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Of the Rights of Partnership Creditors in the Separate Property of a Partner

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OF THE RIGHTS OF PARTNERSHIP CREDITORS
IN THE SEPARATE PROPERTY
OF A PARTNER

A Thesis

By Herbert L. Smith, '93

Presented for the Degree of Bachelor of Laws

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CONTENTS

- I. Introductory.
- II. The Liability of the Separate Property to Process on a Firm Debt.
- III. The Assignment of Separate Property by a Partner for a Partnership Debt.
- IV. The Distribution of the Separate Property of a Bankrupt Partner.
- V. The Distribution of the Separate Estate of a Deceased Partner.

OF THE RIGHTS OF PARTNERSHIP CREDITORS
IN THE SEPARATE PROPERTY
OF A PARTNER.

The separate property of a partner consists of that which he owns aside from others, and that which he possesses in conjunction with others. As to the former class there can be no question as to what it is; it stands out distinct, unhampered by the questions of joint ownership. The latter, however, will admit of a preliminary examination.

A partnership is a relation created by the "contract of two or more persons to place their money, effects, labor and skill, or some or all of them in lawful commerce, or business, and to divide the profits and bear the losses in certain proportions." (3 Kent's Comm., 23) It involves the joint ownership of property. The question which

arises in this connection is, What is a partner's interest therein? It is a chose in action. (Staats v. Bristow, 73 N.Y., 264) It is not the interest of a tenant in common either at law or in equity. Tenants in common do not contemplate a division of the profits while together. On the other hand, a sharing of the profits is a vital characteristic of a partnership. The members of a firm depend upon each other for the make up, or personnel, of the concern. It is a machine, so to speak, composed of different members working harmoniously to accomplish the same purpose. Each member is selected by the others for his particular ability along certain lines. In other words, it is a personal trust, and can not be delegated. It cannot be the interest of a tenant in common for then the fundamental purpose of the relation would be destroyed. What right should one partner have to substitute for himself, a stranger, whose connection with the firm was never in the contemplation of the partners? (Burnett v. Snyder, 76 N.Y., 344)

The necessity, in business affairs carried on by partnerships, for the utmost good faith in all transactions, negatives such a proposition. On account of this inviolability of the rights of the other partners, the introduction of a new member, or rather, the attempted introduction of such an one, dissolves the firm, (Marquand v. N.Y.Manuf.Co., 17 Johns., 525) though Lindley, in his work on partnership, qualifies this statement by stating that a partnership at will would be thus dissolved, but that in one not at will this act simply gives the other partners a cause for dissolution. The authority cited has been approved in later opinions in the same jurisdiction and allows no qualification of the rule, though Lindley's reasoning is sound. (Lindley on Partnership, 363)

A partner has no undivided interest in the firm property of which he can dispose; it is a right to an accounting--an ascertainment of the amount over and above the liabilities of the concern. Such a right is enforced in equity and thither should

a partner, or one occupying his position, seek relief. So that, if the partner's interest is taken to satisfy the claims of his creditors, they can reach nothing but what that share represents in the final accounting. A sheriff, with an execution, reaches nothing more. He cannot sell an undivided interest; its non-existence prevents that. If his levy be on all the goods of the firm, in satisfying the claim against the debtor-partner, he can sell but this same interest. Taken in the light of the decisions, a partner's interest as a chose in action, has been held to be barred by the lapse of time prescribed by the statute of limitations. (Knox v. Gye, 5 L.R.Eng.& Ir.App., 656)

Upon the death of a partner, and the consequent dissolution of the firm, the legal interest in the assets goes to the surviving members and they have the exclusive right to sell, mortgage, and dispose of them in the performance of their duties in closing up the affairs of the partnership as they deem best for all parties interested. This legal

title of the survivors is held subject, however, to the equitable rights of the representatives of the deceased partner to have a proper application made of the proceeds. So that they may require the due application of the assets to the payment of partnership debts, but the time, manner, and mode of so doing are purely matters of administration and, as such, under the exclusive control of the surviving partners. The interest of these representatives, is, then, a mere contingency which may, or may not, ripen into a legal right, upon the existence, or non-existence, of a surplus after the payment of all the debts.

It is generally stated that partition of partnership cannot be had, and, although there are cases cited at times as holding the contrary view, they are few in number, and some of them, at least, doubtful authorities. A moments reflection will call to mind substantial reasons in support of the proposition. How can you have partition in such a case? The partner's interest is not a tangible;

an ascertained quantity. He has not even an undivided interest. What he will receive depends upon the existence of surplus assets after the payment of all the debts. In what way can a mere naked right be divisible? Surely there must be a definite thing in order to have partition, and if that does not exist, how can it be had? But a partner can compel a sale of the partnership property. This he accomplishes by means of the right he has, upon dissolution, to have the whole assets disposed of in adjustment of matters between the partners. (Wild v. Milne, 26 Beaven, 504)

Having determined the character of the separate property of a partner, the next step is, in this article, to determine how it is affected by various situations in which it figures. It will appear, then, that a discussion of this question best resolves itself into, and may be stated under the following classes, or typical cases: (a) The Liability of the Separate Property to Process on a Firm Debt; (b) The Assignment of Separate Property by a

Partner for a Partnership Debt; (c) The Distribution of the Separate Property of a Bankrupt Partner; and; (d) The Distribution of the Separate Estate of a Deceased Partner.

The Liability of the Separate Property to
Process on a Firm Debt.

The question in this class of cases generally arises where there are conflicting claims of partnership and separate creditors. The individual creditor insists that his debt only shall be satisfied from the separate estate, while the firm creditor maintains that he shall share in the separate estate because he extended credit upon the faith of the liability of each and every partner, jointly and severally. What justice can there be in saying that if "A" have a claim against "X" and "Y", co-partners, "B", a creditor of "Y", can compel "A" to seek satisfaction from the estate of "X" alone, whether it be sufficient to cancel the debt or not? Surely no such right can exist, unless "Y", for his own sake, has a right in equity, to compel "A" to seek

payment from that source. Though the well established equity rule is, that, as between the joint and separate creditors of partners, the partnership property is to be first applied to the payment of the partnership debts, and the separate property of the individual partners to the payment of their separate debts; and that neither class of creditors can claim anything from the fund which belongs primarily to the opposite class until all the claims of the latter are satisfied, it is limited in its application to equitable assets only. Equity tribunals had never sought to over-ride, or in any way interfere with an absolute right of priority at law. So that the existence at law of the right of firm creditors to pursue both the joint and separate estates, to the extent of each, for the satisfaction of their joint demands, has been given full faith and credit in equity. (Meech v. Allen, 17 N.Y., 300) The position is even stronger where an absolute right

of legal priority is given by force of a positive statute, as in the case of a judgment. This rule at law is not without reason. Each partner is liable in solido for the debts of the partnership and, though technically it has been called a joint liability, yet each is liable for the entire debt. But a several suit cannot be brought to enforce it. The judgment should be against all the partners, but the execution may be enforced against so many of them as will cancel the debt, and a firm creditor with a first execution against the individual property of a partner takes precedence of a separate creditor with a second execution against the same property.

On the other hand, if equity did not follow the law in this case, principles applied by that tribunal could be resorted to and both the assets of the partnership and of the individual partner would be saved to the firm creditor. This results from the application of what is technically termed "the partner's equity." Each partner has

the personal right in equity to have the assets of the partnership first applied to the payment of the firm debts, and by a subrogation recognized in chancery, the joint creditors receive the benefit of this right. This is not the rule followed, however, for, as was previously stated, equity follows the law.

The Assignment of Separate Property by a
Partner for a Partnership Debt.

As a primary proposition under this division, the rule may be stated to be, that a partner, while he has control of his own property, and even when he becomes insolvent (Crook v. Rindskopf, 105 N.Y., 482) has the perfect legal right to apply his individual, as well as partnership, property to the payment of the partnership debts, because he is under the legal obligation as a member of the firm to pay the debts owing by the firm, or by himself as a member thereof. (Smith v. Howard, 20 How.Pr.Rep., 124) And this obligation is just as binding and perfect in its nature and effect as is the obligation to pay an individual indebtedness. The force of this rule may be appreciated when it is stated that the rights of the partnership creditors are so carefully guard-

ed that a transfer made, or a lien given, by one member of the firm, transferring or incumbering the corpus of the partnership property to pay, or secure an individual debt, is void as to such creditors, unless it is shown that the firm is solvent and sufficient assets remain to cancel the partnership indebtedness (Menagh v. Whitwell, 52 N.Y., 146)

There are two ways by means of which he may dispose of such property, however, and the transfers will be valid. They are, first, where the firm is solvent and sufficient property remains to pay the partnership debts; and, second, where a bonafide sale has been made by a retiring partner in a solvent firm of two members, to his co-partner, the latter assuming the debts. By this transfer the property, formerly belonging to the firm, becomes the separate property of the purchasing partner, and the partnership creditors are not entitled to any preference as against his individual creditors in case of his subsequent insolvency. This is a settled rule of law. (Ex parte Ruffin, 6 Ves. 119;

Dimon v. Hazard, 32 N.Y., 65) Such transfer is not to be taken, however, as the sole act of the one partner. It is the act of both partners jointly, for it is participated in by both, and they, having the power to dispose of the corpus of the joint property, and exercising that power bona fide, can divest the title of the firm as effectually as if they had joined in a transfer to a stranger, for it must be conceded that the creditors have no lien which would affect the title of a purchaser from the firm. But so long as the property remains in the possession of the purchasing partner, it is liable to execution for partnership debts.

A proper question in this connection is in regard to the effect of transfers of the partner's chose in action on the rights of creditors. Where the character of the property remains unchanged and no act has been done by the firm to divest its title, will the transfer, by the partners, of their respective individual interests to different persons operate to discharge them from the claims of

firm creditors, or will the interests still remain subject, in the hands of the transferees, to the demands of those creditors? There are conflicting views on this question. The rule adopted by the Supreme Court of the United States, in Case v, Beau- regard, (99 U.S., 119) is to the effect that so long as the equity of a partner to have the property applied to the satisfaction of the partnership debts remains, just so long can the joint creditors have a remedy against the property, but when it is gone, the rights of the creditors are lost. In this case, the court say, " The joint estate is converted into the separate estate of the assignee by force of the contract of assignment, and it makes no difference whether the partner sells to the other partners, or to a third person, or whether the sale is made by him, or under a judgment against him. In either case the equity is gone." It declares, in effect, that a partner loses his right to have the firm assets applied to the payment of the firm debts; that his right so to do is not personal.

On the contrary, the other and better view is emphatically stated by Judge Rapallo in Menagh v. Whitwell, (supra) It is, " that the title of the firm, as between it and its creditors, to the corpus of the property, or at least to so much of it as is necessary for the debts, is not divested by these separate transfers to strangers." He further declares that the equity of a partner to have the partnership property applied to the payment of the partnership debts, is a personal right of which the partner cannot divest himself by a sale of his interest. To quote the learned judge's language, " Could it be tolerated that the interest of a partner should be sold under execution against him, on which sale only the value of his interest in the surplus could be realized, and that the purchaser should be allowed to take the corpus of the property and leave him liable for the debts ?" A partner cannot transfer to his assignee more than he himself is entitled to, namely, his share after all accounts have been taken. (Hankey v. Garrett,

1 Ves., 241, Am. Ed. note ; Young v. Keighly, 15 Ves., 557) No person deriving under a partner can be in a better condition than the partner himself. (Fox v. Hanbury, Cowp. 445) Neither can a partner, by an assignment of his interest take from the creditors, or other partners, the right to have their claims against the firm satisfied out of its property, Hence a mortgage, made by one partner, of his undivided interest, cannot avail against the creditors of the partnership who attach the partnership property. (Lovejoy v. Bowers, 11 N .H., 404) It would seem that enough has been written to demonstrate that the better and more logical view is the one which protects the partnership creditors and does not dissolve the firm as to them.

The Distribution of the Separate Property
of a Bankrupt Partner.

Born of the Roman law, fostered by the courts of Spain and England, and adopted by the judiciary of the United States, the rule, that partnership property shall first satisfy partnership debts and separate property first satisfy individual debts, has become firmly embraced in the law governing bankrupts, assignees and insolvents. Could the good fathers of the Civil law have known what uneasiness they have occasioned modern commercial lawyers, and the many silent maledictions breathed by a host of judges who have been forced to admit its existence, though deeming it harsh, they would have repented long since in sack-cloth and ashes. The courts of England were in a state of delightful uncertainty for nearly a century as to

the adoption of the rule in that jurisdiction, until finally Lord Loughborough, in 1796, in the case of Ex parte Elton, (3 Ves., 238) squarely and forcibly enunciated the rule as stated. Like all rules, it has been subjected to objections, which, in this instance, have been not a few in number. The result has been to withhold the application of the rule where the joint creditors have no fund or means of satisfaction of any kind, which is the case where there is no joint estate and no living solvent partner. Both conditions must co-exist, however. Just what " no joint estate " means has been a bone of contention, but it now appears to be well settled that if the joint creditors can get a dividend from the partnership estate, no matter how small, they cannot share with the separate creditors in the separate estate; and, it is said, that if the joint estate is so small as to be entirely consumed in costs, there is no joint estate. (Bates on Partnership, sec. 833) Where there is no living solvent partner, the joint cred-

itors cannot prove pari passu with the separate creditors in the individual estate. By this is meant a partner from whom no fund, however small, can be derived. (Bates on Partnership, sec. 835) And it seems that his mere insolvency does not, as would his bankruptcy, entitle the firm creditors to prove upon the other partner's separate estate, (Wilder v. Keeler, 3 Paige, 167; Rodgers v. Meranda, 7 O. St., 179; Cleghorn v. Bank, 9 Ga. 319; Emanuel v. Bird, 19 Ala., 596; Sperry's Estate, 1 Ashmead, 347) but this is doubted by some authorities. (Merrill v. Neill, 8 How., 414; Weyer v. Thornburgh, 15 Ind., 124)

There has been not a little discussion as to the arbitrary character of this rule, but aside from the fact that its adoption was to give a correlative to the rule admitting separate creditors to participation in the surplus remaining from the partnership fund after the payment of the joint obligations, there are substantial reasons in its support. Chief Judge Bartley, in Rodgers v. Meran-

da, (supra) has stated these so comprehensively, that an extended quotation from his learned opinion in that case, seems justified. "What then," Judge Bartley says, "is the true foundation of the rule which gives the individual creditor a preference over the partnership creditor in the distribution of the separate estate of a partner? To say that it is a rule of general equity, as has been sometimes said, is not a satisfactory solution of the difficulty; for the very question is, whether it be a rule of equity or not. In the distribution of the assets of insolvents, equality is equity; and to say that the rule which gives the individual creditor a preference over the partnership creditor in the separate estate of a partner, is a rule of equality, does not still rid the subject of difficulty. For leaving the rule to stand, which gives the preference to the joint creditors in the partnership property, and perfect equality between the joint and individual creditors is, perhaps, rarely obtainable. That it is, however, more equal and just, as a general rule, than

any other which can be devised, consistently with the preference to the partnership creditors in the joint estate, cannot be successfully controverted. It originated as a consequence of the rule of priority of partnership creditors in the joint estate, and for the purposes of justice, became necessary as a correlative rule. With what semblance of equity could one class of creditors, in preference to the rest, be exclusively entitled to the partnership fund, and, concurrently with the rest, entitled to the separate estate of each partner? The joint creditors are no more meritorious than the separate creditors; and it frequently happens, that the separate debts are contracted to raise means to carry on the partnership business. Independent of this rule, the joint creditors have, as a general thing, a great advantage over the separate creditors. Besides being exclusively entitled to the partnership fund, they take their distributive share in the surplus of the separate estate of each of the several partners, after the payment of the separate cred-

itors of each. It is a rule of equity, that where one creditor is in a situation to have two or more distinct securities or funds to rely on, the court will not allow him, neglecting his other funds, to attach himself to one of the funds to the prejudice of those who have a claim upon that, and no other to depend on. And besides the advantage, which the joint creditors have, arising from the fact, that the partnership fund is usually much the largest, as men in trade, in a great majority of cases, embark their all, or the chief part of their property, in it, and besides their distributive rights in the surplus of the separate estates of the other partners, the joint creditors have a degree of security for their debts and facilities for recovering them, which the separate creditors have not; they can sell both the joint and separate estate on an execution, while the separate creditor can sell only the separate property and the interest in the joint effects that may remain to the partners after the accounts of the debts and effects of the firm

are taken, as between the firm and its creditors, and also as between the partners themselves. With all these advantages in favor of partnership creditors it would be grossly inequitable to allow them the exclusive benefit of the joint fund, and then a concurrent right with individual creditors to an equal distribution in the separate estate of each partner. What equality and justice is there in allowing partnership creditors, who have been paid eighty per centum on their debts out of the joint fund, to come in pari passu with the individual creditors of one of the partners, whose separate property will not pay twenty per centum to his separate creditors? How could it be said to be an equal distribution of the assets of insolvents among their creditors? It is true that an occasional case may arise when the joint effects are proportionably less than the separate assets of an insolvent partner. But as a general thing, a very decided advantage is given to the partnership creditors, notwithstanding this preference of the

individual creditors in the separate property. And that advantage, arising out of the nature of a partnership contract, is unavoidable. Some general rule is necessary; and that must rest on the basis of the unalterable preference of the partnership creditors in the joint effects, and their further right to some claim in the separate property of each of the several partners. The preference, therefore, of the individual creditors of a partner in the distribution of his separate estate, results, as a principle of equity, from the preferences of partnership creditors in the partnership funds, and their advantages in having different funds to resort to, while the individual creditors have but the one."

Contrary to this are arrayed reasons, apparently substantial, but upon mature consideration, not so convincing. Briefly, they are, that the rule is not founded upon principle; that the creditors of the firm are also creditors of each partner, while the separate creditors of one partner

are not creditors of the firm; and, that such a rule affords facility for shifting funds from one portion of one's estate to another, to which it may be said in reply, that such will always be the case where a debtor may prefer a creditor by paying or securing one and not another.

There is a rule in force in Kentucky which is a modification of the proposition, to the effect that where a firm is insolvent and there are partnership and separate estates, and both classes of creditors, the firm creditors, having exhausted the joint estate, must wait, before proceeding against the separate estate, until the individual creditors have received an equal percentage from the separate estate, than the two classes share pari passu in the balance. (Northern Bank of Kentucky v. Keiser, 2 Duval, 169) In declaring this rule, the learned judge frankly admitted that the principle was long and well established, but seemed to overlook considerations vital to his proposition .

Such is the situation of the law on this

branch of the question. While there are reasons in favor of each of the several positions, the preponderance of authority is in favor of the old established rule so forcibly laid down by Lord Loughborough, in Ex parte Elton.

The Distribution of the Separate Estate
of a Deceased Partner.

Partnership creditors reach the estate of a deceased partner in equity. As to the time when they can reach it, there are conflicting views, the generally excepted rule in the United States being that inability to collect from the surviving partner must be shown before proceeding in equity, while in England, the courts have allowed them to proceed in equity the same as they would at law.

For a considerable length of time prior to the case of Devaynes v. Noble, (1 Mer., 397) the decisions of the English Court of Chancery seem to have been in harmony with the New York view. There were various reasons for the change, but the particular and important one was that in the earlier cases it had been assumed that the liability in

equity of the estate of the deceased partner was brought about by a species of equitable transfer to the creditor of the right of the surviving partners to insist that the estate of their late associate should contribute to the payment of the debts of the firm, but upon its being held subsequently that the obligations of partners were to be regarded as joint and several, the English courts said, that, in all cases of that kind, creditors had a right to pursue their remedies against all or either of their debtors. As a natural consequence of the adoption of this view, they held that the creditors might proceed immediately in equity against the representatives of a deceased partner regardless of the fact as to whether they had exhausted their legal remedy against the surviving partners. The New York courts did not follow this change and their decision, in so declining, seems to be supported by sound reasoning. The course of the English courts naturally led to the application in an equity proceeding of the strict legal rules applicable to

suits at law and the setting aside of many equitable considerations of great force. These have been very clearly stated by Judge Selden, in Voorhis v, Childs' Executors. (17 N.Y., 354) He says, in part, " The surviving partners succeed primarily to all the rights and interests of the partnership. They have the entire control of the partnership property and the sole right to collect the partnership dues. The assets of the firm are of course to be regarded as the primary fund for the payment of the partnership debts, and it would seem equitable at least, that the parties having the exclusive possession of the fund should be first called upon. The answer given to this by the English courts, that the representatives have their remedy over, seems hardly satisfactory. The presumption is, that the primary fund is sufficient to meet the demands upon it. Why then permit in equity a resort to another fund and thus give rise to a second action for its reimbursement? Besides, these English decisions permitting the creditors to proceed

in the first instance in equity against the estate of the deceased partner, are in conflict with the established doctrine that parties must first exhaust their legal remedies before resorting to courts of equity." This rule is well settled in New York and has been followed in many American cases.

The estate of the deceased partner may be released from liability to creditors by acts of the parties conclusively showing such an intention. The different holdings of the English and American tribunals, however, affect the results.

In a case in which it was sought to hold the estate of a deceased partner, it was set up as a defence that an agreement had been made with the survivors whereby the money due the creditors was contributed by the deceased as capital to the co-partnership newly formed by the survivors. It was held that if such defence was affirmatively proven it would be valid, but it could not be inferred from the fact that the creditor dealt exclusively with the survivors and recognized them as his debt-

ors. He could do this as they were his exclusive debtors at law and his primary debtors in equity, without in any way relinquishing the secondary liability of the deceased partner. (Forgarty v. Cullen, 49 Super. Ct., 397)

In another case a partnership was dissolved by agreement; one of the partners was to settle the affairs. Shortly afterwards the other partner died. One of the creditors thereafter accepted a note signed by the surviving partner, and on his subsequent insolvency, brought an action against the estate of the deceased. It was held that the acceptance of the note under these circumstances did not indicate any intention to release the estate of the deceased partner. (Titus v. Todd, 25 N.J.Eq., 458)

So much for the American examples. One of the English decisions is found in the case of Bilborough v. Holmes, (L. R. 5 Ch. D. 255) in which a firm consisting of two partners was in the habit of issuing deposit notes. After issuing a

number of these, they took in two new partners. One of the old firm died. The business was advertised to be continued under the old firm name. The remaining old partner died and the business was carried on by the new partners. Subsequently the firm went into bankruptcy and all the holders of these notes proved their claims in only this proceeding. When, later, an action was begun to settle the estate of the partner who first died, the holders of the notes asked to be admitted as creditors. They were all holders of notes at the time the testator died and had all received interest from the new partners. All knew of the death of the testator and had never before made a claim, but some had not altered the amount after deposit, others had increased it and had received new deposit notes from the new partners, and still others had diminished it and had also received new notes. It was held that as to all claims, the acceptance of interest by the new partners worked a complete novation and released the estate of the old partners.

Such is the result of a conscientious effort to present acceptably the results of an investigation of this subject. Flaws there are, undoubtedly, but it is to be remembered that the theme is one worthy a master's mind--a distinction the present writer cannot claim.