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The Revised Uniform Partnership Act Midstream: Major Policy Decisions

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ARTICLES

THE REVISED UNIFORM PARTNERSHIP ACT MIDSTREAM: MAJOR POLICY DECISIONS

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I. INTRODUCTION

IN 1914, the National Conference of Commissioners on Uniform State Laws ("the Conference") approved the Uniform Partnership Act ("UPA"), which was ultimately enacted in every state except Louisiana. The UPA, which applies both to general partnerships and to limited partnerships, has been the object of surprisingly few state variations and remained unchanged by the Conference for over seventy-five years. Nevertheless, a number of developments have caused the Conference to reconsider what may be its most venerable act.

The years since the adoption of the UPA have seen the introduction and development of entire systems of law that bear heavily on partnerships and limited partnerships. Consider, for example, the impact on partnerships of the federal income tax, the federal securities laws and the nationwide adoption of the Uniform Commercial Code. In addition, bodies of law that existed when the UPA was first crafted, such as the federal Bankruptcy Code, have undergone significant change. Until now, the UPA was not amended either to make course corrections in policy or to harmonize in any other way with these developments. Yet the mere passage of time meant that the very language of the law was itself changing.

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In addition to the more global changes, fundamental changes were taking place in the very backyard of partnership law—the law of limited partnerships. The backyard, indeed, had become a shopping center—for venture capital. Aided by favorable tax classification rules and depreciation policy, limited partnerships were reborn in the 1970's. The Uniform Limited Partnership Act ("ULPA"), which the Conference first adopted in 1916, was a statutory covered wagon in a world of cars sporting compact disc players and cellular phones. The ULPA was revised first in 1976 and again in 1985. As ULPA became Revised Uniform Limited Partnership Act ("RULPA") and the law of the limited partnership was brought into the late twentieth century, it was only a matter of time that UPA would become Revised Uniform Partnership Act ("RUPA"). In 1984, Georgia enacted a major revision of its partnership act.[1] In January of 1986, an American Bar Association Committee issued a detailed report that recommended extensive changes to the UPA, many of them along the lines of the recent Georgia changes.[2] In the fall of 1986, Congress enacted the Tax Reform Act of 1986 ("the 1986 Act").[3] The 1986 Act changed the comparative tax advantages of partnerships and corporations by setting corporate income tax rates higher than individual income tax rates while tightening up on the corporate income tax.

In the fall of 1987, the Conference appointed a Drafting Committee to Revise the Uniform Partnership Act. The Drafting Committee held its initial meeting in January of 1988, and has been meeting periodically ever since. In August of 1989, a first draft of RUPA was presented to the Conference at its annual plenary session. The presentation that was begun last summer will continue this summer, and it is expected that RUPA will be finalized and approved by the Conference in the summer of 1991. My presentation today treats five fundamental areas of policy concern in the revision process, with emphasis on two that have proven particularly difficult: breakups and fiduciary duties.

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1. GA. CODE ANN. §§ 14-8-1 to -43 (Supp. 1987).

2. UPA Revision Subcommittee of the Committee on Partnerships and Unincorporated Business Organizations, *Should the Uniform Partnership Act Be Revised?*, 43 BUS. LAW. 121 (1987) [hereinafter ABA Report].

3. Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085 (1986) (codified as amended in scattered sections of 26 U.S.C.).

II. The Partnership Agreement and Default *Versus* Mandatory Rules

The UPA has a wide range of provisions that govern the rights and obligations the partners have among themselves. It is not completely clear which of these rules are default rules and which are mandatory rules. A default rule is one that applies only in the absence of a provable partnership agreement to the contrary. A mandatory rule, on the other hand, is one that applies even in the face of a partnership agreement to the contrary.

Some, but not all, of the UPA rules governing the relations among partners state that they are "subject to" a contrary agreement. UPA section 18, for example, is the basic section that defines the rights and liabilities the partners have among themselves. The introductory language of UPA section 18 provides that its rules are "subject to any agreement between" the partners, thus making it inescapable that the rules of UPA section 18 are default rules rather than mandatory rules. There are, however, other provisions governing the relations among the partners that do not expressly state they are subject to contrary agreement. Does *expressio unius est exclusio alterius*, the maxim of statutory construction, require or at least suggest that the remaining rules in the UPA are mandatory because they do not contain the same or similar qualifying language?

Consider, for example, UPA section 20, which provides without qualification that partners "shall render on demand true and full information of all things affecting the partnership to any partner." Is an attempt to contract away this rule enforceable? For further example, is only part of UPA section 19 subject to contrary agreement? UPA section 19 provides that partnership books and records shall be kept, "subject to any agreement between the partners," at the principal place of business of the partnership. It then provides, without express qualification, that "every partner shall at all times have access to and may inspect and copy any" partnership books. If the partnership agreement limits or eliminates completely a partner's access to the partnership books, is it enforceable? Finally, consider the rule of UPA section 21 that partners must account for any profit they derive "without the consent of the other partners from any transaction connected with the . . . conduct . . . of the partnership." Is a partnership agreement that waives all rights to bring a claim under UPA section 21 enforceable?

Questions about whether these rules are default rules or mandatory rules do not arise simply because textual analysis raises the inevitable comparisons. They arise because different policy conclusions could be reached by different people. A libertarian, free-market oriented policy maker is likely to suggest that all the rules governing the relations among the partners should be merely default rules—that partners ought to be held to whatever bargain they negotiate. A more parentalistic policy maker, on the other hand, would be more inclined to support mandatory fiduciary duties to protect minority partners. For example, a parentalist might resist the conclusion that a minority partner should be permitted to contract away his access to partnership books and records.

The Drafting Committee wanted to make clear that all but a very few of the rules governing the relations among partners are merely *default* rules. It was only in rare situations that the Committee felt that the rules should be *mandatory*. Mandatory rules governing the relations among partners are essentially parentalistic, and the Committee felt that, with only very limited exception, adults in nonconsumer transactions are old enough and wise enough to be held to their agreements. The results of the Committee deliberations are reflected in RUPA's new section 4X.

RUPA section 4X(a) contains the general rule that RUPA governs the relations among the partners unless there is a partnership agreement to the contrary. It thus states, although somewhat indirectly, the basic principle that the agreement of the parties is supreme. The statement of general principle avoids the need for repetitive parenthetical statements within individual rules that they are "subject to" contrary agreement. This statutory structure also avoids the interpretative problems that would arise in the most unlikely event the Reporter falls asleep at the quill and neglects to place properly a parenthetical. Given the basic libertarian policy perspective of the Drafting Committee, it is easier to note the limited expressions of parentalism than the much more numerous expressions of the supremacy of the partnership contract.

RUPA section 4X lists the handful of mandatory rules that govern the relations among partners. First, the partners' general duty of good faith and fair dealing under RUPA section 21(a) may not be varied. Second, the agreement may not vary the requirement to wind up the partnership business upon certain events. Third, the agreement may not vary the partners' right to expel a member in certain situations. Finally, the agreement may not vary the power of any partner to withdraw from the partnership at any time.

A more extreme libertarian would argue that our list is too long. Indeed, we were urged to abandon our traditional rule that every partner has the power to withdraw at any time. On the other hand, one who prefers a more parentalistic system would prefer a longer list. The longer list might, for example, give every partner a right to access to partnership books that cannot be varied by agreement. I would like to return to parentalism *versus* libertarianism and mandatory *versus* default rules in the context of RUPA section 21, the core provision on the fiduciary duties among partners.

III. The Move to the Entity Theory

RUPA contains a number of changes that move the law of partnership closer to an entity theory. In general, both for state law and tax law purposes, an entity model tends toward simplicity. The move closer to an entity theory also reflects the Drafting Committee perception that business people tend to perceive partnerships as business entities and not merely as aggregations of individuals.

The changes more fully incorporating an entity model are numerous. At common law, in the absence of an enabling statute, a partnership, not being a legal entity, could not sue or be sued in the firm name. RUPA section 5(a) provides that a partnership "may sue and be sued in the partnership name." This eliminates the problem that exists in certain jurisdictions in which a partnership may sue or be sued only if every partner is named in the action. RUPA section 5(b) provides, on the other hand, that a partner "is not personally liable for any judgment against the partnership unless he [or she] has been served or has appeared in the action." RUPA section 8(e) advances the entity theory by adding to the present rule that property may be acquired in the partnership name the further rule that title "so acquired vests as partnership property in the partnership itself rather than in the partners individually." RUPA section 13 advances the entity theory by an amendment adding partners to the list of those who may sue the partnership on a tort or other theory. This expands the remedies of a partner far beyond the traditional remedies of actions for a dissolution or an accounting. RUPA section 15 is amended to provide that partners are jointly and severally liable for all partnership obligations, which does not sound like a move to an entity theory. It continues, however, by providing that creditors must first seek satisfaction out of partnership assets. The liability of partners is liability for the deficiency that cannot be collected from the entity. Partners are thus more like guarantors of the obligations of an entity than principal debtors.[4]

The shift closer to an entity model can perhaps best be illustrated by examining RUPA's discard of UPA's tenancy in partnership. UPA section 24 states that every partner has "rights in specific partnership property." UPA section 25(1) elaborates by stating that each partner "is co-owner with his partners of specific partnership property holding as a tenant in partnership." These statements reflect an aggregate conception that each partner is a direct owner of an undivided interest in the partnership business, including its assets. On the other hand, the remaining subsections of UPA section 25 strip the individual partners of all the incidents of ownership of partnership assets. By a process of elimination, the incidents of ownership that are taken from the partners are left in the partnership. Stated simply, the UPA's provisions reach an entity result but insist on stating that result in aggregate terms.

RUPA reaches an entity result and states it in entity terms. RUPA section 25(a) states directly that property "transferred to or otherwise acquired by a partnership becomes property of the partnership rather than of the partners individually." RUPA also eliminates all reference to a partner's rights in specific partnership property. RUPA section 18X reaffirms that partners are cut off from particular partnership assets, even ones they contributed, by providing that no partner has a right to receive a distribution in kind. Similarly, no partner can be forced to take a disproportionate distribution in kind. RUPA section 26 provides that a partner's "assignable interest in the partnership

4. ABA Report, *supra* note 2, at 143 states that "this result would be most consistent with general business expectations today."

is the partner's share of the distributions. The interest is personal property."

RUPA's new rules on partnership breakups also reflect a significant move closer to an entity model. These rules are discussed more fully below but are noted briefly here to complete the picture of a broad move to an "entity" model. In short, under RUPA, partnerships are no longer dissolved every time a partner leaves. Although some withdrawals will trigger a winding up of the business of the partnership, others will not. In many situations, the partnership will continue uninterrupted by the departure. RUPA section 41(a) provides that, unless otherwise agreed, the relationships between a partnership and its creditors are unaffected by the cessation of a partner's status or by the addition of a new partner. Because under RUPA the "old" partnership continues, it is no longer necessary to deem the creation of a "new" partnership that must in turn be deemed to assume the obligations of the "old" partnership. Under RUPA, the "old" partnership simply continues with its rights and obligations intact.

It was only after making these and other changes closer to an entity model that the Drafting Committee finally moved to amend RUPA to define partnerships as entities. As a result of the most recent meeting of the Drafting Committee, RUPA defines a partnership as "an entity resulting from the association of two or more persons to carry on as co-owners a business for profit." RUPA does not, however, declare that the aggregate theory is never appropriate. Nor does RUPA suggest the relentless application of any general theory of the partnership form.

It is therefore to be expected that an aggregate approach will continue to be applied in certain situations. The aggregate approach often seems suited to the small partnership, including the inadvertent partnership. Small partnerships seem more personal, and so does the aggregate theory. Indeed, parties often document small partnerships in aggregate terms. Larger partnerships seem less personal, and hence more likely candidates for the application of the entity theory. The larger the partnership, moreover, the greater the harvest from the simplicity of the entity model. With respect to both large and small partnerships, however, the aggregate model is particularly useful to state the traditional fiduciary duties among partners. For example, despite RUPA's major move toward an entity theory, RUPA section 21(a) states that partners have a duty of good faith and fair dealing "towards the partnership *and the other partners.*" Not only must partners be concerned about the effect of their conduct on the partnership business as an entity, but also they must avoid oppressive behavior toward individual partners.

It is also expected that courts will not needlessly apply either theory. The resort to the general theory of the business organization is all too often a substitute for analysis, and we do not urge a return to a jurisprudence of conceptions. There are many cases in which the general theory of the business organization should be of no concern. Unfortunately, shorthand statements of theory are often treated as talismanic. Consider, for example, the recent case of *Mississippi Valley Title Insurance Co. v. Malkove*,[5] which immediately became my favorite illustration of this point. Two individuals received a conveyance of a parcel of land and obtained a title insurance policy. Within the year, they formed a partnership with two other individuals and contributed the parcel. A restrictive covenant encumbering the parcel was discovered, and suit was brought against the title insurance company. The suit is good, said the majority, applying the logic of the aggregate theory. The two individuals remained co-owners of the property even after they contributed it to the partnership, said the court, relying on the UPA's declaration of a tenancy in partnership. Not so, said the dissent, because the thrust of the tenancy in partnership provisions, especially when put in the context of other UPA provisions, is that an entity theory must be applied. And, concluded the dissent, under the entity theory the partnership, not the two individuals, owns the property. The partners may have some interest in the property, but "these mere derivative rights are simply inadequate to support a finding" against the title insurance company.[6]

Mississippi Valley need not have been decided on the basis of the general theory of the business organization. I enthusiastically support RUPA's move closer to an entity theory, but do not believe the theory should shortcircuit policy analysis. There is no reason why the logic of the entity theory should be any more ineluctably applied in the partnership area than in the corporate area, and the entity theory of corporations is often set aside to reach the right result. In *Sandler v. New Jersey Realty Title*

5. 540 So. 2d 674 (Ala. 1988).
6. *Id.* at 682.

Insurance Co.,[7] for example, the fee owner purchased a title insurance policy and subsequently conveyed the fee to his wholly-owned corporation. The court said that "any change short of a complete transfer of his entire interest" would not defeat the title insurance policy. It held that it was sufficient to retain an insurable interest and that such an interest is retained by a person who contributes property to his wholly-owned corporation. In short, *Sandler* was decided on the basis of the right result under the insurance policy, and not by blind application of the general entity theory of the organization. I assume that similar decisions can be reached under RUPA.

IV. Statement of Partnership Authority

The Drafting Committee rejected the idea of a mandatory statement of partnership. It was felt that there is no need to add paperwork or disclosure requirements to the law of partnership simply because paperwork and disclosure may be required to form corporations and limited partnerships. For one thing, our focus throughout RUPA has been on informal partnerships that are formed, operated and liquidated with little or no written agreement. For another, RUPA also applies to inadvertent partnerships. It was unclear how we can ask a group of people who do not think they are partners to register as partners. Nor was it clear what the sanction should be for noncompliance.

RUPA section 10X provides for voluntary recordation at the state level of a statement of partnership authority. The most important goal of the statement of authority is to facilitate real property transfers. RUPA section 10X(a)(4) provides that the statement must "specify the partners required to sign a transfer of real property held in the name of the partnership." The new provision is also intended to give effect to statements of authority far beyond real property transfers. RUPA section 10X(a)(5) provides that the statement may "contain any other matters the partnership chooses, including the authority, or restrictions upon the authority, of some or all of the partners to enter into other transactions on behalf of the partnership."

7. 36 N.J. 471, 178 A.2d 1 (1962).

The recording of an extraordinary grant of authority is treated differently than a recorded restriction on authority. A recorded grant of extraordinary authority, whether the grant concerns real estate or other transactions, binds the partnership. RUPA section 10X(c) provides:

> (c) The filing of the statement . . . creates a conclusive presumption in favor of any bona fide purchaser or encumbrancer of partnership property, or any creditor of the partnership giving value, that the partners stated to be authorized to convey or encumber partnership property or enter into other transactions on behalf of the partnership are authorized to do so.

On the other hand, a recorded restriction on authority only binds nonpartners who have actual knowledge of the restriction. RUPA section 10X(d) provides:

> (d) A statement of authority may limit or restrict the authority of a partner granted under Section 9 to enter into transactions on behalf of the partnership, but a limitation on or restriction of authority . . . is effective only against persons who are not partners if they have knowledge of the restriction or limitation.

The Drafting Committee felt that it would be unfair to bind third parties to recorded restrictions on authority they were most unlikely to consult.

The Committee rode a wave of populism that swept in from California to exact disclosure of partnerships that exercise the option to file a statement of partnership authority. Accordingly, RUPA section 10X(a)(2) provides that the statement must "list the names and street addresses of either all of the partners or of an agent who must be appointed and maintained by the partnership and who must maintain a list of all partners and make it available to any third party on request." I personally do not see the need for imposing this disclosure tax on partnerships. Given that the statements are likely to be filed at the insistence of third parties, such as title insurance companies, I see the "privilege" of recording as falling outside the partnership. Further, the disclosure tax was imposed in our discussion of RUPA section 10X before it became clear that third parties will not be bound by constructive notice of restrictions on authority. There might have been more of a "privilege" if partnerships could have bound third parties by recorded restrictions on the power of their members to bind the partnership. Finally, the imposition of the disclosure tax seems to be second-guessing our basic policy decision that the statement of authority provision is optional.[8] The disclosure will be mandatory for partnerships that are forced to file by title insurance companies or other creditors.

The latest draft of RUPA section 10X has caused one member to suggest that we reconsider RUPA section 9. The most significant change in RUPA section 9 is the elimination of the rule that was previously contained in UPA section 9(3). UPA section 9(3) contained a list of actions that could not bind the partnership unless there was unanimous consent. After discussing revisions to the list in UPA section 9(3), the Drafting Committee decided to eliminate the list completely. The elimination of the list leaves it to the courts to place certain decisions outside the actual, apparent or inherent authority of partners. It has been suggested that we were willing to eliminate UPA section 9(3) because the partnership was going to have an opportunity to record restrictions on authority under RUPA section 10X. Now it is clear that, although the partnership can record the restrictions, they will have little or no effect because they will bind only third parties who know of them. According to this view, RUPA section 10X would be more valuable if it provided a way to bind third parties by recorded restrictions on authority. The view that won the day, however, was that the case for binding third parties had not been made.

V. New Rules on Partnership Breakups

At the beginning of this century, the law of partnership breakups was couched in terms of dissolution and was confused. Dean William Draper Lewis, the Reporter who saw the UPA to completion, thought that the concept of dissolution was perfectly logical but sadly misunderstood. He said the source of the

8. Under RULPA, a certificate of limited partnership must be filed to form a limited partnership, but it need not name the limited partners. R.U.L.P.A. § 201(a). An office must be maintained at which certain records are to be kept, including the name and business address of each limited partner. *Id.* § 105(a)(1). These records are only subject to inspection and copying at the request "of any partner." *Id.* § 105(b).

confusion lay in the failure to give a consistent meaning to the term dissolution. His solution to the confusion, which was approved by the Conference and incorporated into the UPA, was to continue with the term dissolution and define in the statute both what dissolution is and is not. UPA section 29 states what dissolution 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." UPA section 30 states what dissolution is not: "[o]n dissolution the partnership is not terminated, but continues until the winding up of partnership affairs is completed." All the UPA provisions on partnership breakups are then activated by a dissolution.

Seventy-five years later, the law of partnership breakups is still couched in terms of dissolution and it is still confused. There are cases that find a dissolution and apply the strict logic of dissolution even though justice would seem to require otherwise.[9] There are cases that struggle to reach a right result by refusing to find a dissolution even though the statute seems to require a dissolution.[10] More basically, there are cases that appear to reflect a complete misunderstanding of the concept of dissolution as it is used in the statute.[11]

Savor for a moment the UPA conception of dissolution as a "change in the relation of the partners caused by any partner ceasing to be associated in the carrying on" of the business. This definition of dissolution is actually an indirect definition of partnership. More precisely, it is an aggregate conception that a partnership is a unique aggregation of individuals, a specific cast of characters. The cast is "dissolved" whenever anyone leaves. Let us take as a simple example a firm of four partners. Assume all the partners, including the departing

9. *See* Fairway Dev. Co. v. Title Ins. Co., 621 F. Supp. 120 (N.D. Ohio 1985).

10. *See* Zeibak v. Nasser, 12 Cal. 2d 1, 82 P.2d 375 (1938), in which the court said that the death of a partner does not necessarily dissolve the partnership, especially if the partner who dies is a passive investor.

11. In Great Hawaiian Fin. Corp. v. Aiu, 863 F.2d 617 (9th Cir. 1988), the court stated that the withdrawal of three managing partners "indicates that the original partnership including those partners was dissolved as to *those partners*," but did not necessarily indicate that the partnership was dissolved as to the remaining partners. *Id.* at 620 (emphasis added). The UPA does not support the argument that the partnership is dissolved as to some partners but not as to others.

partners, happily and harmoniously agree the departing partner will leave and the remaining partners will continue with the business. In particular, assume it is agreed that the withdrawing partner will neither be required to make any additional contributions nor entitled to receive any additional distributions. Cannot we just say that the partnership continues? That is what the tax law says.[12] No, says the UPA, the "old" partnership is dissolved and a "new" partnership is created.

Could that possibly mean that property of the "old" partnership must be conveyed to the "new" partnership? Yes it could.[13] Could it possibly mean that contracts of the "old" partnership lapse because the old partnership, the party to the contract, no longer exists, leaving a "new" partnership that is simply a stranger to the bargain? Yes it could. No, you might protest in disbelief, those are not practical problems or likely outcomes in the real world. Surely such fanciful arguments demonstrate what is wrong with legal education today. Surely the raising of such questions constitutes the worst of academic hair-splitting. Surely this evening's speaker spent too many years at the hands of the Jesuits.

I wish that I could tell you that these are fanciful problems or issues that were satisfactorily resolved decades ago. But I cannot. Consider the illustration of a recent case from this very part of this very state. In *Fairway Development Co. v. Title Insurance Co.*,[14] a real estate development partnership consisting of three individuals took out a title insurance policy. Subsequently, two of the partners "transferred not just their interest in the partnership, i.e., their respective shares of profits and surplus, but their entire respective bundles of partnership rights" to the remaining partner and a third person.[15] An undisclosed pipeline easement was discovered and the surviving partnership sued the title insurance company.

12. I.R.C. § 708 (1988).

13. *See* VA. CODE ANN. § 50-37.1 (1989), which supplements the UPA. It provides that if the partnership is dissolved but its business is continued "without liquidation of the partnership affairs, the title to any real estate or any interest therein vested in the dissolved or former partnership shall be deemed to be transferred to and vested in such new partnership as may be created by the remaining partners without further act or deed."

14. 621 F. Supp. 120 (N.D. Ohio 1985).

15. *Id.* at 124.

The court began its discussion with the "fundamental principle of law" that "any change in the personnel of a partnership will result in its dissolution."[16] Accordingly, the old partnership was dead, a new partnership was born, and the new partnership had no "standing" to bring the action because it was not a party to the insurance contract.[17] The court was unimpressed with the argument that, even if there was an "old" partnership and a "new" partnership, all members of both partnerships intended the new partnership to continue with all the rights and liabilities of the old partnership.[18]

The problem with the UPA's use of the term dissolution is clearly much more fundamental than the absence of explicit definition. The problem is with the way dissolution is defined and the role it is given in the statute. The basic problem with dissolution under the UPA is that it is an aggregate concept that fails to recognize the stability of partnerships as business

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16. *Id.* at 122. The court reiterated its strict aggregate approach by stating that UPA § 41(1) "seems to assume that a dissolution occurs upon the admission of a new partner or the retirement of an old partner." *Id.* at 123.

17. *Id.* at 125. The court said its approach "accords with the aggregate theory of partnership, which, applied to these cases, recognizes Fairway Development I not as an entity in itself, but as a partnership made up of three members . . . . That partnership ceased when the membership of the partnership changed." *Id.* at 124.

18. *Id.* at 121. In addition to the UPA provisions, the Ohio statutes also contained a special supplement on fraud in partnership affairs and the use of fictitious names in partnerships. Partnerships transacting business in Ohio under names that are fictitious or do not reveal the names of all the partners must record a certificate stating the name and residence of each partner. OHIO REV. CODE ANN. § 1777.02 (Anderson 1985). The *Fairway Development* court found significance in the requirement to file a new certificate whenever there is a change in membership in a registered partnership. 621 F. Supp. at 123. *See* OHIO REV. CODE ANN. § 1777.03 (Anderson 1985). Incorrectly assuming that the special Ohio provisions are part of the UPA, the court found them further support for the aggregate theory:

> [W]here members of a general partnership change, the partnership must file a new certificate of partnership, unlike a limited partnership, which simply may amend its certificate of partnership. The fact that the Uniform Partnership Law makes this distinction supports a finding that the authors of the Uniform Partnership Act recognized that a change of the members of a general partnership in fact changes the original partnership and creates a new partnership requiring a new certificate, as opposed to an amendment to the original certificate.

621 F. Supp. at 123.

organizations. Most law students are asked to consider at the extreme the law firm with one hundred partners. Does the firm technically dissolve and reform every time a member leaves? Yes, they are likely to be told, at least in most jurisdictions. Does that dissolution of the old partnership and the creation of a new partnership have any practical significance apart from *Fairway Development*-type problems? Stated differently, does the dissolution have any consequences as among the partners? That depends, they are probably told, on whether there is a continuation agreement. The same questions and answers arise in the context of small partnerships. The UPA actually destabilizes some partnerships. The UPA suggests that the partnership business is coming to a close when it may not be. All that may be coming to a close is one person's participation. In short, the UPA does not adequately distinguish a departure that triggers a winding up of the business from a departure that does not.

Consider the policy goals that must be achieved when a partner leaves. Let us return to our simple example of the four-person firm of contented partners. Assume, once again, that one of the four will withdraw from the business and the remaining three will continue the business. Assume, now, however, that the withdrawing partner is entitled to a payment for her equity in the business. There are three basic things the partnership statute must do. First, it must end the power of the withdrawing partner to bind the partners she has just left. Second, it must end the power of the continuing partners to bind the withdrawing partner. Third, it must pay the withdrawing partner her equity. The UPA provides that the partnership must be dissolved before *any* of these things can be done. The UPA breakup provisions are all triggered by dissolution. *Yet it may not be necessary to declare the partnership dissolved to do any of these things.* For the sake of simplicity, why not let the partnership continue if the business is to continue?

The provisions of RUPA were drafted without the use of the word dissolution. For almost two years, the project proceeded without the use of "the D word." The provisions in RUPA reached their present structure and substance without the use of the D word. RUPA has three central provisions on partnership breakups. RUPA section 31 lists all the ways in which one ceases to be a partner. RUPA section 31Y identifies the cessations that will cause a winding up of the business of the partnership. RUPA section 32 states that all other cessations will result only in a buyout of the departing partner and not a winding up of the business.

The term "ceases to be a partner" is awkward, but the Drafting Committee felt it was more precise than the term "withdrawal." The group did not think the term withdrawal was appropriate, for example, in cases of expulsion. Under RUPA, the cessation of partner status triggers the rules that achieve the first two policy objectives: (1) end the power of the departing partner to bind the others; and (2) end the power of the others to bind the departing partner. The third policy objective is then achieved in one of two ways, depending upon the reason for cessation of partner status. Some cessations of partner status will trigger a winding up of the partnership business. RUPA section 31Y lists the cessations that trigger a winding up of the business. If a winding up is triggered, the partnership assets must be applied to discharge its liabilities and any surplus paid in cash to the partners. On the other hand, other cessations will not result in a winding up of the business but will only result in a buyout of the departing partner by the partners who continue with the business. RUPA section 32 provides that, if a cessation does not cause a winding up under RUPA section 31Y, the departing partner must be bought out.

RUPA section 32(a) provides that if a person ceases to be a partner but no event triggers a winding up, the partnership "*shall purchase* the interest of the person who ceases to be a partner *for its fair market value.*" RUPA section 32(f), however, provides that a partner who has withdrawn by express will prior to the expiration of a specified term or undertaking need not be paid any portion of the value of her interest until the expiration of the term or undertaking, unless she persuades a court that payment should be made over a lesser term.

RUPA section 32(b) attempts to give some guidance on "fair market value," recognizing the difficulty in determining value in the context of closely-held businesses. It begins with the rule drawn from case law that the fair market value "shall be determined as of the moment of the event causing cessation."[19] The fair market value of the interest is defined as "the amount that would have been distributable to that person in a winding up of the partnership business." The sense of the statute is

19. *See* United States v. Land, 303 F.2d 170 (5th Cir. 1962).

that, theoretically, the departing partner should get the same amount through the buyout route that she would get if the business were wound up.

To determine the amount that would have been distributed in a winding up, RUPA section 32(b) provides that partnership assets "must be valued at the greater of (i) liquidation value or (ii) value based on sale of the entire business as a going concern without the departing partner." This language is intended to cut through some of the confusion in the partnership cases concerning the term going concern value. I grew up thinking of "going concern value" as a term that meant that assets have greater value if they are part of a going concern. On the other hand, there is recent partnership case law that states that going concern value is lower than liquidation value if the assets cannot be liquidated because they are committed to a going concern.[20] In effect, dedication to a going concern is seen as an encumbrance.

Whether liquidation value or going concern value is used, RUPA section 32(b) provides that the assets are to be valued "on the basis of the price that would be paid by a willing buyer to a willing seller, neither being under any compulsion to buy or sell, and with the knowledge of all relevant facts." The "willing buyer-willing seller" standard is taken from the estate tax regulations, which are also used for income tax purposes.[21]

RUPA section 32(b) also contains a parentalistic rule that was included primarily to protect the spouse of a deceased partner. In the case of "a partnership in which capital is a material income producing factor, regularly scheduled distributions must continue to be made to the former partner or successor in interest." Our sense was that the surviving partners should not be permitted to cut off all distributions to pressure a buyout at a low price. The concept of a partnership in which capital is a material income producing factor has long been in the family partnership rules.[22]

So there you have the basic architecture of the RUPA provisions on partnership breakups. Many hours of drafting and discussion went into the new rules, which were forged

20. *See* Estate of Watts v. Commissioner, 823 F.2d 483 (11th Cir. 1987), *aff'g* 51 T.C.M. 60 (CCH) (1985).

21. Treas. Reg. § 20.2031-1(b) (1965).

22. I.R.C. § 704(e) (1988).

without the use of the term dissolution. At the very last hour of our most recent meeting, the word dissolution was put back into the statute. This is not to say that the suggestion was only raised at the eleventh-hour. Quite the contrary. Throughout the project, there have been those who have expressed the desire to reinstate the word dissolution. They were asked to hold this suggestion, to give us a chance to see the kind of statute we could craft without "the D word." They finally had a chance to state their case, and the Drafting Committee at its latest meeting decided that the word could be added back into the statute without the need to change either the basic structure we had drafted or the substantive decisions we had hung on that structure. Accordingly, RUPA section 29 provides: "A partnership is dissolved when an event causes the winding up of its business under Section 31Y." RUPA section 31Y, in turn, begins by stating that "[a] partnership is dissolved and its business shall be wound up on the occurrence of" certain events. This echoes the language at the beginning of RULPA section 801 that a limited partnership "is dissolved and its affairs shall be wound up upon the happening" of certain events.

The Drafting Committee was told that there would be strong opposition to RUPA if the word dissolution were deleted. Why? First, not everyone believes that the term dissolution causes confusion. Why else? Second, RULPA uses the word dissolution, and there are those who believe that RUPA should follow RULPA whenever possible. Why else? These reasons do not seem adequate to explain the intense and unceasing insistence on the use of one word. Would RUPA's elimination of the word dissolution have left the law of general partnerships in a more confused state? I do not think so. The suggestion was that RUPA could cause trouble for limited partnerships, particularly those with sole corporate general partners, by providing an occasion for the Treasury Department to reconsider the regulations that distinguish partnerships from corporations for tax purposes.

The limited partnership is a corporate antecedent, an historical compromise on the road to general incorporation acts. It is therefore not surprising that questions have been raised about the proper tax classification of limited partnerships, particularly those with sole corporate general partners.[23] The Treasury

23. For a brief history of limited partnerships in the United States that

Regulations that distinguish a partnership from a corporation for tax purposes are known as the "association" regulations.[24] Those regulations identify four characteristics that tend to be found in a "pure corporation," and state that three of the four must be present before an organization will be classified as a corporation. This "numerical supremacy" test provides that, if only two of these characteristics are present, partnership classification results. Stated from the point of view of someone who hopes to classify a limited partnership as a partnership for tax purposes, the goal is to eliminate any two of the corporate characteristics.

The association regulations are highly formalistic and the characteristics are defined in bizarre ways. Continuity of life is one of the four characteristics that limited partnerships typically say is not present. The elimination of continuity of life is a "freebie" in the sense that it is a characteristic that is eliminated independent of the particular features of the limited partnership. It can be eliminated as a formalistic matter because the regulations state that continuity of life is not present if the departure of any partner causes a "dissolution."[25] Take away the dissolution,

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includes a discussion of the tax classification issue, see Weidner, *The Existence of State and Tax Partnerships: A Primer*, 11 FLA. ST. U.L. REV. 1, 46-92 (1983).

24. Treas. Reg. § 301.7701-2 (1983).

25. *Id.* § 301.7701-2(b)(1):

> An organization has continuity of life if the death, insanity, bankruptcy, retirement, resignation, or expulsion of any member will not cause a dissolution of the organization. On the other hand, if the death, insanity, bankruptcy, retirement, resignation, or expulsion of any member will cause a dissolution of the organization, continuity of life does not exist.

The regulations state that it does not matter if the partners have a continuation agreement, so long as a dissolution takes place:

> An agreement by which an organization is established may provide that the business will be continued by the remaining members in the event of the death or withdrawal of any member, but such agreement does not establish continuity of life if under local law the death or withdrawal of any member causes a dissolution of the organization. Thus, there may be a dissolution of the organization and no continuity of life although the business is continued by the remaining members.

Id. § 301.7701-2(b)(2). Even though the partner who dissolves in contravention of the agreement has lesser rights than one who dissolves in accordance with the agreement and can be liable for breach, the power to dissolve precludes it is argued, and you may make it more difficult for limited partnerships to argue that the corporate characteristic of continuity of life is negated.

I have two basic responses to the argument that the word dissolution should be retained to preserve present tax classification results. First, RULPA has received the endorsement of the Internal Revenue Service[26] even though *as a formal matter* it eliminates dissolution in many situations. Under RULPA, many withdrawals of general partners no longer result in dissolutions.[27]

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a finding of continuity of life:

> [I]f the agreement provides that the organization is to continue for a stated period or until the completion of a stated transaction, the organization has continuity of life if the effect of the agreement is that no member has the power to dissolve the organization in contravention of the agreement. Nevertheless, if, notwithstanding such agreement any member has the power under local law to dissolve the organization, the organization lacks continuity of life. Accordingly, a general partnership subject to a statute corresponding to the Uniform Partnership Act and a limited partnership subject to a statute corresponding to the Uniform Limited Partnership Act both lack continuity of life.

Id. § 301.7701-2(b)(3). This last sentence has been referred to as "the shorthand test" to determine whether a limited partnership has continuity of life. It appears, however, not to be a test but a flat rule that ULPA limited partnerships do not have continuity of life.

26. Rev. Rul. 89-123, 1989-47 C.B. 9.

27. R.U.L.P.A. § 801(4) is far from a model of clarity on this point:

> § 801. Nonjudicial Dissolution
>
> A limited partnership is dissolved and its affairs shall be wound up upon the happening of the first to occur of the following:
>
> . . .
>
> (4) an event of withdrawal of a general partner unless at the time there is at least one other general partner and the written provisions of the partnership agreement permit the business of the limited partnership to be carried on by the remaining general partner and that partner does so, but the limited partnership is not dissolved and is not required to be wound up by reason of any event of withdrawal, if, within 90 days after the withdrawal, all partners agree in writing to continue the business of the limited partnership and to the appointment of one or more additional general partners if necessary or desired . . . .

It is unclear how this provision meshes with the UPA rules on breakups, which as a general matter are only activated by a dissolution. *See* U.P.A. §§ 34-43. For example, assume that a general partner withdraws from a limited partnership operating under an agreement that gives the remaining general partner the right to continue the business. If the remaining general partner does so and there is no dissolution because of R.U.L.P.A. § 801(4), what rules end the authority of the departing partner to bind the partnership?

Second, more basically and wholly apart from the formal elimination of the word dissolution, RUPA retains the substantive rules of the UPA that *as a practical matter* deprive partnerships of continuity of life in the corporate sense.

The key to the elimination of continuity of life is discussed in *Larson v. Commissioner*,[28] the leading case interpreting the association regulations. The various opinions in *Larson* recognized that the regulations are highly formalistic but nevertheless tried to make some sense out of them. Judge Tannenwald's majority opinion contains the following trenchant observation about why partnerships do not have continuity of life in a corporate sense:

> The significant difference between a corporation and a partnership as regards continuity of life, then, is that a partner can always opt out of continued participation in and exposure to the risks of the enterprise. A corporate shareholder's investment is locked in unless liquidation is voted or he can find a purchaser to buy him out.[29]

RUPA does not change the basic UPA rules that permit partners to cash out of partnerships at any time. As indicated above, the Drafting Committee expressly rejected the suggestion to make partnerships for a specified term or undertaking specifically enforceable. RUPA section 31(1) continues the traditional rule that every partner has the power to withdraw from the partnership at any time. The Committee also rejected the suggestion that we eliminate the UPA right of each member of an at-will partnership to force a liquidation of the business.[30] If the

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28. 66 T.C. 159 (1976), *acq.* 1979-2 C.B. 2.

29. 66 T.C. at 173-74.

30. *See* Ribstein, *A Statutory Approach to Partner Dissociation*, 65 WASH. U.L.Q. 357, 395-96 (1987):

> [T]he parties to a partnership relationship would not be likely to give each partner the right to liquidate at will. Because liquidation at will is ordinarily beneficial in terms of valuation of the partnership assets only if accompanied by a costly squeezeout, liquidation at will offers the partners only the opportunity to be on the winning side of a zero-sum reallocation of values among the partners. If the partners do not know *ex ante* whether they will be winners or losers, they have little to gain by gambling in this way. If the partners can predict who will benefit from a liquidation right, it is unlikely the potential losers will agree unless they are offered strong inducements under a customized agreement. By com-

partnership is at-will, RUPA section 31Y(1) gives the withdrawing partner the same right she had under the UPA to demand that the partnership business be liquidated so that its liabilities can be satisfied and she can be paid her equity in cash.[31] If there is a binding continuation agreement, however, the withdrawing partner has, as she did under the UPA, only the right to be paid for the fair market value of her interest by the continuing partners.

Nevertheless, responded those who wanted "dissolution" reinstated, the deletion of the word would invite the Treasury to reconsider the association regulations. Unfortunately, I have no logic to dispel this objection. The question is essentially a political one. Can I say as a matter of fact that the deletion of the word dissolution will not cause the Treasury to reconsider its regulations? No, I cannot. Can I say that if I were relentless in the protection of my limited partnership clients, I would not make the same objection? No I cannot. I can only point out as an academic that a significant improvement in the law of general partnerships is being defeated because it *might* prompt the Treasury to reopen a longstanding issue of federal tax policy. Because the tax classification issue is revisited every few years, the fear is really only that it will be revisited sooner rather than later. Indeed, it may not be the limited partnership but the current excitement about the limited liability company that next lets the tax classification cat out of the bag. Finally, even if it is assumed that the issue were forced sooner rather than later, historical experience suggests that limited partnerships that are not publicly traded will win and those who wish to classify them as corporations will lose.[32]

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parison, the buyout right is desireable [sic] because it offers all of the partners, including those who are unlikely to be able to use the buyout as a squeeze-out device, a cost-efficient way to reduce the substantial risks associated with illiquidity.

31. RUPA § 31Y(1) provides that the business of the partnership shall be wound up "on the giving of notice by one partner to another partner of the first partner's express will to withdraw as a partner, unless the partners, including the withdrawing partner, agree in the partnership agreement or at any other time that the business of the partnership be continued by the remaining partners." *Compare* UNIF. PARTNERSHIP ACT § 38(1), 6 U.L.A. 356 (1914).

32. In 1982, the American Law Institute approved its Federal Income Tax

On the other hand, even after the word dissolution is reinstated, RUPA's new rules on breakups constitute a major improvement in the law. Dissolution is redefined in a more workable way to refer to the commencement of the winding up of the business rather than the departure of any partner. I believe the definition and use of the term dissolution in RUPA's latest draft are far preferable to the definition and use of the term in the UPA. Although RUPA's provisions are more lengthy than present law, the length adds clarity. The new rules present a much clearer roadmap to buyouts *versus* liquidations, and they define the buyout. The partnership statute is for the small business people of America, for ranchers, farmers, merchants, and small manufacturers. They and their attorneys and accountants have under RUPA a statute that much more clearly than ever tells them of the rights they have when they break up.

VI. FIDUCIARY DUTIES OF PARTNERS

Traditional analysis of fiduciary duties distinguishes the duty of care from the duty of loyalty. This is true in the general law of principal and agent,[33] and in the law of corporations.[34] The

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Project on Subchapter K. Proposal Q would classify all Uniform Act limited partnerships as partnerships unless they are publicly traded. A.L.I. FEDERAL INCOME TAX PROJECT, SUBCHAPTER K, PROPOSALS ON THE TAXATION OF PARTNERS 366 (1984). The Revenue Act of 1987, P.L. 100-203, added I.R.C. § 7704, under which certain publicly traded partnerships are treated as corporations.

33. *Compare* RESTATEMENT (SECOND) OF AGENCY § 379 (1957) ("Duty of Care and Skill") *with* RESTATEMENT (SECOND) OF AGENCY § 387 ("General Principle") animating the "Duties of Loyalty" in RESTATEMENT (SECOND) OF AGENCY §§ 388-98.

34. The Revised Model Business Corporation Act distinguishes the duty of care from the duty of loyalty by providing separate sections on General Standards for Directors, duty of care, and on Director Conflict of Interest, duty of loyalty. REV. MODEL BUSINESS CORP. ACT §§ 8.30, 8.31 (1984). Similarly, the American Law Institute's Corporate Governance Project continues the distinction. The Institute's treatment of the duty of loyalty begins with the following statement of its relation to the duty of care:

> [B]oth analytically and normatively the principle of loyalty precedes that of due care. Analytically, the principle of loyalty has primacy in that the duty of care entails the principle of loyalty. As stated in § 4.01(a) of Tentative Draft No. 4, the conduct of an officer or director conforms to

UPA has no duty of care provision. It does, however, have a duty of loyalty provision of sorts in UPA section 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.[35]

Although a basic purpose of UPA section 21(1) was to give excluded partners priority over the separate creditors of the disloyal partner as to traceable usurped assets,[36] it has been treated by courts as the statutory foundation for powerful fiduciary duties among partners, particularly duties of loyalty.

It may be best to begin with the latest draft of RUPA's fiduciary duty provision and explain its history. RUPA section 21 is couched in terms of an integrated and exclusive statement of the fiduciary duties of partners:

> SECTION 21. ~~PARTNER ACCOUNTABLE AS A~~ FIDUCIARY *DUTIES OF A PARTNER.*
>
> *A partner's only fiduciary duties are the duty of good faith and fair dealing and the duty of loyalty [and the duty of care] set out in this Section.*
>
> *(a) A partner has a duty of good faith and fair dealing towards the partnership and the other partners in all matters related to the formation, conduct or liquidation of the partnership. This*

> the duty of care when it is "in good faith, in a manner he reasonably believes to be in the best interest of the corporation . . . ." Normatively, the principle of loyalty to the corporation specifies the direction in which the efforts are to be made that are regulated by the due care requirement.

Hazard, *Foreword* to A.L.I., PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS ix (Tentative Draft No. 5, 1986).

35. UNIF. PARTNERSHIP ACT § 21(1), 6 U.L.A. 258 (1914).

36. *Id.* at § 21(1) comment, 6 U.L.A. at 258. The comment states:

> A, B and C are partners; A, as a result of a transaction connected with the conduct of the partnership, has in his hands, so that it may be traced, a specific sum of money or other property. A is insolvent. Is the claim of the partnership against A a claim against him as an ordinary creditor, or is it a claim to the specific property or money in his hands? The words "and hold as trustee for the partnership any profits" indicate clearly that the partnership can claim as their own any property or money that can be traced.

general duty of good faith and fair dealing may not be varied by agreement, but the parties by agreement may identify specific conduct that does not violate the general duty of good faith and fair dealing. A partner shall not be considered to have violated the general duty of good faith and fair dealing merely because the partner's actions furthered that partner's individual interest.

(b) A partner has a duty of loyalty to the partnership and the other partners that is limited to the following:

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

(2) to refrain from dealing with the partnership as, or on behalf of, an adverse party without the informed consent of the partnership; and

(3) to refrain from competing with the partnership without the informed consent of the partnership.

This Section 21(b) does not preclude a partner from purchasing the assets of the partnership in a foreclosure sale or upon liquidation of the partnership.

(c) [a duty of care rule is under study]

(d)~~(2)~~ This *Section 21* ~~section~~ applies also to the *personal* representatives of a deceased partner *or the legal representatives of any other partner* engaged in the liquidation of the affairs of the partnership as the *legal* ~~personal~~ representatives of the last surviving partner.

Before considering the three separate duties listed in RUPA section 21, it is important to note that there are those who are disappointed with the continued use of the word "fiduciary." The title and first sentence of RUPA section 21 include the word fiduciary even though the Drafting Committee was repeatedly urged to purge the word fiduciary from RUPA. The very word is troublesome, the sentiment seemed to be, because it is subject to abuse in the hands of judges, academics and others whose flow of satisfactions is derived in far too large a part from imposing their personal values on the more productive members of society. It was said that a partner is not a fiduciary in the same strict sense as a trustee.[37] It was said that a trustee

37. *See* REV. MODEL BUSINESS CORP. ACT § 8.30 comment (1984). Comment

is a person who acts solely on behalf of a beneficiary, whereas a partner by definition is a co-proprietor, a co-owner acting on his own behalf.

The Drafting Committee, however, retained the word fiduciary, apparently persuaded by the argument that the law of partnership is deeply rooted in the law of agency. Under UPA section 9, every partner is a general agent of the partnership, and under UPA section 4(3), "[t]he law of agency shall apply under this act." The black letter law of principal and agent is that every agent is a fiduciary.[38]

A. Duty of Care

An earlier draft of RUPA contained a duty of care rule based on Model Business Corporation Act ("MBCA") section 8.30(a). The rule provided that a partner "managing or conducting the affairs of the partnership" has a duty to act: "(1) in good faith; (2) with the care an ordinarily prudent person in a like position would exercise under similar circumstances; and (3) in a manner he [or she] reasonably believes to be in the best interests of the partnership." Like its MBCA predecessor, the rule was designed so that managers would not be liable for every incorrect decision. The intent of the rule was to focus "on the manner in which the [partner] performs his duties, not the correctness of his decisions."[39] Under this approach, if a decision is properly

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1 states that "[l]ikewise, Section 8.30 does not use the term 'fiduciary' in the standard for directors' conduct, because that term could be confused with the unique attributes and obligations of a fiduciary imposed by the law of trusts, some of which are not appropriate for directors of a corporation."

38. Restatement (Second) of Agency § 1(1) (1957) states that "[a]gency is the fiduciary relation which results from the manifestation of consent by one person to another that the other shall act on his behalf and subject to his control, and consent by the other so to act."

39. Rev. Model Business Corp. Act § 8.30 comment (1984), which also provides:

> In determining whether to impose liability, the courts recognize that boards of directors and corporate managers continuously make decisions that involve the balancing of risks and benefits for the enterprise. Although some decisions turn out to be unwise or the result of a mistake of judgment, it is unreasonable to reexamine these decisions with the benefit of hindsight. Therefore, a director is not liable for injury or damage caused by his decision, no matter how unwise or mistaken it may turn out to be, if in performing his duties he met the requirements of section 8.30.

reached, even if the decision ultimately proves to be a bad one, the partner will not be liable. The inclusion of this language in RUPA would have had the additional advantage that it would be familiar to many from the corporate context.

The Drafting Committee retained the good faith component of the duty of care rule and made it part of the new integrated fiduciary duty provision. It has for the moment rejected the rest of the rule because it is not yet prepared to impose a "prudent person" liability rule among partners. "Reasonable care" was at one point offered as a lesser standard and also rejected. "Standard care" and skill is the normal standard for a paid agent.[40] The sense of the Committee, however, seemed to be that part of being a partner is throwing in your lot with your fellow partners to the extent of assuming the risk of their ordinary negligence. Stated differently, the initial Committee reaction appeared to be that the default rule should require partners to share the losses caused by each other's ordinary negligence. There was some sense that a "gross negligence" standard is appropriate, but the Committee is reluctant to put the term in the statute.

The leading text on partnerships says that partners "are not subject to the ordinary care standard applicable to a paid agent."[41] Indeed, the authors appear to endorse the absence of a reasonable care standard:

> The difference between a partner and a paid agent is, of course, that the partner is subject to individual liability for partnership debts, so that legal liability is less necessary to encourage the agent to act carefully. Because of this individual liability, perhaps a partner should also be distinguished from a corporate director.[42]

Even if a reasonable care standard is not "necessary" to encourage due care, however, it might be appropriate as a matter

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40. *See* RESTATEMENT (SECOND) OF AGENCY § 379(1) (1957):

> Unless otherwise agreed, a paid agent is subject to a duty to the principal to act with standard care and with the skill which is standard in the locality for the kind of work which he is employed to perform and, in addition, to exercise any special skill that he has.

41. A. BROMBERG & L. RIBSTEIN, PARTNERSHIP § 6.07(f) (1988).

42. *Id.*

of fairness among partners. If a ten percent partner negligently shatters $X of partnership property, why should ninety percent of the loss be borne by the other partners? What if the partner's negligence causes a loss to a third party that not only wipes out all partnership assets but also causes the ninety percent partners to lose their separate assets? Is the goal of distributive justice among partners served if the scrupulously careful ninety percent are wiped out and denied the right to be indemnified by the negligent actor?

In addition, there are both old and new statements that partners are subject to an ordinary care standard. Writing in 1841, for example, Mr. Justice Story opined that "good faith, reasonable skill and diligence, and the exercise of sound judgment and discretion, are naturally, if not necessarily, implied from the very nature and character of the relation of partnership."[43] He traced the principle to Roman law, which he summarized as follows: "[I]n cases of partnership the same diligence is ordinarily required of each partner, as reasonable and prudent men generally employ about the like business; unless the circumstances of the particular case repel such a conclusion."[44]

Much more recently, the Supreme Court of Maine has said that partners are subject to an "ordinary prudent person" standard. In *Rosenthal v. Rosenthal*,[45] the court presented an integrated statement of the fiduciary duties of partners and directors:

> The presiding justice set forth the following four specific fiduciary duties owed by the business associates to each other:
>
> (1) To act with that degree of diligence, care and skill which ordinarily prudent persons would exercise under similar circumstances in like positions;
>
> (2) To discharge the duties affecting their relationship in good faith with a view to furthering the interests of one another as to the matters within the scope of the relationship;
>
> (3) To disclose and not withhold from one another relevant information affecting the status and affairs of the relationship;
>
> (4) To not use their position, influence or knowledge respecting the affairs and organization that are subject to the relationship

43. J. Story, Commentaries on the Law of Partnership 261 (1841).
44. *Id.* at 263.
45. 543 A.2d 348 (Me. 1988).

> to gain any special privilege or advantage over the other person or persons involved in the relationship.
> This delineation of fiduciary obligation reflects accurately the duties of care and loyalty owed under Maine law by a corporate director to the corporation and its shareholders, as well as the duties of a partner to the partnership and his fellow partners.[46]

The *Rosenthal* statement is instructive for a number of reasons. First, it retains the word fiduciary. Second, it uses a prudent person standard.[47] Third, it puts the partner and the director on a level playing field. Fourth, it defines the fiduciary duties of partners in aggregate terms. It defines a partner's duties "as including 'furthering the interests of one another,' rather than being restricted to furthering the interests of the business enterprise." Fifth, the court concluded with the caveat that the general fiduciary standards are qualified by the business judgment rule.[48]

The elegance and simplicity of the *Rosenthal* statement are sufficient reason to keep it in mind. However, it also raises the question about the contribution of RUPA in this area. Assume, for example, that a final draft of RUPA were to contain a gross negligence standard. Assume that a member of the Maine legislature is attempting to decide whether to vote to enact RUPA in Maine and asks what effect it will have on the law of his state. After *Rosenthal*, would RUPA not decrease the duty of care of partners and in so doing create a distinction between partners and directors? I am not sure the Committee

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46. *Id.* at 352.

47. *See also* Roper v. Thomas, 60 N.C. App. 64, 298 S.E.2d 424 (1982), in which the court said it was "meritless" to argue that a general partner "may be personally liable for gross neglect of his duties, mismanagement, fraud and deceit resulting in loss to a third person, but not for error of judgment made in good faith." *Id.* at 72, 298 S.E.2d at 429.

48. The Seventh Circuit recently made a similar comparison of the obligations of partners and directors. In Bane v. Ferguson, 890 F.2d 11, 12 (7th Cir. 1989), a retired partner sued the managing partners of his former firm for negligently causing his retirement benefits to be eliminated. Even if you assume that the managing partners are the fiduciaries of a former partner, wrote Judge Posner, "the business-judgment rule would shield them from liability for mere negligence in the operation of the firm, just as it would shield a corporation's directors and officers, who are fiduciaries of the shareholders." *Id.* at 14.

is ready to craft a statute that would reduce the fiduciary duties of partners in this way. In light of the conflicting statements on the duty of care and the importance of the question, the Committee has decided to give the duty of care rule further study.

B. *The Duty of Good Faith and Fair Dealing*

The duty of good faith that was in RUPA's original duty of care rule was moved to RUPA section 21(a), which provides that each partner "has a duty of good faith and fair dealing towards the partnership and the other partners in all matters related to the formation, conduct or liquidation of the partnership." The reference to "the partnership and the other partners" indicates that both entity and aggregate approaches are appropriate to decide whether the duty of good faith and fair dealing has been satisfied. The concern was with oppressive behavior toward a particular partner that might nevertheless be of benefit to the entity as a whole.

The general duty of good faith and fair dealing "may not be varied by agreement, but the parties by agreement may identify specific conduct that does not violate" it. This last language is drawn from the Uniform Commercial Code ("U.C.C.") rule that says that the duty of good faith "may not be disclaimed by agreement but the parties may by agreement determine the standards by which performance . . . is to be measured if such standards are not manifestly unreasonable."[49] The non-waivable nature of the duty of good faith and fair dealing is clear because it is listed in RUPA section 4X. Indeed, it is striking that no other fiduciary duties are listed in RUPA section 4X. The result is that the duty of good faith and fair dealing is mandatory and all the other fiduciary duties are simply default rules. On

49. U.C.C. § 1-102(3) (1983). It is interesting that the U.C.C. has three different concepts: the document, the agreement and the contract. The document is the piece of paper that states rights and obligations. *Id.* § 1-201(15). The agreement, on the other hand, is "the bargain of the parties in fact as found in their language or by implication from other circumstances . . . ." *Id.* § 1-201(3). Contract, under the U.C.C., means "the total legal obligation which results from the parties' agreement as affected by this Act and any other applicable rules of law." *Id.* § 1-201(11). A contract under the U.C.C., therefore, includes mandatory rules.

the one hand, the duty of good faith and fair dealing might be considered a relatively weak duty because it is from the contract law that governs adversarial relationships. Indeed, the U.C.C. has a general definition of good faith that states that good faith is simply "honesty in fact in the conduct or transaction concerned."[50] On the other hand, the U.C.C. is more exacting in the case of a merchant, for whom good faith "means honesty in fact and the observance of reasonable commercial standards of fair dealing in the trade."[51] In addition, there is authority that suggests that the duty of good faith will be given a much more powerful reading in the partnership context.[52]

The last sentence in RUPA section 21(a) is an attempt to recognize and protect the legitimate pursuit of self-interest by a partner. It provides that a partner "shall not be considered to have violated the general duty of good faith and fair dealing merely because the partner's actions furthered that partner's individual interest." After all, RUPA seems to say, if other adversaries can pursue their own self-interest, so can partners. It was argued that partnership is a dynamic, not a static relationship, and that partners have a right to rebargain for a larger piece of the collective pie. Yet the contrary is suggested by judicial opinions that declare a vague yet powerful duty of loyalty. To clarify the law, the argument concludes, the statute should reflect the legitimate pursuit of self-interest that has been approved by the case law holdings, even if it is not protected by case law language.[53]

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50. *Id.* § 1-201(19).

51. *Id.* § 2-103(1)(b). This definition of good faith applies for purposes of article 2 "unless the context otherwise requires." The definition of "merchant" in U.C.C. § 2-104(1) is extremely broad.

52. *See* Page v. Page, 55 Cal. 2d 192, 197, 359 P.2d 41, 44, 10 Cal. Rptr. 643, 648 (1961), in which the court said that the power to dissolve a partnership at will is confined by the duty of good faith, which it seemed to equate with a powerful duty of loyalty. *Page* is criticized in R. HILLMAN, LAW FIRM BREAKUPS 81-84 (1990). *See also* Donahue v. Rood Electrotype Co., 367 Mass. 578, 587, 328 N.E.2d 505, 512 (1975), in which the court said partners owe each other the "utmost good faith and loyalty," referring repeatedly to a "strict good faith standard."

53. Hillman, *Private Ordering Within Partnerships*, 41 U. MIAMI L. REV. 425, 454-70 (1987).

C. *Duty of Loyalty*

RUPA section 21(b) purports to be an exclusive statement of the duty of loyalty of partners. It provides that every partner has a duty of loyalty "that is limited to" three rules. The rule was motivated by a sense that vague, broad statements of a powerful duty of loyalty cause too much uncertainty. It was said that, even if there are no bad holdings, overly broad judicial language has left practitioners uncertain about whether their negotiated agreement will be voided. It was said that practicing attorneys want to be able to reach a deal, put it down on paper and know that it will not be undone by the application of fiduciary duties. RUPA sections 4X and 21 now provide an exclusive checklist of the duties of loyalty and further provide that they can all be drafted away.

First, RUPA section 21(b)(1) provides that every partner has a duty "to account to the partnership and hold as trustee for it any profit or benefit derived by the partner without the informed consent of the other partners, from any transaction connected with the formation, conduct, or liquidation of the partnership or from any personal use of partnership property." This is drawn virtually unchanged from UPA section 21(1), and will probably continue to be viewed as the statutory foundation of a broad and powerful duty of loyalty.

The final two duty of loyalty rules in RUPA section 21(b)(2) and (3) are new to the partnership act. RUPA section 21(b)(2) provides that each partner has a duty "to refrain from dealing with the partnership as, or on behalf of, an adverse party without the informed consent of the partnership." RUPA section 21(b)(3) provides that each partner has a duty "to refrain from competing with the partnership without the informed consent of the partnership." Neither of these rules, however, is new to the law. They are drawn from sections 389 and 393 of the Second Restatement of Agency.

Interestingly, the Drafting Committee deleted the "general principle" that the Restatement describes as animating the specific rules that were included:

> § 387. General Principle
> Unless otherwise agreed, an agent is subject to a duty to his principal to act solely for the benefit of the principal in all matters connected with his agency.

Eliminating this rule of abnegation of self is consistent with the earlier decision that the good faith duty is not violated "merely because the partner's actions furthered that partner's individual interest." The flush language at the end of RUPA section 21(b) is a more narrow reiteration of the legitimate self interest point. It provides that the duty of loyalty "does not preclude a partner from purchasing the assets of the partnership in a foreclosure sale or upon liquidation of the partnership." In part this reflects the general notion that a partner is an owner who naturally will pursue his own self-interest. In part it is an attempt to confirm that dual-capacity transactions do not violate the duty of loyalty.[54] In particular, the goal was to confirm that a person may be both a partner and a lender. Wearing the hat of lender, lender remedies may be pursued.

D. *Summary of RUPA Section 21*

In summary, RUPA section 21 turned into a battleground between the libertarians and the parentalists. The results are equivocal. On the one hand, the libertarians achieved a victory to the extent that RUPA section 21 can be seen as a three-prong attempt to restrain judicial imposition of fiduciary duties: (1) it purports to be an exclusive statement of fiduciary duties, which in turn purports to include an exclusive list of the duties of loyalty; (2) in conjunction with RUPA section 4X, it makes it clear that all fiduciary duties other than the duty of good faith and fair dealing are merely default rules; and (3) it gives statutory legitimacy to the pursuit of individual self-interest. The second is probably the sweetest victory for the libertarians, who hold sacred that fiduciary duties are merely default rules and not mandatory.[55] On the other hand, the parentalists can also claim victory for two basic reasons: (1) RUPA continues to use the term fiduciary; and (2) RUPA section 21(b)(1) continues

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54. *Compare* UNIF. LTD. PARTNERSHIP ACT § 107, 6 U.L.A. 275 (Supp. 1990), which states that "a partner may lend money to and transact other business with the limited partnership and, subject to other applicable law, has the same rights and obligations with respect thereto as a person who is not a partner." *See also* I.R.C. § 707(a) (1988).

55. 2 A. BROMBERG & L. RIBSTEIN, *supra* note 41, § 6.07(a), which states that "[f]iduciary duties are essentially part of the standard form contract that governs partnerships in the absence of contrary agreement."

the language from UPA section 21(1) that the courts have treated as the statutory foundation for a vague and powerful duty of loyalty. The forces are likely to collide once again when the Conference reviews RUPA section 21 and when the Drafting Committee reconsiders a duty of care rule.

VII. Conclusion

The task of Reporter is difficult for various reasons, only one of which is the amount of work involved. The role is an awkward one. The Reporter is expected to have and express his own opinions. At the same time, the Reporter should refrain from any attempt to force his opinions on the Drafting Committee. It is the job of Reporter to serve the Drafting Committee, not the reverse. It has been my job, my honor and my pleasure to listen, to learn and to try to be of some help. I have learned an enormous amount from a truly extraordinary Drafting Committee, a group that has persuaded me to change my opinion on many matters. Indeed, the group has given me many sharp perceptions where before I had none.

Happily, I find myself an enthusiastic supporter of most of the major policy decisions of the Drafting Committee. There is virtual unanimity that RUPA should make a major move away from the aggregate theory and closer to the entity theory.[56] There is also a strong consensus that most of the rules in RUPA that govern the relations among partners should be default rules rather than mandatory rules. There is also a remarkable consensus that RUPA should include a statement of partnership authority provision that binds the partnership to recorded declarations of extraordinary grants of authority. There is strong consensus that RUPA should give more guidance on the fiduciary duties of partners. Finally, there is a strong consensus that the UPA provisions on partnership breakups need major overhaul. In particular, there is strong consensus that we have improved the statute by restructuring it to distinguish departures that result in a buyout of the departing partner from departures that trigger a winding up of the business of the partnership. Most specifically, there is strong agreement that if the term dissolution is to be

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56. *But see* Rosin, *The Entity-Aggregate Dispute: Conceptualism and Functionalism in Partnership Law*, 42 Ark. L. Rev. 395 (1989).

used, it should not refer to all departures from the partnership, but only to those events that trigger a winding up of the partnership business.

My greatest disappointment is that the word dissolution was put in RUPA's breakup rules at our most recent meeting. The term dissolution is an unnecessary one that was not included in RUPA until the new breakup rules were close to final form. It was reinstated primarily to protect limited partnerships, particularly those with sole corporate general partners. For two reasons, I believe the continued use of the term dissolution is likely to generate confusion: (1) it always has; and (2) RUPA now defines dissolution in a very different way than it has been defined for over seventy-five years.

Over the last fifteen years, I have watched the tax law of partnerships perverted to accommodate limited partnership tax shelters. The basic rules on partnership allocations, for example, are now far beyond the comprehension of the small business people of America, the very people who must deal with them.[57] It saddens me that the state law of general partnerships may now be unnecessarily complicated in an attempt to protect the turf of limited partnerships. In light of longer depreciation schedules[58] and slower depreciation methods,[59] the at-risk rules,[60] and the passive loss rules,[61] I am somewhat surprised that so many think the turf is still so valuable. In light of the success private limited partnerships have had in being classified as tax partnerships, I am amazed by the fear that the turf might be lost if one confusing word were to be deleted from the Revised Uniform Partnership Act.

57. *See* Treas. Reg. § 1.704-1 (1989), which begins with a table of contents with over 80 entries.

58. *See* I.R.C. § 168(c) (1988).

59. *See id.* § 168(b)(3).

60. *Id.* § 465.

61. *Id.* § 469 (West Supp. 1990).