SMU | Dedman School of Law

SMU Law Review

Volume 46
Issue 4 *Annual Survey of Texas Law*

Article 23

1993

Partnerships

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PARTNERSHIPS

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THIS year's Survey period saw a number of cases with interesting partnership issues, some of which were secondary to the deciding issue and appeared against a complex backdrop of other legal issues. Unlike the past several partnership law surveys, this year the authors elected to review several bankruptcy opinions that decided partnership issues.

For the reader's convenience, the cases are grouped under topical headings corresponding to the most important partnership law aspect of the case.

I. PARTNER/PARTNERSHIP RELATIONSHIP

A. AUTHORITY OF A PARTNER TO BIND PARTNERSHIP

1. Authority of "Bankrupt" Partner to File Bankruptcy Petition

a. *Phillips v. First City, Texas-Tyler, N.A., (In Re Phillips).*[1]

This case is remarkable for several reasons. First, the court expressly rejected the analysis and conclusion of the 1986 California bankruptcy decision of *In Re Safren*.[2] There the court held the term "bankrupt" under the Uniform Act (promulgated in 1914) meant one who was the subject of a *liquidation* proceeding, a concept that existed in 1914, but not one who was in a *reorganization* proceeding, which did not appear until much later.[3] Second, the court stated that *Safren* was the only reported case holding that "bankrupt" under state partnership laws did not include debtors in a Chapter 11 proceeding[4]. In fact, at least two Texas bankruptcy decisions have agreed with *Safren*.[5]

The issue in *Phillips* was whether the sole general partner of a two-partner limited partnership could file a voluntary Chapter 11 bankruptcy reorganization petition on behalf of the limited partnership, after the general partner filed his own Chapter 11 petition.[6] The bankruptcy court and the federal

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1. 966 F.2d 926 (5th Cir. 1992).
2. 65 B.R 566 (Bankr. C.D. Cal. 1986).
3. *Id.* at 569.
4. *Phillips*, 966 F.2d at 931.
5. *See In Re Hawkins*, 113 B.R. 315 (Bankr. N.D. Tex. 1990); *In Re BC&K Cattle Co.*, 84 B.R. 69 (Bankr. N.D. Tex. 1988).
6. *See generally* 11 U.S.C. §§ 1101 - 11 (1988).

district court agreed, for different reasons, that the general partner could file a petition for the partnership.[7] The bankruptcy court held that Texas partnership law did not forbid the filing of the petition by the general partner; but, that even if it did, federal bankruptcy law preempted state law and permitted the filing.[8] On appeal, the district court disagreed on the Texas law issue but affirmed the lower court on the basis of federal preemption.[9] The Fifth Circuit reversed and remanded, rejecting both theories relied on by the lower courts. It held that a general partner involved in his own bankruptcy proceeding, even a Chapter 11 reorganization, did not have authority under Texas law to file a petition for the partnership, and that federal law did not produce a different result.[10]

From the state law perspective, the court found that Section 35(3)(b) of the Texas Uniform Partnership Act (TUPA), which provides that a partnership is not "bound by any act of a partner after dissolution . . . [w]here the partner has become bankrupt,"[11] protects non-bankrupt partners from liability created by the acts of bankrupt partners. The court stated that the outlook and responsibilities under federal bankruptcy law of a partner who is the debtor in a federal bankruptcy proceeding may be quite different from those that were present before the filing.[12] Accordingly, the court held that the general partner in bankruptcy lacked authority under Texas law to file a Chapter 11 petition for the limited partnership.[13] In so holding, the court rejected each of the general partner's three arguments for a different interpretation of Section 35(3)(b): (1) that he was not "bankrupt" within the meaning of Section 35(3)(b) because he filed a voluntary petition under Chapter 11 as opposed to Chapter 7,[14] (2) that Section 35 only limits the authority of bankrupt partners to bind partnerships to *third parties*, and does not limit authority to wind up partnership affairs, and (3) the limited partner had effectively consented to the general partner's action.[15]

The court next examined federal law to determine if it preempted Texas

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7. *Phillips*, 966 F.2d at 928.
8. *Id.*
9. *Id.*
10. *Id.* at 933, 935.
11. TEX. REV. CIV. STAT. ANN. art. 6132b, § 35(3)(b) (Vernon 1970).
12. The court gave special attention to Professor Bromberg's analysis of § 35(3)(b): "Professor Bromberg, the chief draftsman of Texas' Uniform Partnership Act, suggests that the reason for [section 35(3)(b)] may be the fear of binding the partnership to unwise transactions entered into by the bankrupt partners." *Phillips*, 966 F.2d at 929. *See* ALAN R. BROMBERG & LARRY E. RIBSTEIN, BROMBERG & RIBSTEIN ON PARTNERSHIP § 7.16(d) (1991).
13. *Phillips*, 966 F.2d at 933.
14. In the *Safren* case, the court held that the term "bankrupt," as used in the California version of the Uniform Partnership Act, did not mean a person who was the subject of a reorganization proceeding under federal bankruptcy law. *Safren*, 65 B.R. at 569-70. The court relied on two grounds: (1) that the concept of reorganization did not exist in 1914 when the Uniform Partnership Act was promulgated, and (2) that the public policy inherent in a reorganization proceeding — to allow time for a debtor to develop a plan under which its debts would be restructured and it could continue its business in some form — would be undercut if a reorganization proceeding filing automatically caused a dissolution of the partnership, which (absent agreement of the partners) would in turn lead to a winding up (liquidation) and termination. *Id.*
15. *Phillips*, 966 F.2d at 929-33.

law on the subject. Bankruptcy Rule 1004(a), relied on by the federal district court to support its preemption holding, states: "A voluntary petition may be filed on behalf of the partnership by one or more general partners if all general partners consent to the petition."[16]

The court stated that before it could invoke Bankruptcy Rule 1004 to preempt state law, it first must find a conflict between the two. It found none.[17] Essentially, the court held that the term "general partner," as used in Bankruptcy Rule 1004, means a general partner who is fully-empowered under applicable state law. The court concluded that the authority under Texas law of a general partner in bankruptcy was restricted because (1) Texas law makes a general partner "subject to all the restrictions and liabilities of a partner in a partnership without limited partners;" and (2) Section 35(3)(b) of TUPA was such a restriction.[18] Finding no conflict between state and federal law, the court saw no basis on which to use Rule 1004 to preempt the state law result.[19]

2. *Authority of Partner to Bring Suit on Behalf of Partnership*

a. *Allied Chemical Co. v. DeHaven.*[20]

The principal issue in *Allied Chemical* was the authority of a former partner to bring a lawsuit on behalf of the partnership.[21] DeHaven, who had withdrawn as a partner of the Maglon Partnership, sued for damages. DeHaven alleged fraud and conspiracy on the part of an Allied officer and a Maglon partner involving a breach of a contract between Allied and Maglon.[22]

Allied complained that DeHaven lacked standing to sue on behalf of Maglon. The court disagreed and noted that DeHaven was a partner of Maglon at all relevant times: when the deal with Allied was struck, when the deal with Allied was carried out, when payment made by Allied was received and deposited, and when monies were paid by the partnership to Allied's officer who cut the deal with Maglon's partner.[23] The court noted the common law rule that partners can bring suit on behalf of the partnership, even though the partnership can sue in its own name under Rule 28 of the

16. Bankr. Rule 1004(a), 11 U.S.C.A. (1984).
17. *Phillips*, 966 F.2d at 933.
18. *Id.*
19. *Id.* The court also concluded that Rule 1004 could not, by itself, augment the state law authority of a "general partner" because the bankruptcy rules expressly "shall not abridge, enlarge, or modify *any* substantive right." *Id.* (quoting 28 U.S.C. § 2075).
20. 824 S.W.2d 257 (Tex. App.—Houston [14th Dist.] 1992, no writ).
21. Although the chronology of events in *Allied Chemical* is difficult to follow, it appears that DeHaven sued Allied, the partnership and DeHaven's former partners. Subsequently, all of the defendants except Allied ratified DeHaven's pleadings and were realigned as plaintiffs. *Id.* at 264.
22. The contracts between Allied and Maglon were exchange agreements which the Allied officer (Gambrell) and the Maglon partner (Novak) voided and replaced with a new exchange agreement calling for $330,000 more to be paid to Allied and $173,000 to be paid to a company owned by Gambrell and Novak. *Id.* at 260.
23. *Id.* at 264.

Texas Rules of Civil Procedure.[24]

Allied also argued that DeHaven's power to sue on behalf of the partnership ended when he withdrew from Maglon. The court correctly differentiated between termination and dissolution, noting that although DeHaven's withdrawal dissolved the partnership, the result was not termination, but winding up, the intermediate legal phase that follows dissolution.[25] The court also assessed the case's circumstances as "exceptional" and concluded that it would be inequitable to prevent a resigning partner victimized by self-dealing conspirators from suing on behalf of the partnership.[26]

Allied lastly argued that, because a partnership is bound by the acts and knowledge of a partner, a partner's execution of a contract on behalf of Maglon bound the partnership and, thereby, DeHaven. The court rejected that position, noting an important exception to the binding effect rule where "a fraud on the partnership [is] committed by or with the consent of that partner."[27] Here, the partner (Novak) conspired to misappropriate funds from Maglon to benefit himself, Gambrell and Allied. Under those circumstances, Maglon was not bound by the partner's knowledge.[28]

B. PARTNERSHIP OR PARTNER PROPERTY

1. In Re Cooper[29]

In this bankruptcy court decision, the debtor, Cooper, filed for relief under Chapter 7 of the U.S. Bankruptcy Code.[30] The filing included a schedule of assets and liabilities and a statement of financial affairs that claimed a business homestead exemption for office property and equipment, tools and medical instruments. Cooper leased the "office homestead" at all times to his own medical professional association, "Thomas W. Cooper, M.D., P.A." Cooper's creditors filed objections to the claimed exemption, arguing that the putative "office homestead" was in fact owned by a partnership and could not be claimed by the debtor as exempt under Texas law.

Cooper and Schreiber jointly purchased the real estate at issue, placing title in both of their names.[31] The two borrowed money and built an office building used by both to conduct business. United States partnership tax

24. *Id.* (citing Chien v. Chen, 759 S.W.2d 484, 491 (Tex. App.—Austin 1988, no writ)).

25. TEX. REV. CIV. STAT. ANN. art. 6132b, §§ 29-30 (Vernon 1970).

26. *Allied Chemical*, 824 S.W.2d at 264.

27. TEX. REV. CIV. STAT. ANN. art. 6132b, § 12 (Vernon 1970).

28. *Allied Chemical*, 824 S.W.2d at 265. Allied was, however, liable for the fraudulent actions of its officer, Gambrell. *Id.* (citing Kirby v. Cruce, 688 S.W.2d 161, 165 (Tex. App.—Dallas 1985, writ ref'd n.r.e.)).

29. 128 B.R. 632 (Bankr. E.D. Tex. 1991).

30. *See generally* 11 U.S.C. §§ 701 - 766 (1979). A Chapter 7 proceeding is designed to liquidate the debtor's non-exempt property, pay the debtor's creditors to the extent of the proceeds of the liquidation, and discharge the debtor from the balance of those debts.

31. This fact created the issue that Cooper tried to exploit. Had title been taken directly in the name of the partnership described later in the text, Cooper would likely not have fought as hard for the exemption. The partnership statute, however, clearly contemplates that title to partnership property may be taken in the name of one or more of the partners of the partnership. *See e.g.*, TEX. REV. CIV. STAT. ANN. art. 6132b, § 10(3),(4) (Vernon 1970) (stating rules governing the conveyance of partnership real property when title is held in partners' names).

returns were filed for the "Schreiber-Cooper Building" partnership and included individual Schedule K-1s for Cooper and Schreiber that showed that the two partners shared profits, losses, and capital equally.

In determining whether a partnership existed, the court discussed the "entity theory" that generally pervades the TUPA, concluding that "the partnership, as a separate entity, owns the partnership property."[32] Section 25(2)(c) of the TUPA specifically precludes a partner from validly claiming a homestead interest in partnership property.[33]

In its analysis, the court identified a number of factors that, if present, were "indicators" that a partnership existed. Two of these factors, sharing in the profits and losses of a business[34] and filing of partnership income tax information returns,[35] were present in this case. The court found, however, that the most important indicator is the *intent* of the parties: if they intend to do a thing that by law constitutes a partnership, then they are partners whether their expressed purpose was to create or avoid the relationship.[36]

The court readily concluded that the partnership formed between Cooper and Schreiber owned the business property and that Cooper could not, as a matter of Texas law, claim the property as exempt.[37] Therefore, Cooper's only use of the property that he attempted to claim as exempt was as an employee of the professional association. Cooper's exemption claim was denied.[38]

II. CREATION OF A PARTNERSHIP

A. PARTNERSHIP BY ESTOPPEL

1. Gosch v. B & O Shrimp, Inc.[39]

In *Gosch*, B & O Shrimp sued Gosch, claiming that he was vicariously liable for fraud committed by his partner, Bach. B & O Shrimp claimed that a partnership existed by estoppel.[40] Bach contracted with B & O Shrimp to purchase a commercial shrimp boat. Bach then mortgaged the boat to secure a $6,000 loan from Gosch, in breach of his conditional sales contract

32. *Cooper*, 128 B.R. at 636.

33. TEX. REV. CIV. STAT. ANN. art. 6132b, § 25(2)(c) (Vernon 1970). Section 25(2)(c) of TUPA states:

> A partner's right in specific partnership property is not subject to attachment or execution, except on a claim against the partnership. When partnership property is attached for partnership debt, the partners, or any of them, or the representatives of a deceased partner, cannot claim any right under the *homestead* or exemption laws.

Id. (emphasis added).

34. TUPA defines partnership as "an association of two or more persons to carry on as co-owners a business for profit," TEX. REV. CIV. STAT. ANN. art. 6132b, § 6(1) (Vernon 1970), and gives as a prima facie indicator "[t]he receipt by a person of a share of the profits of a business." *Id.* § 7(4).

35. *Cooper*, 128 B.R. at 636.

36. *Id.*

37. *Id.*

38. *Id.* at 637.

39. 830 S.W.2d 652 (Tex. App.—Houston [1st Dist.] 1992, writ denied).

40. TEX. REV. CIV. STAT. ANN. art. 6132b, § 16 (Vernon 1970).

under which Bach was not to obtain title for at least one year. Bach defaulted on the loan, and Gosch foreclosed on and took possession of the boat.

At trial, the President of B & O Shrimp testified that Bach introduced Gosch as "my partner" and referred to him as "the man that's going to be giving me the money that's going in partners with me on this shrimp boat."[41] Corroborated trial testimony confirmed that Gosch heard those statements and never denied the partnership. It was also found that Gosch was present when the deal was initially negotiated and when B & O Shrimp explained the conditional nature of the transaction to Bach.

The court of appeals affirmed the trial court's decision that B & O Shrimp relied on Gosch's failure to deny the representation of partnership and believed that Gosch and Bach were partners. The court found Gosch liable to B & O Shrimp for the fraud committed by Bach.[42] Presumably, B & O Shrimp got its boat back, or the value of it.

B. INTENT IS THE KEY ELEMENT

1. City of Corpus Christi v. Bayfront Assocs., Ltd.[43]

In *Bayfront Associates*, Bayfront leased a portion of Corpus Christi Bay from the City, intending to fill the bay bottom (which required a Corps of Engineers permit) and sublease it to various tenants, including a large commercial aquarium. Local opposition to the proposed plan resulted in the aquarium's being located elsewhere, causing the Corps of Engineers to withdraw its notice of intent to issue the required permit. Bayfront sued the City of Corpus Christi for breach of fiduciary duty. The main issue concerned whether a joint venture or partnership relationship existed.

In considering the breach of fiduciary duty claim, the court examined the lease to determine whether, in fact, a partnership existed.[44] The court listed four essential elements to finding an implied partnership: (1) an agreement to share profits, (2) an agreement to share losses, (3) a mutual right of control or management of the business, and (4) a community of interest in the venture.[45] The court also stated that the parties' intent to contract is a prime element in determining whether a partnership exists.[46]

The court concluded that no partnership existed and computed the rent payable to the City as a percentage of *gross* revenues. From this, the court failed to find the profit-sharing agreement required for a partnership to exist.[47] The parties also did not share losses, further supporting the absence of

41. *Gosch*, 830 S.W.2d at 655.
42. *Id.*
43. 814 S.W.2d 98 (Tex. App.—Corpus Christi 1991, writ denied).
44. The parties did not expressly form a partnership; therefore, the court examined their contractual leasehold relationship for evidence of a partnership.
45. *Id.* at 107 (citing Coastal Plains Dev. Corp. v. Micrea, 572 S.W.2d 285 (Tex. 1978)).
46. *Id.* at 108. See the discussion of the *Cooper* case, *supra* text accompanying note 36.
47. *Id.* The court noted 57 of the TUPA states that "[t]he receipt by a person of a share of the profits of a business is prima facie evidence that he is a partner in the business, but no inference shall be drawn if such profits were received in payment . . . as . . . rent to a landlord."

a partnership.[48] In addition, the court noted that the control exercised by the City was as a lessor, as the owner of the underlying fee and adjacent streets and marina, and as an enforcer of municipal construction codes and ordinances. The court concluded that this was not the mutual control required to find a partnership.[49]

The court disagreed with Bayfront's assertion that the parties' mutual interest in the success of the development project satisfied the community of interest criteria.[50] It found that the parties' principal interests were quite different — the City was concerned with a city-wide redevelopment scheme and Bayfront was interested in profiting from subleasing the space.[51] Finally, the court found that references by the mayor and other city representatives to Bayfront as the City's "partner" were not determinative of the legal relationship of a partnership.[52] In sum, because no partnership existed, no fiduciary duties existed and, therefore, no breach of a fiduciary duty occurred.

2. *FDIC v. Claycomb*[53]

In *Claycomb*, the borrower asserted that a loan transaction was actually a partnership relationship. The Fifth Circuit analyzed the borrower's claim against the same four elements considered by the court in *Bayfront Associates* and concluded that a partnership or joint venture did not exist.[54] Again, those essential elements are: (1) a community of interest in the venture/partnership; (2) an agreement to share profits; (3) an agreement to share losses; and (4) a mutual right of control or management of the enterprise. Where one of the elements is absent, no joint venture or partnership exists.[55]

The court found no express agreement in the loan document obligating the parties to share losses.[56] The Fifth Circuit likewise rejected the borrower's theory that a partial non-recourse provision in the loan documents that contractually limited its liability to 50% of the loan evidenced an agreement to share losses.[57] Furthermore, there were several provisions in the loan papers that specifically disclaimed the existence of any relationship other than lender/borrower.[58] The court found it unnecessary to consider

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Id. (quoting TEX. REV. CIV. STAT. ANN. art. 6132b, § 7(4)(b) (Vernon 1970)). So, even if the lease had called for rent measured by a share of profits, the statute disclaims an inference of partnership. Computing the rent from gross receipts is even further removed.

48. *Id.*
49. *Id.*
50. *Id.*
51. *Id.*
52. *Id.* at 108-09.
53. 945 F.2d 853 (5th Cir. 1991), *cert. denied*, 112 S. Ct. 2301 (1992).
54. *Id.* at 858.
55. *Id.*
56. *Id.*
57. *Id.*
58. Section 4.15 of the Loan Agreement states in pertinent part: "4.15 *No Liability of Lender.* Lender shall have no liability, obligation, or responsibility whatsoever with respect to the construction of the Improvements except the Loan and the Borrower's Deposit pursuant to

the other three elements once it concluded that one of the essential elements of joint venture/partnership was missing.[59] The absence of a partnership defeated the borrower's defense based on the lender's alleged breach of fiduciary duty.[60]

III. PARTNERS' FIDUCIARY DUTIES

A. *LSP INVESTMENT PARTNERSHIP V. BENNETT (IN RE BENNETT)*[61]

In this case of first impression, the Fifth Circuit decided whether the managing general partner of a limited partnership owed a sufficient fiduciary duty directly to the limited partners to trigger application of 11 U.S.C. § 523(a)(4). Section 523(a)(4) denies a bankruptcy discharge of debts that result from defalcation by a debtor who is acting in a fiduciary capacity.[62]

In this case, a hotel development was undertaken with a two-tier ownership structure in which a Texas limited partnership, MG was formed to own and develop the hotel; its sole general partner was a limited partnership, No. 20, whose sole general partner was Bennett. The MG partnership agreement gave No. 20 full, exclusive and complete authority and discretion to manage the partnership. Similarly, Bennett, as the sole general partner of No. 20, had full power or authority to direct its affairs.

The MG agreement called for a cash incentive payment to the general partner (No. 20) of up to $4 million if the hotel project was completed for less than the budgeted $22 million and was constructed and equipped as a "first class hotel." The hotel was completed on time and apparently under budget, for which Bennett rewarded No. 20 (himself) with a $1 million cash distribution. It soon became clear that the "first class" requirement had not been satisfied. Mildew appeared in hotel rooms, requiring remodeling to reverse a faulty design in the heating, ventilation and air conditioning system. Some of the repairs were charged to the general contractor, but others were improperly charged by the general partner to the partnership.[63] The limited partners' share of this cost was $72,000.[64]

There were other improper charges and questionable actions. During construction, the general partner entered into several hotel equipment leases and

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this Loan Agreement . . . ." *Id.* at 859. The court looked to the *Micrea* case, cited in the discussion of the *Bayfront* case, *supra* note 46, at 11, as controlling Texas law, and concluded that the provision here that not only disavowed the existence of a partnership, but also disavowed the sharing of losses, was even stronger than the facts in *Micrea* where the sharing of losses element, although absent, was not expressly disclaimed.

59. *Id.*

60. *Id.* at 859-60. The case also upheld the application of an express usury savings clause. *Id.* at 850-61. Such a clause expressly disclaiming an intent to charge or collect usurious interest is routinely inserted into loan documents by knowledgeable lenders.

61. 970 F.2d 138 (Bankr. 5th Cir. 1992).

62. *See* 11 U.S.C. § 523(a)(4) (1979): "A discharge under Section 727, 1141 or 1328(b) of this title does not discharge an individual debtor from any debt . . . for fraud or defalcation while acting in a fiduciary capacity . . . ."

63. The bankruptcy court found the mildew problem to be a continuous construction problem for which the general partner was responsible (including financially) under the MG partnership agreement. *Bennett*, 970 F.2d at 140.

64. *Id.* at 141.

charged the rent to the limited partnership (as on going operating expense), instead of buying the equipment outright and charging the cost to the construction budget. The MG agreement required the general partner to equip and furnish the hotel from that $22 million budget.[65] The amount wrongfully charged to MG for the equipment leases was found to be $832,204.40.[66]

The first question the Fifth Circuit considered was whether the fiduciary duty owed by the managing general partner of a limited partnership to the limited partners met the narrow requirements of Section 523(a)(4).[67] The court reviewed Texas case law in some detail and found ample authority imposing trust obligations on managing partners of a limited partnership, sufficient to satisfy Section 523(a)(4).[68] The court also considered *In Re Hurbace*,[69] which held that Texas law did not impose the type of fiduciary duty between equal co-partners of a general partnership (i.e. there was no managing partner) required to satisfy the express trust requirements of 523(a)(4).[70] The Fifth Circuit distinguished this case from *Hurbace* because of the different status of the co-equal partners in *Hurbace* and the managing partner here — the managing partner had the *control* the Fifth Circuit said was key to finding express trust fiduciary duty. Therefore, as to MG, No. 20 had the requisite duty.

The more difficult question was whether Texas law imposed or imputed the same trust obligations on the managing partner of the managing partner. Although one Texas case did hold that the general partner of a limited partnership owed fiduciary duties to the limited partners,[71] the Fifth Circuit declined to rely on that case because the Texas court's expansion of the fiduciary duty was not made expressly. The court was unwilling to rely on an implied expansion, stating that, in the Fifth Circuit, exceptions to dis-

65. It seems obvious that Bennett caused MG to lease equipment rather than acquire it to make the construction budget look better. There were other "adjustments," including re-negotiation of the base bid of one contractor to reduce the bid by $1,000,000 (the amount by which the total of all bids exceeded the $22 million budget), and reduction of the fee paid to the same contractor by one-half as compensation for MG's waiving the bonding requirement for that contractor.

66. *Id.*

67. The court explained that to satisfy Section 523(a)(4), the trust must be an *express* trust that the parties created or that resulted from a particular relationship, and not a *constructive* trust imposed by law, after the fact, to prevent an unfair result in a particular transaction. *Id.* at 143.

68. The court cited *Huffington v. Upchurch*, 532 S.W.2d 576 (Tex. 1976), as the primary authority for imposing trustee-like duties on the managing partner of a partnership. *Bennett*, 970 F.2d at 145. The *Hurbace* court correctly pointed to TUPA § 21 as imposing a *constructive trust* between partners, requiring each partner to hold for all of the partners' benefit any profits derived in connection with the partnership business or from use of its assets. *Id.* The Fifth Circuit found the element of *control* to be the key common thread among the cases, including the Ninth Circuit case of *Ragsdale v. Holler*, 780 F.2d 794 (9th Cir. 1986) (the only circuit court to have measured partners' duties to each other against the requirements of Section 523(a)(4)), which imposed express trust liability between partners. The *Hurbace* court expressly declined to follow *Ragsdale* on the basis that Texas courts had not imposed the same type of fiduciary liability on partners as had California. *In Re Hurbace*, 61 B.R. at 566.

69. 61 B.R. 563 (Bankr. W.D. Tex. 1986).

70. *Huffington*, 532 S.W.2d at 144.

71. *Crenshaw v. Swenson*, 611 S.W.2d 886 (Tex. Civ. App. — Austin 1980, writ ref'd n.r.e.)

charge are construed against creditors and in favor of the bankrupt.[72] Thus, the court found that Texas law did not support imposition of an express trust relationship between the managing partner of the managing partner of a limited partnership and the limited partners. The result of all of this was that, although Bennett was personally liable to the limited partnership for the misappropriated funds, that liability was dischargeable in Bennett's bankruptcy.

B. *RODGERS V. RAB INVESTMENTS, LTD.*[73]

RAB, a general partnership, and Rodgers and Boughton formed a general partnership to renovate an apartment complex. Rodgers and Boughton managed the project and each had a 25% interest. RAB had a 50% interest. In an apparent attempt to insulate itself from the economic effect of cost overruns and unexpected expenses, RAB formed and transferred its interest in the project partnership to a limited partnership.[74] A few months later, Rodgers and Boughton expelled RAB from the partnership and sued RAB for breach of the partnership agreement. RAB counterclaimed alleging fraud, breach of contract and breach of fiduciary duty. The parties agreed that, during the pendency of their dispute, no funds would be disbursed from the project except by unanimous consent or by an order of the state district court. Nevertheless, Rodgers and Boughton later paid themselves more than $40,000 of project funds as commissions for the sale and lease of renovated apartment units.

The jury found that RAB willfully breached the partnership agreement by transferring its partnership interest to the limited partnership. Unfortunately for them, however, Rodgers and Boughton had not sought damages or other relief for that breach.[75] They were denied relief on appeal.[76] The jury did find, however, that Rodgers and Boughton breached their fiduciary duty to RAB by expelling RAB and by paying commissions to themselves, for which the trial court awarded RAB compensatory and exemplary damages.[77]

In their appeal, Rodgers and Boughton first argued that RAB had no standing to bring the lawsuit after transferring its partnership interest to the limited partnership. The court found that the transfer was invalid and ineffective, based on restrictions stated in the partnership agreement.[78] This conclusion seems completely inconsistent with the jury's finding that RAB

72. 970 F.2d at 148.

73. 816 S.W.2d 543 (Tex. App.—Dallas 1991, no writ).

74. How that was to be accomplished is not obvious and was not explained in the opinion.

75. *Id.* at 546. RAB's action caused a dissolution of the partnership under TUPA Sections 29 and 31(2). *Id.* at 549. Several sections impose consequences for a "wrongful" dissolution or a dissolution "in contravention of the partnership agreement. . .," including TUPA Section 38(2). TEX. REV. CIV. STAT. ANN. 2A. 6132b, § 38(2).

76. *Rodgers*, 816 S.W.2d at 546.

77. *Id.*

78. *Id.* at 547. The partnership agreement provided:

> 6.1 Transfer of Interest. Except as otherwise provided herein, no Partner may sell, assign, transfer, encumber or otherwise dispose of any interest in the Part-

willfully breached the partnership agreement by transferring its partnership interest to a limited partnership. As noted, that was a wrongful dissolution. The court's conclusion that the transfer was ineffective because it violated the terms of the partnership agreement likewise appears wrong. The transfer was wrongful, as the jury found, and the transferee could not become a substituted partner without the consent of the other partners (TUPA section 18(g)), but the appropriate relief is found in the provisions of the statute that deal with wrongful dissolutions, not in allowing a party to benefit from its own wrongful actions. Apparently, the court felt that RAB had been mistreated and it was determined to reach the result that it did. In any case, the court found that the partnership (and the fiduciary relationship) continued and that RAB had standing to bring the lawsuit.[79]

The court also held that, as a matter of law, Rodgers and Boughton dissolved the partnership when they expelled RAB and that, as a result, RAB was entitled to be paid the value of its interest in the partnership as of the date of expulsion/dissolution.[80] In addition, the court determined that there was enough evidence to support the jury award of exemplary damages to RAB, in light of the flagrant self-dealing by Rodgers and Boughton in paying commissions to themselves in violation of the agreement requiring unanimous consent or court approval.[81]

IV. ENFORCEABILITY OF PARTNERSHIP AGREEMENTS

A. COVENANTS NOT TO COMPETE

1. Peat Marwick Main & Co. v. Haass[82]

This case involved a partnership separation provision that the court analyzed as a covenant not to compete (over a vigorous dissent). The enforceability of covenants not to compete has been a contentious area in Texas for several years and, among other things, has inspired important legislative changes.[83] Even though the subject provision pre-dated the 1989 statutory changes, this court found that the result under them would have been the same.[84]

In *Haass* the partnership agreement of a national accounting firm, and a related merger agreement, imposed liability for damages on a former partner

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nership or assets of the Partnership without the unanimous prior written consent of the other Partners. . . .

6.7 Transfer of Partnership Interest. . . . In the event a Partner desires to sell, assign, transfer or otherwise dispose of all or any part of the Partnership interest owned or held by him . . . [he shall,] as a condition precedent to his right to do so, by notice in writing inform all other Partners . . . and . . . offer such shares for sale to the other Partners . . . .

Id.

79. *Id.* at 546.

80. *Id.* at 549.

81. *Id.* at 549-50.

82. 818 S.W.2d 381 (Tex. 1991)

83. *See* TEX. BUS. & COM. CODE ANN. § 15.50 (Vernon Supp. 1993) (Covenant Not to Compete Act, 71st Leg., R.S., ch. 1193, § 2, 1989 Tex. Gen. Laws 4852).

84. *Haass*, 818 S.W.2d at 388.

who solicited or furnished accounting services to partnership clients during the first twenty-four months after the partner left the firm.[85] The agreements broadly defined client to include new clients originated during the twenty-four months after the partner's separation, which could include clients with whom the former partner had no contact while at the prior firm. The court, looking to covenant not to compete law for guidance, held that the restriction was too broad and constituted an unreasonable restraint of trade.[86]

The court also defined the three elements of a reasonable covenant not to compete.[87] First, the covenant must be ancillary to a valid contract, transaction or relationship.[88] Second, the restraint created must not be greater than necessary to protect the promisee's legitimate interests, such as business good will, trade secrets, or other confidential or proprietary information.[89] Third, the promisee's needs for the protection given by the agreement must not be outweighed by either the hardship to the promisor or any injury likely to the public.[90] In this case, the court concluded that the covenant failed the last two elements of the reasonableness definition.[91]

In his dissent, joined in by Justice Gonzalez, Justice Cornyn disagreed that the provision at issue was a covenant not to compete, and found that the provision was reasonably necessary to give the acquiring firm in the merger the benefit of its bargain.[92]

B. DAMAGES OR A PENALTY

1. Phillips v. Phillips[93]

This case may be a useful reminder that the freedom to contract in the partnership area, while very broad, is not without limit. The issue in *Phillips*, which was actually more of a contract/penalty case than a partnership case, concerned the distinction between liquidated damages and unenforceable penalties. The partnership agreement called for payment of decuple[94] the actual damages to the limited partner on a breach by the general partner. The court held that provision to be an unenforceable penalty, not an enforceable liquidated damages provision.[95] Although the case involved that sub-

85. Basically, the former partner had to pay to the firm fees received from those clients. *Id.* at 385.
86. *Id.* at 388.
87. *Id.* at 386.
88. *Id.*
89. *Id.*
90. *Id.*
91. *Id.*
92. *Id.* at 388-91.
93. This is just one chapter in the saga of Mr. and Mrs. Phillips. Other matters involving them, and the business aspects of the dissolution of their 32-year marriage, are contained in the discussion of *Phillips v. First City, Texas-Tyler, N. A.* (In re Phillips), *supra* text accompanying notes 1-19. 820 S.W.2d 785 (Tex. 1991). The lower court's opinion in this case was summarized in an earlier survey article. *See* Steven A. Waters & Joni Gaylor, *Partnerships, Annual Survey of Texas Law*, 45 SW. L.J. 553, 567 (1991).
94. One does not often have the chance to use this word, meaning *ten* times.
95. *Phillips*, 820 S.W.2d at 789.

stantive issue, it really was more important on a procedural point: whether the penalty defense is waived if not plead under Rule 94 of the Texas Rules of Civil Procedure, which provides that affirmative defenses not plead are waived. The majority held that a contract containing a penalty should be viewed the same as a plainly illegal contract that courts will refuse to enforce, as a matter of public policy.[96] A spirited dissent argued that the failure to plead penalty as an affirmative defense was a waiver. Further, Mr. Phillips volunteered the provision.[97] It was part of a section of the partnership agreement in which Mr. Phillips (as general partner) expressly agreed to honor his fiduciary duty to Mrs. Phillips (as limited partner), as protection to his soon-to-be-ex-wife that he would manage their $18 million of assets impartially.[98] The dissent continued that the majority's holding "bail[ed] him out of his bargain."[99]

V. PROCEDURAL ISSUES

A. RES JUDICATA

1. Barr v. Resolution Trust Corp.[100]

This recent Texas Supreme Court case provides a detailed analysis of res judicata in a partnership setting. The issue in *Barr* was whether a claim by a financial institution against Barr, based on individual liability as a partner for a partnership promissory note, is barred by application of the doctrine of res judicata as a result of an earlier denial of a claim against him as a guarantor of the same note.

In 1988, the lender filed two lawsuits, one alleging liability against the partnership and against the remaining partner Knott, as guarantor, and the other alleging that Barr was personally liable *as a guarantor* of the note. Barr won a summary judgment in the second lawsuit on the ground that the terms of the guaranty agreement were too uncertain to be enforced. The lender amended its pleadings in the first suit to add Barr as a defendant, based on his liability *as a partner* for the partnership promissory note.[101] The trial court granted summary judgment for Barr on res judicata grounds; the court of appeals, with one dissent, reversed the trial court's judgment, holding that the doctrine did not apply to the facts of the case.

The Texas Supreme Court reversed the judgment of the court of appeals and affirmed the trial court's judgment holding any claim that, with diligence, *could* have been brought in the first lawsuit was barred by res judicata and could not be pursued later.[102] The court noted that both suits sought to

96. *Id.*
97. *Id.*
98. *Id.*
99. *Id.*
100. 837 S.W.2d 627 (Tex. 1992).
101. As a matter of partnership law, the lender was entirely correct: partners of a general partnership have joint and several liability for partnership debts. TEX. REV. CIV. STAT. ANN. art. 6132b, § 15 (Vernon 1970).
102. 837 S.W.2d at 631.

impose liability on Barr for payment of the notes and asked for the same damages.[103] Further, both suits required the same proof: that the partnership notes existed, that the notes were due and that the partnership defaulted in paying them.[104] The court disallowed the claim against Barr, stating that "there is no valid reason to subject Barr to two different lawsuits."[105] In so doing, the court stated that it was reaffirming the "transactional" approach to res judicata.[106] Essentially, this approach maintains that claims arising from the same transaction that, with diligence, could have been brought in the same lawsuit, cannot be divided and maintained separately.

B. LIABILITY OF INDIVIDUAL PARTNERS FOR PARTNERSHIP OBLIGATIONS/SERVICE OF CITATION

1. Fincher v. B&D Air Conditioning[107]

The issue in *Fincher* was whether a partner in a Texas general partnership who received service of citation on behalf of the partnership, could be found individually liable although not named, individually, as a defendant in the petition. The plaintiff subcontractor sued the owners of an apartment complex, the original contractor, and another subcontractor to collect monies owed to the plaintiff for materials furnished to refurbish the apartments. The defendant subcontractor cross-claimed against the original contractor and the apartment owners. One owner of the apartment complex was Yellow Ribbon Enterprises, a Texas general partnership composed of two partners, W. Fincher, individually, and W. Fincher, Trustee for a Texas corporation. The original petition named "Yellow Ribbon Enterprises and William R. Fincher, *Trustee*," as defendants. The citation was addressed "TO: Yellow Ribbon Enterprises, a limited partnership, by serving William R. Fincher, its general partner." Actual physical service was made through W. Fincher.

Under the TUPA, partner liability for partnership debts is joint and several, not merely contractual.[108] Although the partners' individual liability is derivative of partnership liability, it is in addition to partnership liability. Suits may be brought against the partnership, with service on one partner.[109] The court pointed to the citation service rules of the Texas Civil Practice & Remedies Code to support its finding that partners actually served with process are on notice of their individual liability for judgments entered against the partnership.[110]

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103. *Id.*
104. *Id.*
105. *Id.*
106. *Id.*
107. 816 S.W.2d 509 (Tex. App.—Houston [1st Dist.] 1991, writ denied), *cert. denied*, 113 S. Ct. 77 (Oct. 5, 1992).
108. TEX. REV. CIV. STAT. ANN. art 6132b, § 15 (Vernon 1970).
109. *Id.* § 15 cmt. (Vernon 1970).
110. Texas Civil Practice and Remedies Code § 17.022, entitled "Service On Partnership," reads: "Citation served on one member of a partnership authorizes a judgment against the partnership *and the partner actually served.*" TEX. CIV. PRAC. & REM. CODE § 17.022 (Vernon 1986) (emphasis added).

The court reached an important distinction. Even though a partner is jointly and severally liable for, and therefore can be sued on, liabilities established by judgments against the partnership, the assets of the partner can be reached only when there is a judgment against the partner, individually.[111] Therefore, the court's interpretation of Section 17.022 of the Civil Practice & Remedies Code was important in determining whether a new, separate suit against the individual partner was required. The court held that when Fincher received actual service as general partner for Yellow Ribbon, even in his capacity as trustee, Fincher was also before the trial court as a general partner. Therefore, a judgment establishing partnership liability was also a judgment against the partner individually.[112]

Justice Maribel argued in his dissenting opinion that a reasonable person *A* would not be put on notice that he is being sued *individually* when he is served with a citation addressed to ABC Partnership and a petition naming ABC Partnership, *B*, individually, and *C*, individually (but without naming *A*, individually, as a defendant).[113]

111. *Fincher*, 816 S.W.2d at 512-13.

112. *Id.* at 513. In this case, Yellow Ribbon and Fincher never denied their partner status, *Id.* at 512, which the court used to support its ruling that partner status could not be controverted at trial. The appellate court also held that the trial court did not abuse its discretion by allowing the pleadings to be amended, after the trial, to add Fincher as a party defendant in his individual capacity because it was not necessary to name Fincher *individually*. *Id.* at 514.

113. *Id.* Justice Maribel also argued that the post-trial amendment that added Fincher, *individually*, as a party defendant, when he did not participate in the trial or file any pleadings in the case, *individually*, was insufficient to authorize a judgment against Fincher, *individually*. *Id.*