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Partnerships

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PARTNERSHIPS

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I. INTRODUCTION

THE Survey period did not see any Texas Supreme Court cases in the area of partnership law. There were, however, some interesting, if not earthshattering, cases on the topic decided in the Texas appeals courts and the lower federal courts. One case reiterates the rule that for a partnership to be formed under Texas law, there must be an agreement to share profits. There were also two cases relating to the effect on the existence and validity of a limited partnership of a failure or delay in filing a certificate of limited partnership under Texas law. Still other cases focused on the liability of partners, one in the general partnership context, and the other in the limited partnership context.

II. CASES

A. FORMATION—REGARDLESS OF HOW PARTIES CHARACTERIZE THEIR BUSINESS RELATIONSHIP, THERE IS NO PARTNERSHIP IF THERE IS NO AGREEMENT TO SHARE PROFITS AND LOSSES—*VALERO ENERGY CORP. V. TECO PIPELINE CO.*[1]

In *Valero*, a Texas court of appeals held that conclusory testimony and documents regarding the existence of a partnership, separate from the operation of an operating agreement between co-owners of a natural gas pipeline, was not sufficient to establish that a separate partnership existed. In *Valero*, there was no evidence that the co-owners had agreed to share profits and losses, other than in the operating agreement itself.[2] Through a series of mergers and other transactions, Valero Energy Corporation and Teco Pipeline Company reluctantly became joint owners of the TransTexas Pipeline.[3] As part of the overall ownership structure, Teco and Valero were parties to (i) an Operating Agreement, which created a joint venture to operate and manage the pipeline, (ii) an Ownership Agreement, which defined their respective ownership interests, and

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1. 2 S.W.3d 576 (Tex. App. – Houston [14th Dist.] 1999, no pet. h.).
2. *Id.* at 586.
3. *Id* at 580.

(iii) a Transportation Agreement.[4] A dispute arose almost immediately, and Teco sued Valero for breach of fiduciary duty, fraud, tortious interference and professional malpractice.[5] Valero moved to stay the litigation on the ground that the Operating Agreement provided that all disputes be resolved exclusively by arbitration.[6] Teco argued that the dispute was not subject to the arbitration clause of the Operating Agreement because the dispute was based on a partnership separate from the joint venture established by the Operating Agreement.[7]

On interlocutory appeal, the appeals court considered whether a separate partnership was formed between Valero and Teco when Teco became an owner in the pipeline. The court first stated the general rule with respect to the formation of a partnership: "An express or implied partnership agreement has four essential elements: (1) a community of interest in the venture, (2) an agreement to share profits, (3) an agreement to share losses, and (4) a mutual right of control or management of the enterprise. . . . As a matter of law, a partnership does not exist if any one of these elements is not established."[8]

The court examined Teco's evidence supporting its argument that a separate, unwritten partnership agreement was created by its investment in the pipeline. The court found that while the president of Teco testified that he believed that a partnership existed, he did not testify to any facts to support his conclusion.[9] Teco also presented several documents intended to demonstrate a separate partnership in which Valero referred to the joint ownership in the pipeline as a partnership, including Valero management committee meeting minutes that reflected that Valero had considered, but tabled the idea of drafting a partnership agreement between Valero and Teco.[10]

The court found that there was no evidence of an agreement to share profits or to share losses.[11] The fact that Teco's president believed that Teco and Valero were to divide revenues and expenses in accordance with the Operating Agreement was evidence that the relationship between the two companies was based on the Operating Agreement and not a separate partnership.[12] Furthermore, the court found that the documents were not determinative because, "A representation contained in a document or made to a third party that a partnership relationship exists constitutes a legal conclusion and is not determinative of the relationship."[13] Without evidence of a separate profit and loss agreement, Teco could not

4. *Id.*
5. *Id.* at 581.
6. *Valero*, 2 S.W.3d at 581.
7. *Id.*
8. *Id.* at 584-85.
9. *Id.* at 586.
10. *Id.* at 585-86.
11. *Valero*, 2 S.W.3d at 586.
12. *Id.*
13. *Id.*

prevail in its argument that a separate partnership existed.[14]

This may be a fact and industry-specific result. The oil and gas area has long seen these operating agreements with the parties opting out of federal partnership tax treatment. Had there been no operating agreement, it is entirely possible that the facts offered to support a partnership would have been found sufficient by a court.

B. FORMATION—A TEXAS LIMITED PARTNERSHIP IS VALID IF FORMED IN SUBSTANTIAL COMPLIANCE WITH THE TEXAS REVISED LIMITED PARTNERSHIP ACT—*CHURCH V. U.S.*[15]

In *Church*, the federal district court found that a Texas limited partnership had been validly formed as of the date of death of one of the limited partners, even though at the time of the limited partner's death the limited partnership certificate had not yet been filed, and the general partner was not created until months after the limited partner's death.[16] Ms. Church and two of her children, Mr. Miller and Ms. Newton, each owned undivided interests in ranch land in West Texas. In 1993 they decided to form a limited partnership to manage and operate the ranch.[17] On October 22, 1993, Ms. Church, Mr. Miller and Ms. Newton executed a limited partnership agreement and special warranty deeds conveying their interests in the ranch to the limited partnership.[18] A limited liability company[19] to be owned by Mr. Miller, and Ms. Newton was intended to be the general partner of the limited partnership. Mr. Miller executed the partnership agreement and a limited partnership certificate on behalf of the general partner.[20]

Two days later, on October 24, 1993, Ms. Church unexpectedly died.[21] As of the date of her death, the general partner had not yet been formed and the certificate of limited partnership had not been filed with the Texas Secretary of State.[22] The certificate of limited partnership was filed on October 26, 1993.[23] The general partner was eventually formed in March 1994.[24]

After the estate of Ms. Church filed her estate tax return and payment with the internal revenue service, the IRS sent a notice to the estate that it intended to assess a deficiency against the estate, arguing that the lim-

14. *Id.* The court stated, "Accordingly, we find no evidence of any partnership separate from the joint venture established under the terms of the Operating Agreement." *Id.*
15. 2000 U.S. Dist. LEXIS 714 (W.D. Tex. Jan. 18, 2000)
16. *Id* at *17.
17. *Id.* at *2.
18. *Id.* at *4, *5.
19. The court's opinion refers to the general partner entity as a corporation, but based on its name "Stumberg Ranch, L.C.," it appears to be a limited liability company. This article will refer to the general partner as a limited liability company. *Id.* at *4.
20. *Church,* 2000 U.S. Dist. LEXIS 714 at *5.
21. *Id.* at *6
22. *Id.*
23. *Id.* at *7.
24. *Id.* at *8.

ited partnership was never properly formed and, therefore, the valuation given by the estate of assets related to the ranch was too low.[25] Ms. Church's estate filed a lawsuit in federal district court against the IRS seeking, among other things, a decision that the limited partnership was formed and in existence as of the date of Ms. Church's death.[26] The district court found that the formation of the limited partnership was in "substantial compliance in good faith"[27] with the Texas Revised Limited Partnership Act[28] and, the limited partnership was "a valid Texas limited partnership" as of the date of Ms. Church's death.[29]

This appears to be very much a result-oriented decision that easily could have gone the other way. The statutory test of "substantial compliance with the requirements for filing a certificate"[30] is, as this decision clearly demonstrates, subjective. If the issue in the case had been liability to a third party who was unaware of the existence of a limited partnership, perhaps the result would have been different. Here, it appears that the court concluded that the parties were caught by Ms. Church's sudden death and that they did not "deserve" to be penalized for that. That they had begun the process by executing a limited partnership agreement and special warranty deeds demonstrated their intent (to the court's satisfaction).

C. PARTNER LIABILITY—A GENERAL PARTNER'S LIABILITY FOR PARTNERSHIP DEBT IS NOT PREEMPTED BY FEDERAL INCOME TAX LAW—*REMINGTON V. U.S.*[31]

In *Remington*, the federal court of appeals held that the internal revenue code does not preempt the Texas state partnership law principle that partners in a general partnership are jointly and severally liable for all debts and obligations of the partnership.[32] Mr. Remington was a partner in a law firm that was organized as a general partnership under Texas

25. *Church*, 2000 U.S. Dist. LEXIS 714 at *15.
26. *Id.* at *1.
27. *Id.* at *17.
28. TEX. REV. CIV. STAT. ANN. art. 6132a-1, §1 et seq. (Vernon Supp. 2000).
29. *Church*, 2000 U.S. Dist. LEXIS 714 at *17. The court does not elaborate on its reasoning for this finding but does refer to "the reasons stated in its order on the Government's motion in limine (docket no. 44) . . ." *Id.*

Also, the court in an unpublished opinion in the case of *Isaminger v. Gibbs*, No. 05-99-00978-CV, 2000 Tex. App. LEXIS 4525 (Tex. App. – Dallas July 7, 2000, no pet. h.) (not designated for publication), held similarly. In that case, the appeals court upheld a trial court finding that a Texas limited partnership was validly created even though a limited partnership certificate was never filed with the Texas Secretary of State. *Id.* at *7-8. In that case, the court relied on Section 2.01(b) of the Texas Revised Limited Partnership Act in holding that a limited partnership is formed "when there has been substantial compliance with the requirements for filing a certificate." *Id.* at *9. The court went on to find that because the partners had done everything except file the certificate, they substantially complied with the statutory requirements and, therefore, the limited partnership had been validly formed. *Id.* at *10.

30. *See* note 29 and accompanying text.
31. 210 F.3d 281 (5th Cir. 2000).
32. *Id.* at 283.

law.[33] In 1986, he discovered that the firm had failed to prepare and file certain federal employment tax returns.[34] He supervised the preparation of the returns by a certified public accountant and submitted them to the Internal Revenue Service.[35] The IRS then assessed the taxes and filed liens against partnership property and against the property of Mr. Remington as a general partner of the partnership.[36] When the IRS attempted to satisfy the debt by levying against Mr. Remington's property, he filed suit in Federal district court for wrongful levy.[37] After the district court denied Mr. Remington's claim, he filed an appeal with the Fifth Circuit, arguing that the IRS cannot proceed against a general partner of a partnership to collect taxes owed by the partnership.[38]

The court rejected Mr. Remington's claim that federal tax law, which provides that the IRS may impose penalties against a responsible person who failed to collect and remit employment taxes, preempts the state law rule that partners in a general partnership are jointly and severally liable for the debts of the partnership.[39] The court held that the internal revenue code provisions relating to the assessment and collection of penalties for an employer's failure to withhold and remit employment taxes apply to all types of business organizations, and in the case of partnerships, create an additional or supplemental source of liability, not a preemptive one.[40]

The only comment the authors can think to offer here is "nice try." The results seem straightforward and required by established partnership law principles.

D. Partner Liability—A General Partner in a Limited Partnership Cannot Rely on an Indemnity to Release It from Liability to Limited Partners Who Have Paid Debts of the Limited Partnership—*Wallerstein v. Spirt*[41]

In *Wallerstein*, a Texas court of appeals held that a general partner could be held liable for the indemnity obligation of a limited partnership to certain of its limited partners even though the limited partnership agreement stated that only the partnership, and no partners individually, would be responsible for that indemnity. Mr. Wallerstein was the general partner in a limited partnership that defaulted under a loan agreement.[42] After default, the lender recovered the debt from the guarantors of the loan, who were limited partners in the partnership.[43] The limited partner

33. *Id.* at 282.
34. *Id.*
35. *Id.*
36. *Remington*, 210 F.2d at 282.
37. *Id.*
38. *Id.*
39. *Id.*
40. *Id.*
41. 8 S.W.3d 774 (Tex. App. – Austin 1999, no pet. h.).
42. *Id.* at 776.
43. *Id.* at 778.

guarantors successfully sued the partnership for indemnification of the amounts they paid under the guarantees.[44] The limited partners then sued Mr. Wallerstein, as general partner, to collect the judgment against the partnership.[45]

Mr. Wallerstein argued that the limited partnership agreement provision relating to the liability of the partners released him from liability to the limited partners.[46] The court held that Mr. Wallerstein's argument confused the idea of *indemnity* with the idea of *release*.[47] Because the court held that the partnership language cited by Mr. Wallerstein was clearly an indemnity rather than a release, Wallerstein was not released from any liability he might have to the limited partners.[48]

Mr. Wallerstein also argued that he should not be personally liable for the debts of the partnership because the partnership agreement stated that the partners are not liable to one another for indemnity. It stated only the partnership is required to indemnify partners.[49] The court disagreed, holding that the limited partners already had won indemnification against the partnership and were merely seeking to collect the judgment against the partnership from Wallerstein as the general partner of the partnership.[50] The court's finding centered on the fact that the limited partners were not acting in their capacity as limited partners in the partnership but as third party creditors against the partnership.[51]

The pertinent language from the Partnership Agreement bears quoting in full (with the emphasis given by the court in its opinion):

> *Liabilities of the Partners.* All obligations, expenses and losses incurred, and all payments made by the Partners in connection with the Partnership and the Property from and after the date hereof, including without limitation, payments due on mortgages and other indebtedness incurred in connection with the Property, and any liability for damages arising out of claims or actions against any of the Partners on account of ownership of the Property, shall be obli-

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44. *Id.*

45. *Id.* at 778.

46. *Wallerstein*, 8 S.W.3d at 779. The limited partnership agreement provided: "No Limited Partner shall have any personal liability for the payment of Partnership Obligations. The Partnership (but not the Partners individually) shall indemnify and hold each Partner harmless in respect of all payments reasonably made and personal liabilities reasonably incurred by each Partner in the ordinary and proper conduct of the Partnership's business . . ." *Id.*

47. *Id.* The court stated that, "Unlike a release, which suppresses a cause of action, an indemnity creates a potential cause of action between the indemnitee and the indemnitor." *Id.*

48. *Id.* at 780.

49. *Id.*

50. *Id.* In support of this holding, the court cited Section 4.03 of the Texas Revised Limited Partnership Act, TEX. REV. CIV. STAT. ANN. art. 6132a-1, § 4.03(b) (Vernon Supp. 2000), which provides that "Except as provided by this Act, a general partner of a limited partnership has the liabilities of a partner in a partnership without limited partners to persons other than the partnership and the other partners." But the court also acknowledged that the agreement of the parties could override this (*Id.* at 778), which was the main issue here—did it so override.

51. *Wallerstein*, 8 S.W.3d at 780.

gations of the Partnership if made or incurred in accordance with the terms hereof (such obligations are hereinafter referred to as "Partnership Obligations"). *No limited Partner shall have any personal liability for the payment of Partnership Obligations. The Partnership (but not the Partners individually) shall indemnify and hold each Partner harmless* in respect of all payments reasonably made and personal liabilities reasonably incurred by each Partner in the ordinary and proper conduct of the Partnership's business or for the preservation of its business or property.[52]

The Texas Revised Limited Partnership Act allows the partners to provide, in their partnership agreement, that a general partner is not liable for debts owed by the partnership to the partners, as opposed to third party creditors.[53] There is a plausible argument that the parenthetical in the second italicized sentence above expressed the agreement of the partners that partnership assets, alone, would stand behind obligations of the partnership, at least with respect to debts owed to the partners (as opposed to true third party creditors). It appears that when the court read the second italicized sentence with the first, which states that only the *limited partners* are released from liability for partnership obligations,[54] it decided that the language simply was not precise enough for the court to conclude, as a matter of law, that the partners intended to release the general partner from liability for debts owed by the partnership to the limited partners. It would have been less surprising if the court had declined to find this in a summary judgment context, and the court certainly could have found in favor of the general partner under the reported facts and circumstances.

52. *Id.* at 779.

53. TEX. REV. CIV. STAT. ANN. art. 6132a-1, § 4.03(b) (Vernon Supp. 2000) provides that "Except as provided by this Act, *a general partner* of a limited partnership has the liabilities of a partner in a partnership without limited partners to persons *other than the partnership and the other partners.* Except as provided by this Act or *in the partnership agreement,* a general partner of a limited partnership has the liabilities of a partner in a partnership without limited partners *to the partnership and the other partners.*" (emphasis added).

54. Note that in the quoted language above "Partnership Obligations" is fully defined, and includes payments made on mortgage obligations of the partnership. Ironically, the provision states that the limited partners are not personally liable for these obligations; but, they signed separate contracts—guaranties—under which they took on personal liability for which they sought reimbursement here.