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Partnerships

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PARTNERSHIPS

*Steven A. Waters**

I. INTRODUCTION

THE cases in the partnership area (in keeping with our recent practice, we included limited liability company cases) decided during this Survey period were not life-altering, but a few are worthy of coverage. And, the bankruptcy courts continue to be a fertile source.

II. FIDUCIARY DUTY

Harwood v. FNFS, Ltd.[1]

Mr. Harwood spent some time with us last year[2] when we reported on his unsuccessful attempt to obtain a discharge in bankruptcy. Harwood was the president and 50% shareholder of B&W Finance Co., Inc., which was the sole general partner of FNFS, Ltd. ("FNFS").[3] He is back, after appealing the adverse result of his bankruptcy proceeding.[4]

Harwood challenged the bankruptcy decision on the two fronts that led to denial of his discharge—whether he was a fiduciary to FNFS and whether failure to file the deeds of trust was a defalcation.[5] The district court[6] had no difficulty with the first issue, finding that, in addition to fiduciary duties owed to B&W,[7] Harwood owed a direct fiduciary duty to

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1. *In re* Harwood, 427 B.R. 392 (Bankr. E.D. Tex. 2010), *aff'd*, 637 F.3d 615 (5th Cir. 2011).

2. FNFS Ltd. v. Harwood (*In re* Harwood), 404 B.R. 366, 406–07 (Bankr. E.D. Tex. 2009).

3. *Id.* at 378, 379 n.15.

4. The bankruptcy court found that Harwood acted in a fiduciary capacity, and that he committed a defalcation (having failed to record in the public records the deeds of trust, thus creating liens on his real property pledged to secure funds borrowed by him, individually, from FNFS; therefore, based on U.S. Bankruptcy Code § 523(a)(4), the court refused to discharge this debt. *Id.* at 398–99.

5. The issues raised in a cross-appeal by FNFS were rendered moot by the court's affirmation of the bankruptcy court decision. *Id.* at 399.

6. The court reviewed the basis for its jurisdiction and its procedurally sitting as an appellate court. *Id.* at 395 (citing 28 U.S.C. § 158(a), (c)(2)).

7. Corporate directors and officers are generally considered to owe fiduciary duties to the corporation. *See* Elizabeth S. Miller, *Fiduciary Duties, Exculpation, and Indemnification in Texas Business Organizations*, *in* ST. B. OF TEX.: ESSENTIALS OF BUS. L. 1 (2010), *available at* http://www.baylor.edu/content/services/document.php/117971.pdf. ("The provisions of the [Texas Business Organizations Code] governing for-profit corporations (like the predecessor Texas Business Corporation Act), do not explicitly set forth or define the fiduciary duties of corporate directors; however, case law generally recognizes that directors owe a duty of obedience, a duty of care, and a duty of loyalty.") "[I]t is relatively well-

FNFS "because he controlled the daily operations of FNFS."[8] As predicted in last year's Survey discussion of the bankruptcy court decision here and in another case *McBeth v. Carpenter*,[9] *McBeth* and *In re Bennett*[10] (a case cited in both *McBeth* and in the bankruptcy court decision) were invoked by the court to support a two-tier fiduciary proposition without discussing any potentially-distinguishing facts, procedural posture, etc., in those cases.[11] The *Harwood* court additionally cited an Oklahoma bankruptcy court decision for the proposition that "the sole shareholder and director of a corporate managing partner owes fiduciary duties to the limited partnership when he controls corporate actions."[12] The argument that Harwood's situation was factually distinguishable because he was only B&W's President and not its sole shareholder (but a 50% shareholder) did not slow the court's finding that Harwood, individually, owed a fiduciary duty to the lower-tier entity FNFS.[13]

In last year's Survey discussion of the bankruptcy court decision, we expressed concern about imposing personal liability on an individual who acted in a representative capacity for an entity designed to shield the individual from that personal liability.[14] It does not fit the historical and (we suggest) reasonable expectations of the parties—that using a liability-limiting organization within which to conduct one's business activities provides a protective shield from personal liability[15]—to so lightly reach this result. In fact, it is distressing. Is it virtually impossible for the member of a single-member limited liability company ("LLC") (by definition, the person "in control") to carry on without fear of imposing personal liability that the LLC shield was intended to avoid?[16]

The court agreed on the defalcation issue, that Harwood's reckless failure "to ensure that the deeds of trust securing his personal debt of more than $800,000 were properly recorded" did, as found by the bankruptcy court, constitute the requisite defalcation.[17] In reading this part of the

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settled that officers will be held to the same duty of care standards as directors and that sound public policy supports holding officers to the same duty of care and business judgment standards as directors)." *Id.* at 3 (citing AM. LAW. INST., PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 4.01 cmt. a (1994)).

8. *In re* Harwood, 427 B.R. at 396.

9. 565 F.3d 171 (5th Cir. 2009).

10. 989 F.2d 779 (5th Cir. 1993).

11. Steven A. Waters & Matthew P. Reinhart, *Partnerships*, 63 SMU L. REV. 703, 705 n.17 (2010) [hereinafter "Waters & Reinhart"].

12. *In re* Harwood, 427 B.R. at 397 (citing Park v. Moorad (*In re* Moorad), 132 B.R. 58, 62–63 (Bankr. N.D. Okla. 1991)).

13. Citing Schwager v. Fallas (*In re* Schwager), 121 F.3d 177, 186 (5th Cir. 1997), the court said: "When the president of a corporate managing partner controls the partnership's daily operations, the president owes a fiduciary duty to the partnership." *In re* Harwood, 427 B.R. at 397. Whether or not the results reached in these cases are correct, which is debatable, *control* has been the central, common denominator of them.

14. Waters & Reinhart, *supra* note 11, at 705.

15. Elizabeth S. Miller, *Are There Limits on Limited Liability? Owner Liability Protection and Piercing the Veil of Texas Business Entities*, 43 TEX. J. BUS. L. 405, 416 (2009).

16. The cynical answer is to avoid "doing bad things, and everything should be just fine." Not good enough.

17. *In re* Harwood, 427 B.R. at 398.

court's opinion, it was annoying to not know until the very end that there were other creditors competing for the same assets covered by the unrecorded deeds of trust. In the penultimate paragraph of the main part of the opinion, the court finally noted that there was not only a failure to record, but that Harwood pledged the same properties to another bank.[18] Though sounding close to fraud, it may be that Harwood was speaking completely truthfully when he said he left that recording job to another B&W shareholder. The court found the combination of his failure to record, then not following up to ensure that the filing occurred, constituted the "reckless failure" and therefore the defalcation.[19] The bankruptcy court's decision to deny the discharge was upheld.[20]

III. PARTNER LIABILITY FOR PARTNERSHIP DEBT

Crane v. Samson Resources Co.[21]

Samson Resources Company ("SRC") was a general partner of Samson Lone Star Limited Partnership ("SLS"), a Texas limited partnership. SLS performed a seismic survey on Crane's property before drilling to access subsurface minerals.[22] Only SRC, and never SLS, was a party to this litigation.[23]

While the principal action was for breach of contract, the court determined that it did not have to interpret the contract because the partnership issues were dispositive.[24] Because Crane sought relief against SRC, a general partner, Texas law required Crane to first obtain an unsatisfied judgment against SLS, the limited partnership.[25]

This case involved a variation on a theme covered over several years in Survey articles, including 2008 and 2009:[26] "Under what circumstances can a partner be found liable for a partnership obligation, and how is imposing that liability accomplished?" Yes, general partners are jointly and severally liable for debts and obligations of a partnership;[27] but, statutory and procedural requirements must be met to impose that liability.

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18. *Id.*
19. *Id.* at 398–99.
20. *Id.* at 399.
21. 356 F. App'x 683 (5th Cir. 2009).
22. *Id.* at 684.
23. *Id.* Apparently, there were earlier, failed state-court efforts to impose liability on SLS. *Id.*
24. *Id.*
25. *Id.* at 684–85 (*citing* TEX. REV. CIV. STAT. ANN. art. 6132b-3.05(c) (West Supp. 2009)) [hereinafter "TRPA"].
26. Steven A. Waters & Bradley S. Carson, *Partnerships*, 62 SMU L. REV. 1345, 1345–47, (discussing KAO Holdings, L.P. v. Young, 261 S.W.3d 60 (Tex. 2008)); Steven A. Waters & Peter Christofferson, *Partnerships*, 61 SMU L. REV. 995, 995–98 (discussing KAO Holdings, L.P. v. Young, 214 S.W.3d 504 (Tex. App.—Houston [14th Dist.] 2006, pet. granted), *aff'd as modified*, 261 S.W.3d 60 (Tex. App.—Houston [14th Dist.] 2008, pet. denied) (where the Texas Supreme Court overturned the appellate court decision, effectively holding that "service" on a general partner is more than a physical act of handing over a piece of paper, and requires that the person be named as a defendant and be served)).
27. TEX. BUS. ORGS. CODE ANN. § 152.304 (West 2011) (successor to TRPA § 3.04).

Unless a partner is directly, individually liable for the partnership obligation (such as where a partner signs a personal guaranty), than a judgment must also be obtained against the partnership before liability is imposed on the partner.[28]

Here, there was a very clumsy, failed effort[29] to impose liability on the general partner for an asserted partnership obligation. SLS was never even a party to this litigation. The plaintiffs tried to "save" their claim by asserting that they sued SRC "as general partner in its partnership capacity."[30] The court rejected the hail mary effort and affirmed the lower court take-nothing-judgment.[31]

Seidel v. Hospital Resources Management, LLC (In re HRM Holdings, LLC)[32]

On a personal note, the author is pleased to report on a case authored by his former partner, Bankruptcy Judge Stacey G. C. Jernigan. It is not this case's holding that justifies its inclusion in this Survey—the court basically determined that the pleadings were wholly inadequate to support the asserted claim (though the court reluctantly gave the bankruptcy trustee another chance by allowing a third amended complaint).[33] Rather, the court's discussion of the Texas veil-piercing statutes[34] and a recent Texas Supreme Court case dismissing the notion that Texas recognized a "single business enterprise liability theory"[35] are what is of value here. The case has a good discussion of these topics, and of replacing other business organization statutes by the Texas Business Organizations Code[36] and the pertinent effective dates of the replacement.

The goal of the veil-piercing claims here was to impose liability on five non-debtor LLC parties for claims of creditors against the LLC-debtor.[37] A similar case on yet another variation of the seemingly-mushrooming theme where an attempt to impose liability on those who organized the ownership of business are personally shielded from liability by an entity intended to afford just that protection.

Evanston Insurance Co. v. Dillard Department Stores, Inc.[38]

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28. *Id.* § 152.306(b)(1) (successor to TRPA § 3.05(d)(1)).

29. Or, perhaps, it was just too clever—the plaintiff's earlier lack of success in imposing liability on SLS may have unsettled him enough to launch this futile effort. *See Crane*, 356 F. App'x at 684.

30. *Id.* at 685 n.3.

31. *Id.* at 686.

32. 421 B.R. 244 (Bankr. N.D. Tex. 2009).

33. *Id.* at 250–51.

34. The court identified those statutes as follows: "As earlier mentioned, Tex. Bus. Corp. Act Art. 2.21 expires January 1, 2010. Sections A and B of article 2.21 have been recodified in substantially similar form in Tex. Bus. Orgs. Code § 21.223 and §§ 21.224–.225, respectively." *Id.* at 249.

35. *Id.* at 248. The court briefly discussed the conclusion reached in SSP Partners v. Gladstrong Invs. (USA) Corp., 275 S.W.3d 444 (Tex. 2008), that a single business enterprise theory "is inconsistent with what the Texas Legislature decreed in article 2.21 of the Tex. Bus. Corp. Act." *Id.*

36. *Id.* at 246.

37. *Id.* at 245.

38. 602 F.3d 610 (5th Cir. 2010).

For what appears to be a "little" per curiam decision, this one had quite a bit going on in it. Not all the action is relevant here, but at least two principal inquiries are: (i) if LLP status is lost between the time of a partner's conduct and the time which judgment liability is established, is LLP protection still available? and (ii) if liability is established against a partnership within the applicable statute of limitations, and then general partners are sued individually after the statute of limitations expires for the claim against the partnership, is the second action still valid?

To answer these questions, the court was required to develop the facts and to construe applicable partnership statutes and the Texas Civil Practice and Remedies Code (TCPRC).[39]

Why this case went from a primary claim by an insurance company against Dillard Department Stores[40] to a cross-claim by Dillard against two attorneys is not important to our discussion.[41] The essential facts are that Dillard sued the law firm of Chargois & Enrster, L.L.P. ("CELLP"), while the firm was registered as a limited liability partnership, for improper use of Dillard's name and logo.[42] Dillard obtained a judgment against CELLP *after* the law firm's registration as a limited liability partnership with the Texas Secretary of State expired.[43]

Dillard obtained a judgment against the law firm, but its efforts to collect on the judgment were unsuccessful. Logically enough, it then pursued the two partners, first filing a request for declaratory judgment that they were liable and then in a "first amended complaint"[44] that sought to impose personal liability on the two individuals. The court granted Dillard's request for summary judgment against the two partners, jointly and severally, and each lawyer appealed.[45]

The court quickly dismissed the lawyers' due process argument—they claimed that because they were not, individually, parties to the lawsuit against their law firm, their due process rights to combat the claim were denied.[46]

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39. *See id.* at 617.

40. The claim was a request for declaratory relief that professional liability insurer Evanston was not responsible for the claims brought against the CELLP. *Id.* at 612.

41. After these actions were mutually dismissed, all that was left was Dillard's claims against the law firm. *Id.*

42. If you clicked on Dillard's logo on CELLP's website, you were directed to dillardsalert.com, a website that alleged racial profiling by Dillard. *Id.*

43. The two lawyers in the firm had executed a document "dissolving" the partnership several months before expiration for failure to complete the required annual renewal. That private action had no effect on continuation of the lawsuit or the parties to it, and no action was taken to substitute any parties in place of the "dissolved" partnership. *Id.*

44. Initially, the request for declaratory relief was styled as a third-party complaint, presumably owing to original structure of the case. *Id.*

45. *Id.*

46. *Id.* at 613. Curiously, that the opinion did not say anything about the lawyers being served as general partners of CELLP in the action against the firm or anything about their personal participation in the effort to defeat liability of the firm itself. Surely, *someone* was involved, other than counsel handling the case, on behalf of the law firm CELLP. Instead, the court cited the lawyers' "vigorous" defense in the suit brought against them to satisfy the judgment obtained against the firm. *Id.*

The defendants' next argument was that each was individually immune from liability as a partner, which they maintained was the case whether or not their partnership was an LLP. Again, the court quickly identified the joint and several liability that results under TRPA section 3.04, absent applying one of two exceptions stated therein, the first under section 3.07, which relates to the liability of incoming partners, the court found not to be relevant.[47]

Under section 3.08, the second exception houses the limited liability partner provisions. Neither partner sought to avoid liability under section 3.08(a)(2).[48] Instead, the lawyers argued that they were protected by the partnership's being a duly-registered LLP at the time their infringing website was up, while Dillard argued that "debt was incurred" when judgment was entered against the partnership, at which time the LLP protection was gone (from failure to renew the registration).[49]

The court agreed with the Dillard's interpretation that the debt incurred by the partnership (for which its partners were jointly and severally liable) occurred when judgment was entered, not when the initial act (misuse of the Dillard's intellectual property) took place.[50] The court compared the language of TRPA sections 3.08(a)(1) and 3.08(a)(2) and said that: "The Texas legislature, when it so chooses, is capable of drafting a provision that focuses on the commission of events that lead to liability, rather than the fixing of consequent liability from those events."[51] By comparison, section 3.08(a)(1) limits liability of a partner for debts and obligations of the partnership that are *incurred* while the partnership is a limited liability partnership.[52] Because the partnership was not a validly-

47. *Id.* at 614. The opinion did not discuss the theory proffered by the partners supporting the non-LLP claim that they did not have general-partner liability for the partnership debts under section 3.04.

48. *Id.* at 615 n.4. This subsection contains the exceptions to a non-acting partner's protection from liability granted by section 3.08(a)(1) and includes liability (i) as the actor's supervisor, (ii) as a participant in the activity, and (iii) arising from having knowledge and then failing to take steps to rectify the situation. *Id.* at 615.

49. *Id.*

50. The court said many things could have happened to the end that no "debt" was ever "incurred" when the eye is on the time the act was committed, including that Dillard may have chosen not to pursue the matter or it might have been found the act was not improper. *Id.* at 615.

51. *Id.* at 615–16. The court quoted from TRPA section 3.08(a)(2), which says one partner is insulated from liability for actions of another partner *committed* by that partner "while the partnership is a registered limited liability partnership." *Id.* at 616.

52. *Id.* at 615 n.4. Subsection (a)(1) was added in 1997. *Id.* Interestingly, the court noted that the comments of the 1993 Bar Committee, which on their face supported the lawyers, referred to then subsection (a)(1), now (a)(2), and therefore referred to the wrong section. That comment: "Subsection (a)(1) [now (a)(2)] clarifies that the partnership must be a registered limited liability partnership at the time of the errors and omissions for which partner liability is limited." *Id.* Dismissing that because it now refers to the wrong subsection seems a bit disingenuous. Ultimately, the court could not reconcile the Legislature's use of "committed" in one place and "incurred" in the other without concluding that they intended to produce a different result. *Id.* at 616. In effect, it likened the statutory protection to that of a "claims made" liability insurance policy (which would support the "committed" result), instead of an "occurrence" policy (supporting the court's view of when the claim was "incurred").

registered limited liability partnership at the time the debt was incurred (that is, when the judgment against the partnership was entered), the court found that the default liability under section 3.04 attached, making each partner jointly and severally liable.[53] Interestingly, the court points out in a footnote that the district court avoided section 3.08(a) altogether by finding liability on the basis that the two partners continued business under the law firm name instead of winding up (after their mutual act of "dissolution"), which the lower court characterized as "essentially ratif[ying] the firm's debts."[54]

Like the main issue discussed above in *Crane*, this case also included a claim that the plaintiff did not follow the proper procedure to impose personal liability on partners for a partnership debt or obligation. The defendants claimed that TRPA section 3.05(c) required they be sued, individually, in the litigation against the partnership.[55] TRPA section 3.05(c) provides: "A judgment against a partnership is not by itself a judgment against a partner, but a judgment may be entered against a partner who has been served with process in a suit against the partnership."[56] The defendants invoked *KAO Holdings;*[57] however, unlike the plaintiff in that case, Dillard had not sought the "two-fer" of establishing liability against the partnership and the partners in the same litigation, which the Texas Supreme Court made clear requires naming and suing the individual partners in the litigation against the partnership.[58] Rather, Dillard first obtained a judgment against the partnership, and then pursued the TRPA section 3.04 derivative liability of the individual partners for that partnership debt.

The defendants' final attempt to pull their chestnuts out of the fire was based on the statute of limitations. They maintained that their individual conduct was the basis of the claim, which meant that the statute of limitations had long run; however, the court properly rejected that argument. First, the court stated that the four-year statute of limitations (not the two-year tort/trademark claim statute of limitations) applied, and second, the court restated that the statute began to run when judgment was entered (a little more than three years before the third-party complaint was asserted against the defendants).[59]

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53. *Id.*

54. *Id.* at 616 n.8.

55. *Id.*

56. *Id.* (quoting TRPA § 3.05(c)).

57. *Id.* at 616; *see supra* note 26.

58. *Evanston*, 602 F.3d at 616–17. Though that result could be debated, based on the language of the TRPA and TCPRC, and while the default judgment context of the original case might have influenced the court's sense of fairness (as it clearly did the dissent in the intermediate appellate court decision), the issue has been settled.

59. *Id.* at 617. Among other things, the court dismissed conflicting authority cited by the lawyers (which the court characterized as a "nonbinding district court decision from a [different] . . . circuit") and, instead, relied on *In re* Jones, 161 B.R. 180 (Bankr. N.D. Tex. 1993). *Id.* at 617–18. The *Jones* court acknowledged that a partnership and partners could be sued in the same action (the "two-fer" approach), but concluded: "On the other hand, there is nothing wrong with the partnership being sued and, if its liability is established, a

IV. CONCLUSION

The earth did not move because of the partnership and LLC cases decided during the Survey period, but some recent trends appear to be continuing, if not gaining momentum. These trends include: (i) finding liability of a party, notwithstanding the existence of one or more layers of liability-limiting entities, and (ii) how to impose liability on a general partner for partnership obligations.

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subsequent suit being filed against the partners *on their personal liability for the partnership's obligation.*" *Id.* at 618 (quoting *Jones*, 151 B.R. at 183–84).