the former partner is obtained through a life insurance buyout policy.

Partnerships routinely insure the lives of the partners, who have no ownership interests in the insurance policies. The policies should bear a face amount equal to each partner's interest in the partnership and should be adjusted as the fortunes of the partnership change. Proceeds of the insurance policy are used on
death to pay the purchase price of the interest inherited by the deceased’s estate. If the insurance policy pays out more than the interest at stake, the partnership retains the difference. If the policy pays out less, the partnership agrees to pay the difference in installments.

Another set of issues arises when the partnership changes because an old partner departs and a new one joins. Suppose that Baker leaves the car dealership business and his interest is purchased by Alice, who is then admitted to the partnership. Assume that when Baker left, the business owed Mogul Parts Company $5,000 and Laid Back Upholsterers $4,000. After Baker left and Alice joined, Mogul sells another $5,000 worth of parts to the firm on credit, and Sizzling Radiator Repair, a new creditor, advances $3,000 worth of radiator repair parts. These circumstances pose four questions.

First, do creditors of the old partnership remain creditors of the new partnership? Yes. [8]

Second, does Baker, the old partner, remain liable to the creditors of the old partnership? Yes. [9] That could pose uncomfortable problems for Baker, who may have left the business because he lost interest in it and wished to put his money elsewhere. The last thing he wants is the threat of liability hanging over his head when he can no longer profit from the firm’s operations. That is all the more true if he had a falling out with his partners and does not trust them. The solution is given in UPA Section 36(2), which says that an old partner is discharged from liability if the creditors and the new partnership agree to discharge him.

Third, is Alice, the new partner, liable to creditors of the old partnership? Yes, but only to the extent of her capital contribution. [10]

Fourth, is Baker, the old partner, liable for debts incurred after his withdrawal from the partnership? Surprisingly, yes, unless Baker takes certain action toward old and new creditors. He must provide actual notice that he has withdrawn to anyone who has extended credit in the past. Once he has done so, he has no liability to these creditors for credit extended to the partnership thereafter. Of course, it would be difficult to provide notice to future creditors, since at the time of withdrawal they would not have had a relationship with the partnership. To avoid liability to new creditors who knew of the partnership, the solution required under UPA Section 35(l)(b)(II) is to advertise Baker’s departure in a general circulation newspaper in the place where the partnership business was regularly carried on.

**Winding Up and Termination**

Because the differences between UPA’s and RUPA’s provisions for winding up and termination are not as significant as those between their provisions for dissolution, the discussion for winding up and
termination will cover both acts at once, following the discussion of dissociation and dissolution under RUPA.

**Dissociation and Dissolution of Partnerships under RUPA**

Comment 1 to RUPA Section 601 is a good lead-in to this section. According to the comment, RUPA dramatically changes the law governing partnership breakups and dissolution. An entirely new concept, “dissociation,” is used in lieu of UPA term “dissolution” to denote the change in the relationship caused by a partner’s ceasing to be associated in the carrying on of the business. “Dissolution” is retained but with a different meaning. The entity theory of partnership provides a conceptual basis for continuing the firm itself despite a partner’s withdrawal from the firm.

Under UPA, the partnership is an aggregate, a collection of individuals; upon the withdrawal of any member from the collection, the aggregate dissolves. But because RUPA conforms the partnership as an entity, there is no conceptual reason for it to dissolve upon a member’s withdrawal. “Dissociation” occurs when any partner ceases to be involved in the business of the firm, and “dissolution” happens when RUPA requires the partnership to wind up and terminate; dissociation does not necessarily cause dissolution.

**Dissociation**

Dissociation, as noted in the previous paragraph, is the change in relations caused by a partner’s withdrawal from the firm’s business.

**Causes of Dissociation**

Dissociation is caused in ten possible ways: (1) a partner says she wants out; (2) an event triggers dissociation as per the partnership agreement; (3) a partner is expelled as per the agreement; (4) a partner is expelled by unanimous vote of the others because it is unlawful to carry on with that partner, because that partner has transferred to a transferee all interest in the partnership (except for security purposes), or because a corporate partner’s or partnership partner’s existence is effectively terminated; (5) by a court order upon request by the partnership or another partner because the one expelled has been determined to have misbehaved (engaged in serious wrongful conduct, persists in abusing the agreement, acts in ways making continuing the business impracticable); (6) the partner has declared bankruptcy; (7) the partner has died or had a guardian appointed, or has been adjudicated as incompetent; (8) the partner is a trust whose assets are exhausted; (9) the partner is an estate and the estate’s interest in the
partnership has been entirely transferred; (10) the partner dies or, if the partner is another partnership or a corporation trust or estate, that entity's existence is terminated. [11]

**Effect of Dissociation**

After a partner dissociates, the partner’s right to participate in management terminates. (However, if the dissociation goes on to dissolution and winding up, partners who have not wrongfully caused the dissociation may participate in winding-up activities.) [12] The dissociated partner’s duty of loyalty and care terminates; the former partner may compete with the firm, except for matters arising before the dissociation. [13]

When partners come and go, as they do, problems may arise. What power does the dissociated partner have to bind the partnership? What power does the partnership have to impose liability on the dissociated one? RUPA provides that the dissociated partner loses any actual authority upon dissociation, and his or her apparent authority lingers for not longer than two years if the dissociated one acts in a way that would have bound the partnership before dissociation, provided the other party (1) reasonably believed the dissociated one was a partner, (2) did not have notice of the dissociation, and (3) is not deemed to have constructive notice from a filed “statement of dissociation.” [14] The dissociated partner, of course, is liable for damages to the partnership if third parties had cause to think she was still a partner and the partnership became liable because of that; she is liable to the firm as an unauthorized agent. [15]

A partner’s dissociation does nothing to change that partner’s liability for predissociation obligations. [16] For postdissociation liability, exposure is for two years if at the time of entering into the transaction the other party (1) reasonably believed the dissociated one was a partner, (2) didn’t have notice of the dissociation, and (3) is not deemed to have constructive notice from a filed “statement of dissociation.” For example, Baker withdraws from the firm of Able, Baker, and Carr. Able contracts with HydroLift for a new hydraulic car lift that costs $25,000 installed. HydroLift is not aware at the time of contracting that Baker is disassociated and believes she is still a partner. A year later, the firm not having been paid, HydroLift sues Able, Baker, and Carr and the partnership. Baker has potential liability. Baker could have protected herself by filing a “statement of dissociation,” or—better—the partnership agreement should provide that the firm would file such statements upon the dissociation of any partner (and if it does not, it would be liable to her for the consequences).

**Dissolution**
Dissociation does not necessarily cause dissolution (see the discussion later in this section of how the firm continues after a dissociation); dissolution and winding up happen only for the causes stated in RUPA Section 801, discussed in the following paragraphs.

**Causes of Dissolution**

There are three causes of dissolution: (1) by act of the partners—some dissociations do trigger dissolution; (2) by operation of law; or (3) by court order. The partnership agreement may change or eliminate the dissolution trigger as to (1); dissolution by the latter two means cannot be tinkered with. [17]

(1) Dissolution by *act of the partners* may occur as follows:

- Any member of an at-will partnership can dissociate at any time, triggering dissolution and liquidation. The partners who wish to continue the business of a term partnership, though, cannot be forced to liquidate the business by a partner who withdraws prematurely in violation of the partnership agreement. In any event, common agreement formats for dissolution will provide for built-in dispute resolution, and enlightened partners often agree to such mechanisms in advance to avoid the kinds of problems listed here.

- Any partnership will dissolve upon the happening of an event the partners specified would cause dissolution in their agreement. They may change their minds, of course, agree to continue, and amend the partnership agreement accordingly.

- A term partnership may be dissolved before its term expires in three ways. First, if a partner dissociated by death, declaring bankruptcy, becoming incapacitated, or wrongfully dissociates, the partnership will dissolve if within ninety days of that triggering dissociation at least half the remaining partners express their will to wind it up. Second, the partnership may be dissolved if the term expires. Third, it may be dissolved if all the partners agree to amend the partnership agreement by expressly agreeing to dissolve.

(2) Dissolution will happen in some cases by *operation of law* if it becomes illegal to continue the business, or substantially all of it. For example, if the firm’s business was the manufacture and distribution of trans fats and it became illegal to do that, the firm would dissolve. [18] This cause of dissolution is not subject to partnership agreement.
(3) *Dissolution by court order* can occur on application by a partner. A court may declare that it is, for various reasons specified in RUPA Section 801(5), no longer reasonably practicable to continue operation. Also, a court may order dissolution upon application by a transferee of a partner’s transferable interest or by a purchaser at a foreclosure of a charging order if the court determines it is equitable. For example, if Creditor gets a charging order against Paul Partner and the obligation cannot reasonably be paid by the firm, a court could order dissolution so Creditor would get paid from the liquidated assets of the firm.

**Effect of Dissolution**

A partnership continues after dissolution only for the purpose of winding up its business. The partnership is terminated when the winding up of its business is completed. However, before winding up is completed, the partners—except any wrongfully dissociating—may agree to carry on the partnership, in which case it resumes business as if dissolution never happened.

**Continuing after Dissociation**

Dissociation, again, does not necessarily cause dissolution. In an at-will partnership, the death (including termination of an entity partner), bankruptcy, incapacity, or expulsion of a partner will not cause dissolution. In a term partnership, the firm continues if, within ninety days of an event triggering dissociation, fewer than half the partners express their will to wind up. The partnership agreement may provide that RUPA’s dissolution-triggering events, including dissociation, will not trigger dissolution. However, the agreement cannot change the rules that dissolution is caused by the business becoming illegal or by court order. Creditors of the partnership remain as before, and the dissociated partner is liable for partnership obligations arising before dissociation.

Section 701 of RUPA provides that if the firm continues in business after a partner dissociates, without winding up, then the partnership must purchase the dissociated partner’s interest; RUPA Section 701(b) explains how to determine the buyout price. It is the amount that would have been distributed to the dissociated partner if, on the date of dissociation, the firm’s assets were sold “at a price equal to the greater of the liquidation value or the value based on a sale of the entire business as a going concern,” minus damages for wrongful dissociation. A wrongful dissociater may have to wait a while to get paid in full, unless a court determines that immediate payment “will not cause an undue hardship to the partnership,” but the longest nonwrongful dissociaters need to wait is 120 days. A dissociated partner
can sue the firm to determine the buyout price and the court may assess attorney’s, appraiser’s, and expert’s fees against a party the court finds “acted arbitrarily, vexatiously, or in bad faith.” [23]

**Winding Up the Partnership under UPA and RUPA**

If the partners decide not to continue the business upon dissolution, they are obliged to wind up the business. The partnership continues after dissolution only for the purpose of winding up its business, after which it is terminated. [24] Winding up entails concluding all unfinished business pending at the date of dissolution and payment of all debts. The partners must then settle accounts among themselves in order to distribute the remaining assets. At any time after dissolution and before winding up is completed, the partners (except a wrongfully dissociated one) can stop the process and carry on the business.

UPA and RUPA are not significantly different as to winding up, so they will be discussed together. Two issues are discussed here: who can participate in winding up and how the assets of the firm are distributed on liquidation.

**Who Can Participate in Winding Up**

The partners who have not wrongfully dissociated may participate in winding up the partnership business. On application of any partner, a court may for good cause judicially supervise the winding up. [25]

**Settlement of Accounts among Partners**

Determining the priority of liabilities can be problematic. For instance, debts might be incurred to both outside creditors and partners, who might have lent money to pay off certain accounts or for working capital.

An agreement can spell out the order in which liabilities are to be paid, but if it does not, UPA Section 40(a) and RUPA Section 807(1) rank them in this order: (1) to creditors other than partners, (2) to partners for liabilities other than for capital and profits, (3) to partners for capital contributions, and finally (4) to partners for their share of profits (see Figure 19.3 "Priority Partnership Liabilities under RUPA"). However, RUPA eliminates the distinction between capital and profits when the firm pays partners what is owed to them; RUPA Section 807(b) speaks simply of the right of a partner to a liquidating distribution.

*Figure 19.3 Priority Partnership Liabilities under RUPA*
Partners are entitled to share equally in the profits and surplus remaining after all liabilities, including those owed to partners, are paid off, although the partnership agreement can state a different share—for example, in proportion to capital contribution. If after winding up there is a net loss, whether capital or otherwise, each partner must contribute toward it in accordance with his share in the profits, had there been any, unless the agreement states otherwise. If any of the partners is insolvent or refuses to contribute and cannot be sued, the others must contribute their own share to pay off the liabilities and in addition must contribute, in proportion to their share of the profits, the additional amount necessary to pay the liabilities of their defaulting partners.

In the event of insolvency, a court may take possession of both partnership property and individual assets of the partners; this again is a big disadvantage to the partnership form.

The estate of a deceased partner is credited or liable as that partner would have been if she were living at the time of the distribution.

**KEY TAKEAWAY**

Under UPA, the withdrawal of any partner from the partnership causes dissolution; the withdrawal may be caused in accordance with the agreement, in violation of the agreement, by operation of law, or by court order. Dissolution terminates the partners’ authority to act for the partnership, except for winding up, but remaining partners may decide to carry on as a new partnership or may decide to terminate the firm. If they continue, the old creditors remain as creditors of the new firm, the former partner remains liable for obligations incurred while she was a partner (she may be liable for debts arising after she left, unless proper notice is given to creditors), and the former partner or her estate is entitled to an accounting and payment for the partnership interest. If the partners move to terminate the firm, winding up begins.
Under RUPA, a partner who ceases to be involved in the business is dissociated, but dissociation does not necessarily cause dissolution. Dissociation happens when a partner quits, voluntarily or involuntarily; when a partner dies or becomes incompetent; or on request by the firm or a partner upon court order for a partner’s wrongful conduct, among other reasons. The dissociated partner loses actual authority to bind the firm but remains liable for predissociation obligations and may have lingering authority or lingering liability for two years provided the other party thought the dissociated one was still a partner; a notice of dissociation will, after ninety days, be good against the world as to dissociation and dissolution. If the firm proceeds to termination (though partners can stop the process before its end), the next step is dissolution, which occurs by acts of partners, by operation of law, or by court order upon application by a partner if continuing the business has become untenable. After dissolution, the only business undertaken is to wind up affairs. However, the firm may continue after dissociation; it must buy out the dissociated one’s interest, minus damages if the dissociation was wrongful.

If the firm is to be terminated, winding up entails finishing the business at hand, paying off creditors, and splitting the remaining surplus or liabilities according the parties’ agreement or, absent any, according to the relevant act (UPA or RUPA).

**EXERCISES**

1. Under UPA, what is the effect on the partnership of a partner’s ceasing to be involved in the business?
2. Can a person no longer a partner be held liable for partnership obligations after her withdrawal? Can such a person incur liability to the partnership?
3. What obligation does a partnership or its partners owe to a partner who wrongfully terminates the partnership agreement?
4. What bearing does RUPA’s use of the term *dissociate* have on the entity theory that informs the revised act?
5. When a partnership is wound up, who gets paid first from its assets? If the firm winds up toward termination and has inadequate assets to pay its creditors, what recourse, if any, do the creditors have?
Trans fats are hydrogenated vegetable oils; the process of hydrogenation essentially turns the oils into semisolids, giving them a higher melting point and extending their shelf life but, unfortunately, also clogging consumers’ arteries and causing heart disease. California banned their sale effective January 1, 2010; other jurisdictions have followed suit.
19.4 Cases
Breach of Partnership Fiduciary Duty

*Gilroy v. Conway*

391 N.W. 2d 419 (Mich. App. 1986)

PETERSON, J.

Defendant cheated his partner and appeals from the trial court’s judgment granting that partner a remedy.

Plaintiff was an established commercial photographer in Kalamazoo who also had a partnership interest in another photography business, Colonial Studios, in Coldwater. In 1974, defendant became plaintiff’s partner in Colonial Studios, the name of which was changed to Skylight Studios. Under the partnership agreement, defendant was to be the operating manager of the partnership, in return for which he would have a guaranteed draw. Except for the guaranteed draw, the partnership was equal in ownership and the sharing of profits.

Prior to defendant’s becoming a partner, the business had acquired a small contractual clientele of schools for which the business provided student portrait photographs. The partners agreed to concentrate on this type of business, and both partners solicited schools with success. Gross sales, which were $40,000 in 1974, increased every year and amounted to $209,085 in 1980 [about $537,000 in 2011 dollars].

In the spring of 1981, defendant offered to buy out plaintiff and some negotiations followed. On June 25, 1981, however, plaintiff was notified by the defendant that the partnership was dissolved as of July 1, 1981. Plaintiff discovered that defendant: had closed up the partnership’s place of business and opened up his own business; had purchased equipment and supplies in preparation for commencing his own business and charged them to the partnership; and had taken with him the partnership employees and most of its equipment.

Defendant had also stolen the partnership’s business. He had personally taken over the business of some customers by telling them that the partnership was being dissolved; in other cases he simply took over partnership contracts without telling the customers that he was then operating on his own. Plaintiff also learned that defendant’s deceit had included the withdrawal, without plaintiff’s knowledge, of partnership funds for defendant’s personal use in 1978 in an amount exceeding $11,000 [about $36,000 in 2011 dollars].
The trial judge characterized the case as a “classic study of greed” and found that defendant had in effect appropriated the business enterprise, holding that defendant had “knowingly and willfully violated his fiduciary relationship as a partner by converting partnership assets to his use and, in doing so, literally destroying the partnership.” He also found that the partnership could have been sold as a going business on June 30, 1981, and that after a full accounting, it had a value on that date of $94,596 less accounts payable of $17,378.85, or a net value of $77,217.15. The division thereof after adjustments for plaintiff’s positive equity or capital resulted in an award to plaintiff for his interest in the business of $53,779.46 [about $126,000 in 2011 dollars]....

Plaintiff also sought exemplary [punitive] damages. Count II of the complaint alleged that defendant’s conduct constituted a breach of defendant’s fiduciary duty to his partner under §§ 19-22 of the Uniform Partnership Act, and Count III alleged conversion of partnership property. Each count contained allegations that defendant’s conduct was willful, wanton and in reckless disregard of plaintiff’s rights and that such conduct had caused injury to plaintiff’s feelings, including humiliation, indignity and a sense of moral outrage. The prayer for relief sought exemplary damages therefore.

Plaintiff’s testimony on the point was brief. He said:

*The effect of really the whole situation, and I think it was most apparent when I walked into the empty building, was extreme disappointment and really total outrage at the fact that something that I had given the utmost of my talent and creativity, energy, and whatever time was necessary to build, was totally destroyed and there was just nothing of any value that was left....My business had been stolen and there wasn’t a thing that I could do about it. And to me, that was very humiliating that one day I had something that I had worked 10 years on, and the next day I had absolutely nothing of any value.*

As noted above, the trial judge found that defendant had literally destroyed the partnership by knowingly and willfully converting partnership assets in violation of his fiduciary duty as a partner. He also found that plaintiff had suffered a sense of outrage, indignity and humiliation and awarded him $10,000 [$23,000 in 2011 dollars] as exemplary damages.

Defendant appeals from that award, asserting that plaintiff’s cause of action arises from a breach of the partnership contract and that exemplary damages may not be awarded for breach of that contract....
If it were to be assumed that a partner’s breach of his fiduciary duty or appropriation of partnership equipment and business contract to his own use and profit are torts, it is clear that the duty breached arises from the partnership contract. One acquires the property interest of a co-tenant in partnership only by the contractual creation of a partnership; one becomes a fiduciary in partnership only by the contractual undertaking to become a partner. There is no tortious conduct here existing independent of the breach of the partnership contract.

Neither do we see anything in the Uniform Partnership Act to suggest that an aggrieved partner is entitled to any remedy other than to be made whole economically. The act defines identically the partnership fiduciary duty and the remedy for its breach, i.e., to account:

Sec. 21. (1) Every partner must account to the partnership for any benefit, and hold as trustee for it any profits derived by him without the consent of the other partners from any transaction connected with the formation, conduct, or liquidation of the partnership or from any use by him of its property.

So, the cases involving a partner's breach of the fiduciary duty to their partners have been concerned solely with placing the wronged partners in the economic position that they would have enjoyed but for the breach.

[Judgment for plaintiff affirmed, as modified with regard to damages.]

**CASE QUESTIONS**

1. For what did the court award the plaintiff $53,000?

2. The court characterizes the defendant as having “cheated his partner”—that is, Conway committed fraud. (Gilroy said his business had been “stolen.”) Fraud is a tort. Punitive damages may be awarded against a tortfeasor, even in a jurisdiction that generally disallows punitive damages in contract. In fact, punitive damages are sometimes awarded for breach of the partnership fiduciary duty. In *Cadwalader, Wickersham & Taft v. Beasley*, 728 So.2d 253 (Florida Ct. App., 1998), a New York law firm was found to have wrongfully expelled a partner lawyer, Beasley, from membership in its Palm Beach, Florida, offices. New York law controlled. The trial court awarded Beasley $500,000 in punitive damages. The appeals court, construing the same UPA as the court construed in *Gilroy*, said:
Under New York law, the nature of the conduct which justifies an award of punitive damages is conduct having a high degree of moral culpability, or, in other words, conduct which shows a “conscious disregard of the rights of others or conduct so reckless as to amount to such disregard.” Since the purpose of punitive damages is to both punish the wrongdoer and deter others from such wrongful behavior, as a matter of policy, courts have the discretion to award punitive damages. [The defendant] was participating in a clandestine plan to wrongfully expel some partners for the financial gain of other partners. Such activity cannot be said to be honorable, much less to comport with the “punctilio of an honor.” Because these findings establish that [the defendant] consciously disregarded the rights of Beasley, we affirm the award of punitive damages.

As a matter of social policy, which is the better ruling, the Michigan court’s in Gilroy or the Florida court’s in Cadwalader?

**Partnership Authority, Express or Apparent**

*Hodge v Garrett*

614 P.2d 420 (Idaho 1980)

Bistline, J.

[Plaintiff] Hodge and defendant-appellant Rex E. Voeller, the managing partner of the Pay-Ont Drive-In Theatre, signed a contract for the sale of a small parcel of land belonging to the partnership. That parcel, although adjacent to the theater, was not used in theater operations except insofar as the east 20 feet were necessary for the operation of the theater’s driveway. The agreement for the sale of land stated that it was between Hodge and the Pay-Ont Drive-In Theatre, a partnership. Voeller signed the agreement for the partnership, and written changes as to the footage and price were initialed by Voeller. (The trial court found that Hodge and Voeller had orally agreed that this 20 foot strip would be encumbered by an easement for ingress and egress to the partnership lands.)

Voeller testified that he had told Hodge prior to signing that Hodge would have to present him with a plat plan which would have to be approved by the partners before the property could be sold. Hodge denied that a plat plan had ever been mentioned to him, and he testified that Voeller did not tell him that the approval of the other partners was needed until after the contract was signed. Hodge also testified that he
offered to pay Voeller the full purchase price when he signed the contract, but Voeller told him that that was not necessary.

The trial court found that Voeller had actual and apparent authority to execute the contract on behalf of the partnership, and that the contract should be specifically enforced. The partners of the Pay-Ont Drive-In Theatre appeal, arguing that Voeller did not have authority to sell the property and that Hodge knew that he did not have that authority.

At common law one partner could not, “without the concurrence of his copartners, convey away the real estate of the partnership, bind his partners by a deed, or transfer the title and interest of his copartners in the firm real estate.” [Citation] This rule was changed by the adoption of the Uniform Partnership Act....[citing the statute].

The meaning of these provisions was stated in one text as follows:

“If record title is in the partnership and a partner conveys in the partnership name, legal title passes. But the partnership may recover the property (except from a bona fide purchaser from the grantee) if it can show (A) that the conveying partner was not apparently carrying on business in the usual way or (B) that he had in fact no authority and the grantee had knowledge of that fact. The burden of proof with respect to authority is thus on the partnership.” [Citation]

Thus this contract is enforceable if Voeller had the actual authority to sell the property, or, even if Voeller did not have such authority, the contract is still enforceable if the sale was in the usual way of carrying on the business and Hodge did not know that Voeller did not have this authority.

As to the question of actual authority, such authority must affirmatively appear, “for the authority of one partner to make and acknowledge a deed for the firm will not be presumed....” [Citation] Although such authority may be implied from the nature of the business, or from similar past transactions [Citation], nothing in the record in this case indicates that Voeller had express or implied authority to sell real property belonging to the partnership. There is no evidence that Voeller had sold property belonging to the partnership in the past, and obviously the partnership was not engaged in the business of buying and selling real estate.

The next question, since actual authority has not been shown, is whether Voeller was conducting the partnership business in the usual way in selling this parcel of land such that the contract is binding under
[the relevant section of the statute] i.e., whether Voeller had apparent authority. Here the evidence showed, and the trial court found:

1. “That the defendant, Rex E. Voeller, was one of the original partners of the Pay-Ont Drive In Theatre; that the other defendants obtained their partnership interest by inheritance upon the death of other original partners; that upon the death of a partner the partnership affairs were not wound up, but instead, the partnership merely continued as before, with the heirs of the deceased partner owning their proportionate share of the partnership interest.

2. “That at the inception of the partnership, and at all times thereafter, Rex E. Voeller was the exclusive, managing partner of the partnership and had the full authority to make all decisions pertaining to the partnership affairs, including paying the bills, preparing profit and loss statements, income tax returns and the ordering of any goods or services necessary to the operation of the business.”

The court made no finding that it was customary for Voeller to sell real property, or even personal property, belonging to the partnership. Nor was there any evidence to this effect. Nor did the court discuss whether it was in the usual course of business for the managing partner of a theater to sell real property. Yet the trial court found that Voeller had apparent authority to sell the property. From this it must be inferred that the trial court believed it to be in the usual course of business for a partner who has exclusive control of the partnership business to sell real property belonging to the partnership, where that property is not being used in the partnership business. We cannot agree with this conclusion. For a theater, “carrying on in the usual way the business of the partnership,” [Citation to relevant section of the statute] means running the operations of the theater; it does not mean selling a parcel of property adjacent to the theater. Here the contract of sale stated that the land belonged to the partnership, and, even if Hodge believed that Voeller as the exclusive manager had authority to transact all business for the firm, Voeller still could not bind the partnership through a unilateral act which was not in the usual business of the partnership. We therefore hold that the trial court erred in holding that this contract was binding on the partnership.

Judgment reversed. Costs to appellant.
1. What was the argument that Voeller had actual authority? What did the court on appeal say about that argument?

2. What was the argument that Voeller had apparent authority? What did the court on appeal say about that argument? To rephrase the question, what facts would have been necessary to confer on Voeller apparent authority?

**Partnership Bound by Contracts Made by a Partner on Its Behalf; Partners’ Duties to Each Other; Winding Up (omitted)**

**Dissolution under RUPA (omitted)**

### 19.5 Summary and Exercises

**Summary**

Most of the Uniform Partnership Act (UPA) and Revised Uniform Partnership Act (RUPA) rules apply only in the absence of agreement among the partners. Under both, unless the agreement states otherwise, partners have certain duties: (1) the duty to serve—that is, to devote themselves to the work of the partnership; (2) the duty of loyalty, which is informed by the fiduciary standard: the obligation to act always in the best interest of the partnership and not in one’s own best interest; (3) the duty of care—that is, to act as a reasonably prudent partner would; (4) the duty of obedience not to breach any aspect of the agreement or act without authority; (5) the duty to inform copartners; and (6) the duty to account to the partnership. Ordinarily, partners operate through majority vote, but no act that contravenes the partnership agreement itself can be undertaken without unanimous consent.

Partners’ rights include rights (1) to distributions of money, including profits (and losses) as per the agreement or equally, indemnification, and return of capital contribution (but not a right to compensation); (2) to management as per the agreement or equally; (3) to choose copartners; (4) to property of the partnership, but no partner has any rights to specific property (under UPA the partners own property as tenants in partnership; under RUPA the partnership as entity owns property, but it will be distributed upon liquidation); (5) to assign (voluntarily or involuntarily) the partnership interest; the assignee does not become a partner or have any management rights, but a judgment creditor may obtain a charging order against the partnership; and (6) to enforce duties and rights by suits in law or equity (under RUPA a formal accounting is not required).
Under UPA, a change in the relation of the partners dissolves the partnership but does not necessarily wind up the business. Dissolution may be voluntary, by violation of the agreement, by operation of law, or by court order. Dissolution terminates the authority of the partners to act for the partnership. After dissolution, a new partnership may be formed.

Under RUPA, a change in the relation of the partners is a dissociation, leaving the remaining partners with two options: continue on; or wind up, dissolve, and terminate. In most cases, a partnership may buy out the interest of a partner who leaves without dissolving the partnership. A term partnership also will not dissolve so long as at least one-half of the partners choose to remain. When a partner's dissociation triggers dissolution, partners are allowed to vote subsequently to continue the partnership.

When a dissolved partnership is carried on as a new one, creditors of the old partnership remain creditors of the new one. A former partner remains liable to the creditors of the former partnership. A new partner is liable to the creditors of the former partnership, but only to the extent of the new partner's capital contribution. A former partner remains liable for debts incurred after his withdrawal unless he gives proper notice of his withdrawal; his actual authority terminates upon dissociation and apparent authority after two years.

If the firm is to be terminated, it is wound up. The assets of the partnership include all required contributions of partners, and from the assets liabilities are paid off (1) to creditors and (2) to partners on their accounts. Under RUPA, nonpartnership creditors share equally with unsatisfied partnership creditors in the personal assets of their debtor-partners.

**EXERCISES**

1. Anne and Barbara form a partnership. Their agreement specifies that Anne will receive two-thirds of the profit and Barbara will get one-third. The firm suffers a loss of $3,000 the first year. How are the losses divided?

2. Two lawyers, Glenwood and Higgins, formed a partnership. Glenwood failed to file Client’s paperwork on time in a case, with adverse financial consequences to Client. Is Higgins liable for Glenwood’s malpractice?

3. When Client in Exercise 2 visited the firm’s offices to demand compensation from Glenwood, the two got into an argument. Glenwood became very agitated; in an apparent state of rage, he threw a law book at Client, breaking her nose. Is Higgins liable?
4. Assume Glenwood from Exercise 2 entered into a contract on behalf of the firm to buy five computer games. Is Higgins liable?

5. Grosberg and Goldman operated the Chatham Fox Hills Shopping Center as partners. They agreed that Goldman would deposit the tenants’ rental checks in an account in Grosberg’s name at First Bank. Without Grosberg’s knowledge or permission, Goldman opened an account in both their names at Second Bank, into which Goldman deposited checks payable to the firm or the partners. He indorsed each check by signing the name of the partnership or the partners. Subsequently, Goldman embezzled over $100,000 of the funds. Second Bank did not know Grosberg and Goldman were partners. Grosberg then sued Second Bank for converting the funds by accepting checks on which Grosberg’s or the partnership’s indorsement was forged. Is Second Bank liable? Discuss.

6. Pearson Collings, a partner in a criminal defense consulting firm, used the firm’s phones and computers to operate a side business cleaning carpets. The partnership received no compensation for the use of its equipment. What claim would the other partners have against Collings?

7. Follis, Graham, and Hawthorne have a general partnership, each agreeing to split losses 20 percent, 20 percent, and 60 percent, respectively. While on partnership business, Follis negligently crashes into a victim, causing $100,000 in damages. Follis declares bankruptcy, and the firm’s assets are inadequate to pay the damages. Graham says she is liable for only $20,000 of the obligation, as per the agreement. Is she correct?

8. Ingersoll and Jackson are partners; Kelly, after much negotiation, agreed to join the firm effective February 1. But on January 15, Kelly changed his mind. Meanwhile, however, the other two had already arranged for the local newspaper to run a notice that Kelly was joining the firm. The notice ran on February 1. Kelly did nothing in response. On February 2, Creditor, having seen the newspaper notice, extended credit to the firm. When the firm did not pay, Creditor sought to have Kelly held liable as a partner. Is Kelly liable?