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Legal Principles Governing the Determination of Partnership Assets

By Cleaveland R. Cross, A.B., LL.B.

The principles of partnership law have an important place in the legal regulations affecting the acquisition and disposition of property, and not infrequently is title to property, especially with reference to real estate, improperly determined because of the confusion of writers and judges in the application of the rules governing the distinction between individual and partnership title to property. It is the purpose of this article to consider briefly the real nature of a partnership, the true test in determining its existence, and to suggest the fundamental rules of distinction between individual and partnership property.

In most jurisdictions in the United States partnership associations are governed by the common law, and not, as in England, by statutory enactment. Consequently, in America, the subject of partnership law is little more than a development of inconsistent and diversified mercantile and trading customs, having its inception in the recognition by the English courts of the customs of merchants as settled law. This law is commonly referred to as the *law merchant,* and defined as "that general body of commercial usages in matters relating to commerce, consisting of certain principles of equity and usages of trade which general convenience and a common sense of justice have established to regulate the dealings of merchants and mariners in all the commercial countries of the civilized world." Unfortunately, because of the confused notion of the early English jurists that the mercantile customs applicable to the facts of a case, as well as the facts themselves, were within the province of the jury, rather than of the judge, for determination, the early reported cases were without definite statement of law, and amounted to slightly more than an indefinite statement of fact and custom.

The "quasi entity of the firm" theory of partnership, resulting from the constant refusal of the common law to grant any personification to the firm, in contrast with modern statutory regulations permitting the firm to sue and be sued in its firm

name and clothing it with individuality for other incidental purposes, is in direct antagonism to the so-called mercantile and accounting view, which, for all purposes, treats the firm as a separate entity similar to that of a corporation.

The result of this variance between the legal and mercantile view of partnership is that, in the face of the long settled legal principle that the law does not surprise parties into a partnership, there is probably no branch of the civil law so full of surprises to the layman. For example, a partner cannot be guilty of larceny for wrongful appropriation of partnership assets, for he cannot steal from himself. And a partner selling his interest in the enterprise to his co-partner cannot thereafter recover an unpaid portion of his stipulated salary or the amount of a loan made by him to the firm, since all amounts due him from the enterprise are presumed to have been accounted for in the determination of the price demanded by him for his interest. Such conclusions, while the logical result of the non entity theory of partnership, are far from the understanding of persons who enter into a partnership enterprise.

These contradictory and illogical principles of partnership law are applied today to a vastly different subject matter than at the beginning of the *law merchant.* Where partnership associations were at first limited in their use to merchandising and trading, today, in spite of the rapid and wide-spread development of corporate proprietorship, they involve every occupation and profession, and much more extensively than formerly include single ventures and undertakings of an unusual and extraordinary character. Thus, the whole significance of the law of partnership in the world of business has changed. Its principles, where at first more generally invoked to determine the mutual rights and obligations of confessed partners, are now employed more frequently in the determination of the existence of the partnership relation itself. Peculiarly is this true in relation to transactions involving the purchase, operation and management of real estate, and persons are often surprised, and not always by correct conclusion, into a partnership relation as regards the ownership of real estate, when formerly, by reason of the limited application of partnership law, they would have been regarded as owners in common or as co-tenants—a relation which had received particular and detailed legal consideration long before partnership associations were recognized by

the courts. For example, in a recent action for the specific performance of a contract to convey real estate, the court attempted to enforce the right of the plaintiff by holding that the property involved was partnership property, and not the individual property of the apparent co-tenants; that, since the defendant was a surviving partner, and, therefore, under the statute, entitled to purchase all of the partnership assets, he alone was the real owner of the property, and, that, therefore, the plaintiff could secure specific performance of his contract to convey, without consideration of the widow and heirs of the deceased partner. Here there was no express agreement between the parties to show an intention that the property was owned by them as partners. Neither was there such conduct of the owners of the property as to justify the court in implying a contract of partnership in the property. Nor had any representation been made by the defendant to the plaintiff estopping the defendant from denying that he was, in the ownership of the property, a partner with the deceased co-owner. But, unless there is a contract, express, or implied from conduct, or unless the party sought to be charged with the partnership relation is estopped from denying that he is a partner when permitting the party seeking so to charge him to believe that he is, there can be no partnership. In the above case the court failed to consider the relation between the party sought to be charged as a partner and the party seeking to enforce a collateral right in property not based upon a primary obligation of the partnership, or of one or more of the partners as such. Property should never be considered as partnership property merely for the purpose of enforcing collateral rights of third persons, unless the relation of partnership in its ownership can be determined from contract, express or implied, or upon the principle of estoppel.

The determination of the true test in distinguishing partnership property from individual property depends upon a clear and proper understanding of the partnership relation. This relation is defined by Chancellor Kent as resulting from "a contract of two or more competent persons who place their money, effects, labor and skill, or some one, or all of them, in lawful commerce or business, and to divide the loss or profits in certain proportions." It is created by contract, express or implied, and is as commonly implied from the conduct of the parties as determined by express agreement. This is true not only with reference to

disputes between one or more of the partners and third persons, but also as between the partners themselves; but the relation will be implied from the conduct of the parties only when such conduct establishes their intention to enter into the partnership relation, except in those cases where the evidence shows no intention to form a partnership, but where one or more of the parties is charged with the obligations of a partner upon the principle of estoppel which bars him from denying that he is a partner, when by his conduct, he permitted the parties seeking to charge him as such to believe that he was. Accordingly, a party may be held liable as a partner by estoppel without being entitled to partnership privileges and rights.

Thus, aside from the creation of partnership by estoppel, the true test of partnership is the *intention* of the parties. It is not, as is often stated, the sharing of profits. Profits may be a basis of compensation or a mode of computing interest for loans of money or other property, and, in fact, is, in modern commercial relations, as often a method of compensation of agents as it is incident to the partnership relation.

The evidence must show that it was the *intention* of the parties that the business or enterprise should be carried on in behalf of each party. The sharing of profits is more a right growing out of the partnership relation than a test of its existence. If there is such a participation in profits as to establish the relation of principal and agent between persons taking the profits or part of them and those actually carrying on the business, there is clearly shown the intention necessary to establish the partnership relation. There then results a liability of those in whose behalf the business is carried on to the debts of the trade and a right to share in its profits. It is not correct to say that the fact that the parties are entitled to share in the profits makes them liable to the debts of the business, or that the fact that they are so liable entitles them to share in its profits, but rather, the same thing which entitles them to the profits of the enterprise makes them liable to its obligations. This thing or circumstance is *mutual agency*, or *co-proprietorship*, and has been defined as "the existence of such conditions and facts as clearly indicate that the business was carried on in behalf of the person sought to be charged as a partner." Thus, an agent merely receiving his compensation or part of it in the form of a percentage of net profits is not a partner, the business not being

carried on in his behalf. In fact, he is employed to carry on the business in behalf of others, without co-ownership therein.

The foregoing rules furnish a sufficient test to determine partnership upon the theory of its creation by contract, express or implied, but there may be an entire absence of any evidence of mutual agency, and yet one of the parties connected with the enterprise may be liable as a partner therein as against a third person who has been misled by his conduct. This is upon the principle of estoppel referred to above. Estoppel is defined as "that bar which the law raises to prevent a man from proving that a fact is contrary to what he represents it to be," and is based upon the principle that a man "who has been silent as to his rights when he should have spoken should not be heard to speak when he ought to be silent."

The obligations of partnership cannot be imposed upon a party who is not, as between himself and the others connected in the enterprise or ownership of property, a partner, either by express agreement or by implication from his conduct, except where the person seeking to charge him with such liability has been misled by his conduct. Therefore, the partnership relation, either in the conduct of business or the ownership of property, and either as against all of the parties connected with the enterprise, or one or some of them, cannot, in the absence of expressed or implied intention, be imposed by the courts in behalf of a party who has not been misled by the conduct of the person against whom he asserts his right. It is clearly improper to convert, by legal construction, co-tenancy into co-partnership merely for the purpose of enforcing some collateral right against one of the co-tenants.

Whether property is a partnership asset or the separate property of the partners can generally be determined by two lines of inquiry: first, Was there a partnership directly with respect to the property in question? and second, If the property is not the foundation of the partnership enterprise, in what circumstances does it become an asset of the firm? In considering these two lines of inquiry it must be remembered that partnership property may be converted by the partners into the separate property of one or more of them, and individual property may become partnership property by its contribution to the capital of the enterprise, or by reason of a loan thereof to the firm, or by implication from the conduct of the partners in their manner of

dealing with it. Therefore, property which forms the basis of a partnership enterprise may, by the agreement of the partners, express or implied from their conduct, be converted into the separate property of one or more of the partners. This usually results from a division of profits in property in kind rather than in money, or where partners carry on a trade distinct from that of the partnership, or where one or more of the partners retire from the firm, or new partners are introduced. There are two limitations upon the power of the partners, as against creditors, to convert firm property into separate property. The conversion must not amount to a fraudulent disposition of property as against the firm creditors and must be by executed agreement. An executory contract does not change the character of the property as against creditors of the firm, though it may, of course, be enforced in actions between the partners. If, under the test of partnership stated above, the property in question is found to be the foundation of the partnership enterprise, and not a mere contribution of its use by one or more of the partners in a partnership with respect to the profits to be derived from such use, it constitutes partnership property until converted into separate property, by agreement of the partners, without fraud upon firm creditors and by executed agreement, except that as between the partners and those claiming under them, an equitable conversion may result from an executory agreement.

It is usually more difficult to determine the status of property, not the original basis of the partnership, but subsequently used in, or derived from, the partnership undertaking. If it forms an additional capital contribution or a loan to the working capital of the partnership, or is acquired with partnership earnings and not distributed as profits, it is firm property. If, however, its use only is contributed to the firm, it is not firm property as between the partners and those claiming under them, nor as against third persons who have not been led to rely upon it as partnership property.

The capital of a partnership is the aggregate of those sums or property which are contributed by the partners for the purpose of carrying on the business and to be risked therein. It should not be confused with loans or advances made by the partners to the firm, since, upon an accounting, loans will be repaid to the lending partners before capital will be distributed. Confusion sometimes arises with respect to property contributed

for the use of the partnership, but not contributed as capital. For example, two partners may each contribute an automobile to a livery and transfer business with the intention of having a partnership relation only with respect to the profits of the business and not intending to contribute them as capital. Whether property used by the partners in carrying on an avowed partnership business is a capital contribution from one or more of the partners or remains their separate property can be ascertained only by reference to all the circumstances of the case. The circumstances especially to be considered are: first, the source of the property; second, the purpose for which it is used by the partnership; third, the manner of dealing with it; fourth, the nature of the property, and fifth, the relationship of the parties engaged in the controversy. Brief illustrations will suffice to show the significance of these five questions in determining the intention of the parties.

If the partners contribute funds to the capital of the partnership in accordance with their agreement, and the property in question is purchased with these funds, clearly the source of the property is of such a nature as to indicate strongly the intention of the parties that it should be partnership property, and it will remain such until converted by the parties into their individual ownership. On the other hand, if parties carrying on an established partnership business purchase, with funds not earned by the partnership, or borrowed from it so as to constitute a corresponding partnership obligation, the real estate and buildings upon which their business has theretofore been carried on, or other property for the purpose of carrying on their business, the property thus acquired is not necessarily partnership property, in the absence of other circumstances tending to show that it was their purpose to contribute it as additional capital. And even if the property were acquired with the earnings of the partnership, other circumstances might indicate the intention of the parties that the earnings of the firm with which the property was acquired or the property itself, after its acquisition, were distributed as profits and the property, therefore, acquired as the individual property of the partners, and thereafter held by them as co-tenants, rather than as co-partners. However, all of these cases might be further affected by the relationship of the party seeking to charge the property in question as partnership property, and also by the manner with which it was dealt

after its acquisition. For example, property acquired by the partners by funds distributed as profits, but thereafter used in the partnership business, might not, as between the surviving partner and the heirs of the deceased partner, be considered partnership property so as to entitle the surviving partner to purchase through probate court proceedings as provided by law, when as against a creditor of the partnership, by reason of the partners' mode of dealing with the property and the relationship of the party seeking to charge the property as partnership property, with them, namely, that of one entitled to enforce a partnership upon the principle of estoppel, the property would be held to be partnership property, as between such creditor of the partnership and the individual creditors of the partners.

The purpose for which property is acquired may indicate the intention of the parties as to the nature of its ownership. If the property is acquired with the earnings of the partnership apparently distributed as profits, and thereafter is used in the partnership business, and necessary for the convenience of the business, there is a presumption that it is partnership property, but if it is acquired for an unrelated purpose and held merely as an investment of the partners, it may be considered as distributed as profits and thereby converted into the separate property of the individual partners.

The manner of dealing with the property, whether it is acquired with partnership earnings or with the individual investment of the partners, not only may throw light upon the intention as to its ownership, but further, regardless of the intention, may result in a partnership therein upon the principle of estoppel, if such mode of dealing misleads third persons into the belief that the property is in fact partnership property.

The settled policy of the law requires stronger evidence to show that real estate is partnership property than is demanded in the case of personal property. This results largely from the fact that partnership in the beginning related merely to merchandising and trading enterprises, and real estate was not, until comparatively modern times, a subject of merchandising. This conclusion would perhaps be illogical were it not for the fact that co-ownership of real estate in co-tenancy was a definite legal relation before partnership associations came into existence, and because partnership associations did not for a long time include dealing in real estate. There should, therefore, be stronger

proof that the apparent relation of co-tenancy is in fact a co-partnership. This principle is further required for the proper protection of *bona fide* purchasers of real estate relying upon the record title thereto, it being the rule and custom that title to partnership real estate is taken in the individual names of the co-partners, and therefore in much the same manner as title is taken in the case of co-tenancy, whereas title to personal property may be taken in the name of the partnership. Thus the nature of the property is an important factor in fixing the status of property as a firm or individual asset.

But even the determination of the intention of the parties by reference to the source of the property involved, the purpose for which it is acquired, the manner with which it is dealt, and the nature of the property itself, will depend to a very great extent upon the relationship between the party seeking to avoid the conclusion of partnership and the party seeking to charge the property with the incidents of partnership. This relationship is threefold. The parties may be only the partners themselves, or those claiming title or rights under them; they may include third persons who have relied upon conduct or representations to the end that they have parted with value upon the premise that the property is a partnership asset; or they may include persons attempting to establish collateral rights against one of the owners and unable to perfect their title except upon the establishment of the property as joint partnership property, and not as the separate property of the apparent owners. In the last of the three relationships, property should be administered as partnership property only where the parties themselves are plainly seeking to avoid a collateral obligation by denying what the evidence and circumstances clearly show, namely, that the property was in fact, as between themselves, partnership property. But if, as between themselves, it was not in fact partnership property, then, as to those seeking to establish collateral rights, it should be considered as the separate property of the co-owners, which in fact, it was. But if, as in the second relationship, there was a misrepresentation, express or implied from conduct, those entitled to rely upon the misrepresentation, to the extent that it may be binding upon all the owners, should prevail in their assertion of partnership proprietorship. In the first relationship there must be the clearest possible evidence of express or implied agreement of partnership in the property.

Inquiry into circumstances other than those named will afford assistance in the determination of partnership assets, and may perhaps be considered by many as equally important as evidence in the process of such determination. However, the writer believes that a thorough consideration of the circumstances and rules stated will generally lead the investigator to a correct conclusion.

After the establishment of the status of the property as a partnership or individual asset, there logically follows the question of effect in its administration and its position in relation to other subjects of law and accounting. Space allotted is too brief for a consideration of this further inquiry. It is an interesting and important subject in accountancy as well as in law.