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Partnerships

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PARTNERSHIPS

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I. INTRODUCTION

IT is rare for a given year to yield a plethora of Texas cases involving relevant partnership law issues. This is not one of those rare years. But there are a few cases worthy of your time, including two non-Texas bankruptcy cases (one of them a U.S. Supreme Court case).

II. PARTNERSHIP CASES

A. DISSOLUTION UNDER THE TEXAS REVISED LIMITED PARTNERSHIP ACT, ART. 6132A-1, SECTION 4.02(A)(5)[1]—*KENWORTHY V. KENWORTHY CORP.*[2]

This case offers some clarification on the scope and application of the automatic event of withdrawal provided under Article 6132a-1, section 4.02(a)(5) of the Texas Revised Limited Partnership Act ("TRLPA"). In this case, some of the limited partners of a limited partnership sought the dissolution of the limited partnership by suing the general partner and other limited partners. After more than 120 days had passed from the date the suit was filed, the partners seeking dissolution moved for a partial summary judgment, relying on TRLPA section 4.02(a)(5) to support their claim that (i) an "event of withdrawal" resulted when their lawsuit was not dismissed within 120 days of its filing; (ii) the partnership was automatically dissolved (because of the event of withdrawal of the only general partner);[3] and (iii) they were entitled to the appointment of a trustee to wind up the affairs of the partnership. The trial court granted the partial summary judgment and appointed a trustee.[4]

The appellate court reversed the judgment of the trial court relying as a

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1. TEX. REV. CIV. STAT. ANN. art. 6132a-1, § 4.02(a)(5) (Vernon Supp. 2004-05) ("TRLPA").

2. 149 S.W.3d 296 (Tex. App.—Eastland 2004, pet. denied).

3. TRLPA section 8.01(3) provides for dissolution on the withdrawal of the only remaining general partner, unless the limited partners timely act to appoint a replacement (which, of course, would have been contrary to the limited partners' goals here). *See* TRLPA § 8.01(3).

4. *Kenworthy*, 149 S.W.3d at 297.

matter of law on the plain meaning of TRLPA section 4.02(a)(5).[5] That section states:

> A person ceases to be a general partner of a limited partnership on the occurrence of any of the following events of withdrawal: . . . [u]nless otherwise provided in a written partnership agreement or with the written consent of all partners, 120 days expire after the date of the commencement of *a proceeding against the general partner* seeking reorganization, arrangement, composition, readjustment, liquidation, dissolution, or similar relief under any law if the proceeding has not been previously dismissed, or 90 days expire after the date of the appointment, without the general partner's consent or acquiescence, of a trustee, receiver, or liquidator of the general partner or of all or any substantial part of the general partner's properties if the appointment has not previously been vacated or stayed, or 90 days expire after the date of expiration of a stay, if the appointment has not previously been vacated.[6]

The appellate court agreed with the appellant-defendants, who maintained that section 4.02(a)(5) "speaks to lawsuits *against the general partner* in which relief is sought *against the general partner for the general partner's* reorganization, arrangement . . . dissolution, or similar relief."[7] It was noted that this interpretation of section 4.02(a)(5) is consistent with legislative history[8] and other portions of the TRLPA.[9] The appellate court also considered the consequences of the trial court's interpretation of section 4.02(a)(5), which would allow limited partners to name a general partner as a defendant in a lawsuit that sought dissolution, and then recover by default on contested dissolution issues if the suit is not disposed of within 120 days.[10] The court correctly concluded that this was not a result intended by the legislature.[11] Accordingly, it held that, pursuant to the plain meaning of section 4.02(a)(5): (i) an "event of with-

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5. *See id.* at 298-99.

6. *Id.* at 297-98 (quoting TRLPA § 4.02(a)(5)) (emphasis added).

7. *Id.* at 298 (emphasis in original).

8. "[A] 1985 revised comment to the Uniform Limited Partnership Act, former TEX. REV. CIV. STAT. art. 6132a-1, § 4.02, written when the Uniform Act was amended by the National Conference of Commissioners on Uniform State Laws . . . indicated that the purpose of former Section 4.02(a)(5) was to give the limited partners 'the power to rid themselves of a general partner who is in such dire financial straits that he is the subject of proceedings under the National Bankruptcy Code or a similar provision of law.'" *Id.* at 298-99.

9. *Id.* at 299. Whereas section 4.02(a)(5) is intended to provide limited partners with some control or participation in complaints by third parties against general partners, section 8.02 provides protection in situations that do not involve third parties, including the provision of "judicial dissolution when a partner has engaged in conduct 'relating to the limited partnership business' that makes carrying on the business with that partner not reasonably practicable. To read section 4.02(a)(5) as appellees would have us read it would render section 8.02 unnecessary. . . .'" *Id.*

10. *See id.*

11. *Id.* It was as easy for the court to reach this result as it was for the plaintiff's counsel to subvert the meaning of the statute—it was *not* the intent that this provision be used as a weapon, and a bootstrapped one at that, to force the dissolution of a limited partnership by partners who otherwise could not achieve that result directly. *See supra* text accompanying note 6 (stating the real purpose).

drawal" did not occur; (ii) there was no automatic dissolution; and (iii) the parties seeking dissolution were not entitled to have a trustee appointed to wind up the affairs of the partnership.[12]

B. Determining Whether a Partnership Exists—*McDowell v. McDowell*[13]

This case explored the minimum threshold for creating a partnership under the Texas Revised Partnership Act ("TRPA").[14] Brothers James and Greg McDowell disagreed about the existence of a partnership, and about a division of alleged partnership assets that resulted from a mixture of family business and tax fraud (quite a combination!). In 1984, the brothers and their mother Faye formed a corporation to own real property on which they desired to construct a warehouse. To satisfy a lender's requirement to provide financing for the warehouse, Faye and Greg sold their shares in the corporation to James pursuant to a variety of transfer documents, that, among other things, required James to pay Greg a total of $73,776 over a period of thirty years. The warehouse eventually became profitable; income tax returns filed by the brothers showed that each claimed approximately equal rental income amounts from 1992 until 1999, when James sold the subject property and sought to repay Greg the unpaid balance of the loan owed to him. Greg asserted a claim for his half (as partner) of the proceeds. James disputed that there was a partnership, and refused to share any proceeds with Greg, and Greg sued, claiming that James excluded him from sharing in their partnership's profits. The trial court agreed with Greg, and James appealed the order to pay Greg one-half of the sales profits.[15]

After the appellate court affirmed proper jurisdiction,[16] it considered James's argument that the trial court could not properly find that a partnership existed between the brothers because two essential elements of a partnership were missing: (i) an agreement to share losses; and (ii) the right to participate in control of the business.[17] James's argument relied on the Texas Uniform Partnership Act case law, which he argued was applicable because of Greg's claim that the alleged partnership was formed in 1984.[18] The appellate court found that argument to be a red herring, noting that TRPA section 11.03 mandates that, after December

12. *Kenworthy*, 149 S.W.3d at 299.

13. 143 S.W.3d 124 (Tex. App.—San Antonio 2004, pet. denied).

14. Texas Revised Partnership Act, Tex. Rev. Civ. Stat. Ann. art. 6132b, §§ 1.01-10.04 (Vernon Supp. 2004-05) ("TRPA").

15. *McDowell*, 143 S.W.3d at 126-27.

16. Although the real property was located in Florida, the court stated that "the central issue in the case did not involve who held title to the [subject property], but, rather, whether a partnership existed. . . . Thus the trial court as well as this [c]ourt, has jurisdiction over the case at hand." *Id.* at 127.

17. *Id.*

18. *Id.* at 128. Greg claimed that he expressed his desire to remain a partner at the time of the transfer of corporation shares to James, when the predecessor to the TRPA, the Texas Uniform Partnership Act, was applicable; James maintained that his brother's claim was not made until later. *Id.*

31, 1998, all partnerships are governed by the TRPA, whether formed under the prior statute or the TRPA.[19] Under the TRPA a court may consider multiple factors, stated in Article 6132b, section 2.03(a), when determining whether a partnership exists.[20] Further, an agreement to share losses is not necessary to create a partnership, and no one factor is dispositive in the determination.[21] The appellate court noted that conflicting evidence was provided by the brothers at the trial[22]and that there was no direct evidence of Greg's participation in the control of the business.[23] However, the court acknowledged that the standard of review for factual sufficiency allows a court of appeals to set aside a verdict "only if it is so contrary to the overwhelming weight of the evidence that the verdict is clearly wrong and unjust."[24] The appellate court concluded that the trial court could have found that a partnership was formed based on the evidence presented at trial and held that the trial court's findings were legally and factually sufficient.[25] Simply, the appellate court found enough evidence of a partnership in the record to support the trial court's application of the TRPA to those facts to reach that conclusion.[26]

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19. *Id.* (discussing TRPA § 11.03).

20. *See* TRPA § 203(a). Those factors include: (1) receipt or right to receive a share of the profits of the business; (2) expression of an intent to be partners in the business; (3) participation or right to participate in the control of the business; (4) sharing or agreeing to share (A) losses of the business, or (B) liability for claims by third parties against the business; and (5) contribution or agreeing to contribute money or property to the business. *Id.*

21. *See McDowell*, 143 S.W.3d at 129 (citing TRPA § 2.03(a)-(c)). This was an intentional effort to overcome substantial Texas case law that sharing of losses was necessary to find a "joint venture." *See, e.g.*, Steven A. Waters, *Partnerships*, 55 SMU L. REV. 1271, 1274-76 (2002) (discussing Swinehart v. Stubbeman, McRae, Sealy, Laughlin & Browder, Inc., 48 S.W.3d 865 (Tex. App.—Houston [14th Dist.] 2001, pet. denied)). Additional support for this can be found in TRPA section 2.02(a), which states that "an association of two or more persons to carry on a business for profit as owners, creates a partnership, whether the persons intend to create a partnership and whether the association is called a 'partnership,' 'joint venture,' or other name." *Id.* at 1275 n.31 (quoting TRPA § 2.02(a)). The 1993 Bar Committee comment states: "[T]he subsection also explicitly includes a joint venture that satisfies the definition of 'partnership' as a partnership subject to TRPA. This codifies existing case law." *See id.* (quoting TEX. REV. CIV. STAT. ANN. art. 6132b, § 2.02(a) cmt. (Vernon Supp. 2004-05)). Interestingly, notwithstanding the statutory change, the *Swinehart* court perpetuated a four-part test to find a joint venture, the unique element of which (not required to find a *partnership*) is an *agreement to share losses*. *Id.* (citing *Swinehart*, 48 S.W.3d at 878).

22. Greg introduced testimony from several parties who spoke with James about the partnership, all of whom believed there was a partnership. Greg also introduced the brothers' tax returns, some of which showed "GEM/JEM joint venture" expenses and income. The testimony of both James's ex-wife (also ex-accountant) and attorney indicated that the tax forms contained intentional "mistakes" (i.e. claiming only one-half of the income from the subject property). *McDowell*, 143 S.W.3d at 129-30.

23. *Id.* at 130.

24. *Id.* at 128 (citing Mar. Overseas Corp. v. Ellis, 971 S.W.2d 402, 406-07 (Tex. 1998); Cain v. Bain, 709 S.W.2d 175, 176 (Tex. 1986)).

25. *Id.* at 130.

26. *See id.*

C. Breach of Fiduciary Duty; Exemplary Damages—*Harris v. Archer*[27]

It was tempting to provide a detailed account of this very long, factually-complex opinion that appeared to conclude years of legal activity.[28] But at the end of the day, it was felt not to be worth the reader's time (or this fine journal's valuable space). The case does have supporting cites to the Texas Supreme Court[29] and the United State Supreme Court,[30] which does not happen everyday. One extractable essence of the case is that it is not legally acceptable, given the fiduciary relationship shared by partners, for a partner to bargain to acquire his partners' partnership interests, then open negotiations with a third party to sell the partnership property for a big profit, not tell your partners about those negotiations, then close the acquisition of the partnership interests (which included the execution of settlement agreements and releases), sell the partnership property, and try invoke the settlement agreement and releases[31] as a defense to a claim that you breached your fiduciary duty.[32] All of that added up to liability, with exemplary damages.[33]

III. BANKRUPTCY CASES

A. *In re Midpoint Development, LLC*[34]

In this case, the bankruptcy court was faced with the issue of whether a dissolved limited liability company under Oklahoma law was eligible to

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27. Harris v. Archer, 134 S.W.3d 411 (Tex. App.—Amarillo 2004, pet. denied).

28. The parties' business relationships began in 1991, the particulars of this case in 1993, and a prior appeal ended in 1997. *See id.* at 419-23.

29. *See id.* at 431 (discussing Schlumberger Tech. Corp. v. Swanson, 959 S.W.2d 171 (Tex. 1997)).

30. *See id.* at 436 (discussing BMW of N. Am., Inc. v. Gore, 517 U.S. 559 (1996) (Due Process Clause of the Fourteenth Amendment to the United States Constitution is violated when exemplary damages are grossly disproportional to gravity of defendant's offense.)).

31. That is where *Swanson* came into play. There, the Texas Supreme Court held that even though merger clauses in releases can be avoided by the presence of "fraud in the inducement," a disclaimer of reliance on representations that might otherwise support that fraud claim can validly preclude such a claim. *Swanson*, 959 S.W.2d at 171. The court here distinguished *Swanson*, in part based on the existence here of a fiduciary duty (which, all else equal, usually results in an escalation of some kind). *See Harris*, 134 S.W.3d at 431.

32. *Harris*, 134 S.W.3d at 431-35.

33. *See id.* at 435. And it is here that the *Gore* case came into play. The court there established a loose sliding scale for determining when an exemplary damage award was excessive—a combination of relationship to the actual damages and the reprehensibility of the conduct. *See Gore*, 517 U.S. at 559. The court here also looked to Texas Supreme Court precedent, *Alamo National Bank v. Kraus*, which followed *Gore* in laying out its exemplary damage factors: (1) the degree of reprehensibility of the defendant's conduct; (2) the ratio between harm or potential harm to the plaintiff and the amount awarded (measure of punishment must be both reasonable and proportionate to the amount of harm to plaintiff and to the actual damages recovered); and (3) the disparity between the exemplary damages addressed and civil penalties authorized or imposed in comparable cases. *See Harris*, 134 S.W.3d at 437 (discussing Alamo Nat'l Bank v. Kraus, 616 S.W.2d 908, 910 (Tex. 1981)); *see also Gore*, 517 U.S. at 559. If not outrageous, the relationship is capped at a ratio of four to one (4:1). *See Harris*, 134 S.W.3d at 437.

34. *In re* Midpoint Dev., LLC, 313 B.R. 486 (Bankr. W.D. Okla. 2004).

be a debtor in a Chapter 11 bankruptcy proceeding. Despite the lack of an explicit rule in the Bankruptcy Code (that is, "limited liability companies," as such, did not exist when the Code was written and, therefore, are not explicitly identified), the bankruptcy court concluded, following the lead from several commentators, that limited liability companies are sufficiently analogous to corporations to be considered eligible for Chapter 11 protection as a "debtor."[35] The court concluded that a dissolved LLC was still operating as a legal entity (pending conclusion of winding up activities) under Oklahoma LLC laws and, therefore, could serve as a Chapter 11 debtor.[36]

B. *UNITED STATES V. GALLETTI*[37]

It is not everyday that one has a chance to report on a United States Supreme Court case, which may be the most significant thing about this particular one. Here, the partners of a general partnership filed for Chapter 13 bankruptcy protection. Previously, the Internal Revenue Service had properly assessed employment taxes against the partnership itself, but made no separate, direct assessment of those taxes against the individual partners until after the bankruptcy was filed. The debtors objected to the IRS claim, stating that the three-year statute of limitations applied to that claim.[38] The bankruptcy, district, and circuit courts disallowed the IRS's claim. However, the Supreme Court reversed and remanded, holding that the statute of limitations extends to collecting the debt because the IRS properly assessed the taxes against the partnership, and there was no requirement to assess the taxes against the individual partners, separately.[39]

Mostly, the case turned on whether the partners were "employers" under applicable California law or, instead, the partnership itself was the only relevant employer.[40] Following modern partnership law principles that are observed in California, the Court found that the partnership was an entity separate from its partners.[41] So, the fact that the partners had derivative joint and several liability for the obligations of the partnership

35. *Id.* at 488-89.

36. *Id.* It is black letter partnership/limited liability company law that such a pass-through entity does not lose its existence by suffering an event that causes a dissolution; rather, the entity remains in existence until all "winding up" activities have been concluded and the entity is terminated. *See, e.g.*, TRPA § 8.02 ("A partnership continues after the occurrence of an event requiring a winding up until the winding up of its business is completed, at which time the partnership is terminated."). Depending on the nature of the entity's business, winding up can take years to complete.

37. United States v. Galletti, 541 U.S. 114 (2004).

38. The Internal Revenue Code requires that a tax be assessed within three years after the applicable tax return is filed; if that is timely done, then the period for taking action to collect the taxes is extended to ten years from the assessment. *Id.* at 114 (citing 26 U.S.C. §§ 6501(a), 6502(a)).

39. *Id.* at 119-20.

40. *Id.* at 118-19.

41. *See id.* Whether a partnership is an "aggregate" of individuals or a separate legal entity was an issue that raged for years, but which has been resolved in modern statutes in favor of the "entity theory."

did not, in the opinion of the Court, make them directly liable as "*the* taxpayer," which was the key issue.[42] The Court found one tax liability, for which there were multiple obligors, but did not require that the same tax be separately assessed against the secondarily liable partners to extend the collection limitations period as to them.[43]

It may be worth a few lines to discuss some analogous Texas partnership and civil procedure rules and case law. The Texas Civil Practice and Remedies Code ("TCPRC") provides that service of citation on one member of a partnership authorizes judgment against the partnership and the partner served.[44] This means that a judgment obtained against the partnership establishes the derivative liability of the general partners, but does not constitute an executable judgment against any partner who was not served.[45] A partner not served is liable, but a separate lawsuit based on that liability is required to obtain an executable judgment against that partner.[46] The *Galletti* case suggests that a judgment against the partnership within the statute of limitations will serve to toll the statute as to partners, whether served or not.[47] Very limited and questionable, Texas case law authority is to the contrary. The Eastland Court of Appeals concluded that TCPRC section 17.022 does not authorize a judgment against the partners who were not served before the claims (for conversion) against them were barred by the statute of limitations.[48] It has been held that service of citation that names a partner, even when the lawsuit does not, is sufficient under TCPRC section 17.022.[49] Finally, another court held that judgment on a contract claim against a law firm partnership may not be entered against two partners in their individual capacities because they were not served with citation as required by TCPRC sections 17.022

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42. *Id.* at 119.
43. *Id.* at 116.
44. *See* TEX. CIV. PRAC. & REM. CODE ANN. § 17.022 (Vernon Supp. 2004-05).
45. *See id.*
46. *See id.*
47. *See Galletti*, 541 U.S. at 119-20.
48. *See* Cothrum Drilling Co. v. Partee, 790 S.W.2d 796, 800 (Tex. App.—Eastland 1990, writ denied). The court affirmed the judgment against the partnership and the general partner who had been served within the limitations period. *Id.* Later, the same plaintiff sued two of the partners who got out in this case, arguing that the judgment against the partnership (which was affirmed in the Eastland case) is a debt that can be enforced against a partner in a separate cause of action, using the judgment as the basis for liability under section 15 of the Texas Uniform Partnership Act (all partners jointly and severally liable for the debts of the partnership), now codified in TRPA section 3.04. *See id.* The Dallas Court of Appeals, however, affirmed the trial court's holding that res judicata from the earlier action barred the plaintiff's subsequent claim under the predecessor of TRPA. *See* Partee v. Phelps, 840 S.W.2d 512, 513 (Tex. App.—Dallas 1992, no writ). The Dallas court noted that the Eastland court had issued a mandate rendering a take-nothing judgment in favor of the partners sued in the second action because they were not served with citation. *See id.* The Dallas court continued, "the substance of the appellate court's judgment relieves Phelps and Cheek from joint and several liability on Cothrum Drilling Company's obligation." *Id.* at 515. This outcome is debatable, but does strongly suggest that all potentially liable partners be served and included in the original action, as the best course of conduct when suing a partnership.
49. *See* Fincher v. B & D Air Conditioning & Heating Co., 816 S.W.2d 509, 511 (Tex. App.—Houston [1st Dist.] 1991, writ denied).

and 31.003.[50] Perhaps one day all relevant elements in this area will collide in the same case, it will be well researched and briefed, and a thoughtful, reliable decision will be delivered to the bar.

50. *See* Hoeffner, Bilek & Eidman, LLP v. Guerra, No. 13-02-503-CV, 2004 WL 1171044 (Tex. App.—Corpus Christi May 27, 2004, pet. denied) (mem. op.). TCPRC section 31.003 provides "[i]f suit is against several partners who are *jointly indebted under a contract* and citation has been served on at least one but not all of the partners, the court may render judgment against the partnership and against the partners who were actually served, but may not award a personal judgment or execution against any partner who was not served." *Id.* at *11 (quoting TCPRC § 31.003) (emphasis added).