Partnerships

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PARTNERSHIPS

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Janna R. Melton**

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I. SUCCESSOR LIABILITY—Medical Designs, Inc. v. Shannon, Gracey, Ratliff & Miller, L.L.P.1

No Texas case law discusses whether a successor partnership is liable for the tortious acts of a prior partnership, perhaps because the Texas Uniform Partnership Act (TUPA)2 provides that “dissolution of the partnership does not of itself discharge the existing liability of any partner,”3 except under specified, limited circumstances.4

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1. 922 S.W.2d 626 (Tex. App.—Fort Worth 1996, writ denied).
2. TEX. REV. CIV. STAT. ANN. art. 6132b (Vernon Supp. 1995). TUPA continues to apply until after December 31, 1998 to all partnerships formed before January 1, 1994 that do not elect to be governed by the Texas Revised Partnership Act (TRPA). TEX. REV. CIV. STAT. ANN. art. 6132b-10.03(a) (Vernon Supp. 1995). TRPA applies to all partnerships formed after December 31, 1993, except those merely continuing the business of a dissolved partnership under TUPA, and to all partnerships after December 31, 1998. Id. § 10.03(a), (c).
3. Id. art. 6132b, § 36(1).
4. See id. § 36(2), (3) (partner discharged from liability on dissolution pursuant to an expressed or implied agreement among the partnership, the creditor and the partner being discharged; or, person assumes the existing obligations of a dissolved partnership with the creditor’s knowledgeable consent).

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Similarly, under the TRPA,5 "[w]ithdrawal of a partner does not of itself discharge the partner's liability for an obligation of the partnership incurred before withdrawal."6 In this case, however, instead of pursuing former partners, the plaintiff sought to enforce liability against an alleged successor partnership.7 The facts contained in the opinion are skimpy on the history of the defendant law partnership from 1985 forward. Fortunately, although it was argued by the plaintiff to be important to its claim, that history was not crucial to understanding the court's decision, which the court reached without determining whether the defendant partnership was, in fact, a successor partnership.8

In 1985, Medical Designs, Inc. (MDI) engaged a Ft. Worth law firm, operating as a Texas general partnership,9 to prosecute a lawsuit against MDI's competitor.10 The trial court awarded MDI a judgment for over $4 million; that judgment was reversed by the same Fort Worth Court of Appeals that decided this legal malpractice case.11 In 1991, MDI sued the firm, which by then had become a limited liability partnership (that iteration of the firm will be called LLP), alleging legal malpractice and DTPA violations.12 LLP moved for summary judgment on several grounds, including that even if Texas law recognized a theory of successor liability for the tortious acts of a previous partnership, LLP could not be held liable to MDI because: (i) Reynolds, Shannon, Miller, Blinn, White & Cook was not a successor partnership to Shannon, Gracey, Ratliff & Miller; (ii) LLP was not a successor partnership to Reynolds, Shannon, Miller, Blinn, White & Cook; and (iii) LLP was not a successor partnership to the pre-Reynolds Shannon law firm of Shannon, Gracey, Ratliff & Miller.13 Without explanation, the trial court granted summary judgment in favor of LLP on the basis that the defendant law firm was not a successor to the firm that handled the 1985 litigation.14

MDI's principal argument on appeal was that the contractual nature of the attorney-client relationship resulted in the assumption by LLP, as a successor partnership, of both the benefit of its predecessor's contracts

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5. TEX. REV. CIV. STAT. ANN. art. 6132b-7.03.
6. Id. § 7.03(a).
7. Medical Designs, 922 S.W.2d at 628.
8. See id.
9. Although it is difficult to get all of this from the opinion, apparently Shannon, Gracey, Ratliff & Miller existed as a general partnership before 1985. Then, between 1985 and 1988, that firm merged with a Houston-based firm to create the general partnership Reynolds, Shannon, Miller, Blinn, White & Cook. Sometime in 1988, the merger was aborted and Shannon, Gracey, Ratliff & Miller was formed anew. In 1991, the partnership took the necessary actions to become a registered limited liability partnership.
10. Id. at 627.
11. Id.
12. Id. at 628. When MDI filed suit, Shannon, Gracey, Ratliff & Miller was a general partnership governed by TUPA, which imposes liability on the partnership for the malpractice of its lawyers. Id. (citing TUPA § 13); see also TRPA § 3.03 (a partnership governed by TRPA is liable for loss or injury resulting from the wrongful act or omission of a partner acting in the ordinary course or with the partnership's authority).
13. Medical Designs, 922 S.W.2d at 628.
14. Id.
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and the associated burden of liability for the predecessor firm's malpractice. The court affirmed the trial court's judgment holding that LLP could not be held liable for the acts of Shannon, Gracey, Ratliff & Miller, because, even if LLP was a successor partnership, "Texas law does not recognize that successor partnerships are liable for the tortious conduct of predecessor partnerships." Without citing any of them, the court also said that it was not persuaded by MDI's reliance on cases involving a successor entity's liability for contractual obligations, as opposed to tort liability.

Moreover, the court held that MDI waived any argument that LLP was directly liable to MDI by failing to challenge LLP's assertion in its summary judgment motion that it never violated the DTPA or any duty to MDI. Finally, the court noted that MDI was not without remedy—the dissolution of a partnership alone does not discharge the existing liability of an individual partner.

II. FIDUCIARY DUTY

A. EXEMPLARY DAMAGES—Hawthorne v. Guenther

This case involved whether a managing partner breached her fiduciary duties and engaged in self-dealing, justifying an award of exemplary damages. Guenther and Lyn Hawthorne invested in a number of business ventures, both together and separately, using shared investment information. One venture was a partnership called "Cellular Mole" consisting

15. Id.

16. Id. at 629. The court frequently noted that Texas law does not recognize successor liability, but for support it relied only on cases from Illinois, Kansas and Wisconsin. Id. at 628. Neither TRPA nor TUPA provides direct guidance on the continuing liability of a "successor partnership"; however, TRPA defines when a partnership is considered to be "continuing the business" of another partnership and TUPA defines when creditors of a prior or dissolved partnership are creditors of a partnership that continues the business of the prior or dissolved partnership. Tex. Rev. Civ. Stat. Ann. art. 6132b, § 41 (Vernon Supp. 1995). MDI had asserted on appeal that there was at least one fact issue (sufficient to preclude a summary judgment) about whether LLP is a successor law firm to Shannon, Gracey, Ratliff & Miller, but that issue was never reached because the court found no basis for liability. Medical Designs, 922 S.W.2d at 628. The court used the same basis to disallow MDI's attempt to supplement the record and obtain a new trial based on newly discovered advertising materials for LLP. Id. at 629. The materials allegedly contained language that could be construed as holding LLP out as a successor firm of the prior partnership. Id.

17. Medical Designs, 922 S.W.2d at 628 ("[W]hether the new firm must fulfill an obligation created by contract with MDI by the prior firm is certainly a different question than whether the new firm must pay for tortious acts for which the old firm would allegedly have been responsible.").

18. Id. at 629. MDI argued that because LLP used the same name and both partnerships rendered services to MDI, the partnerships were, in fact, the same and the prior partnership was not dissolved as to MDI. Id. at 628-29. Presumably, MDI was asserting that LLP was liable based on a theory that it was continuing the business of one or more partnerships.

19. Id. at 629. MDI did not specifically allege that any of LLP's lawyers committed malpractice. Id. There was no discussion of possible limitations issues affecting claims against individual partners.


21. Id. at 927.
of Hawthorne, as managing partner, Hawthorne’s husband, Monty, Guenther and three others, to participate in a lottery for the rights to cellular telephone licenses. The partners agreed to equally apportion the costs of filing for the licenses and any future remuneration derived from them.

In 1988 and 1990, Lyn Hawthorne sent Guenther letters advising that the partnership had sold two cellular franchises and enclosing checks for $10,153.71 and $150,000, representing Guenther’s purported share of the partnership’s profits from the sales. Guenther testified that: (i) he was never consulted about any sale of the franchises; (ii) his 1989 U.S. income tax Schedule K-1 indicated that his partnership earnings were more than $400,000, even though he received only the two checks; and (iii) proceeds from the 1989 franchise sale were paid to Cellular Mole, which disbursed funds only to Lyn and Monty Hawthorne. None of Lyn Hawthorne’s correspondence to Guenther mentioned either an agreement to offset her investment losses from other ventures involving Guenther’s participation or advice against Guenther’s share of partnership earnings or disclosed the receipt or disbursement of partnership revenues, except the amounts actually paid to Guenther. In addition, Cellular Mole’s accountant testified that the Partnership’s 1986 tax return revealed that Lyn Hawthorne, personally, and two businesses owned by her and her husband owed Cellular Mole a total of $378,500 in “advances,” none of which was evidenced by a promissory note. Guenther demanded an accounting from Lyn Hawthorne, who, apparently for the first time, responded that Guenther was obligated to reimburse her for losses that she incurred in their other joint investments. Guenther refused, filed suit and won a jury award against Lyn Hawthorne for $640,000 in actual damages and $850,000 in exemplary damages for breach of fiduciary duty.

Hawthorne appealed, arguing that the evidence was insufficient to support (i) a finding of a breach of fiduciary duty and (ii) an award of exemplary damages. In deciding the evidence questions, the court first considered the nature and existence of a fiduciary duty. Noting that the partnership issues in this case were governed by the TUPA, the court stated that well-settled Texas law recognizes that partners owe one another a fiduciary duty and that “[a] managing partner owes his co-part-

22. Id.
23. Id. at 927-28.
24. Id. at 928.
25. Id.
26. Id.
27. Id.
28. Id. By 1992, the partnership owed Guenther $440,272.25; Hawthorne, however, withheld Guenther’s distribution because “he owed her money.” Id.
29. Id. at 927.
30. Id. at 929.
31. The partnership was formed before January 1, 1994. Id. at 934 n.2. Despite the absence of a written partnership agreement, there was considerable undisputed evidence that Cellular Mole was a partnership. Id. at 934.
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The court observed that TUPA and common law fiduciary duties require partners to (i) fully disclose matters affecting the partnership, (ii) account for profits and property and refrain from self-dealing, and (iii) refrain from competition with the partnership. In the case of a managing partner, the court found a fiduciary duty (a shade of the duty of loyalty) to avoid being positioned to benefit from violating the duty “to administer the partnership affairs solely for the benefit of the partnership.”

The court identified considerable evidence to support the jury’s finding that Lyn Hawthorne breached her fiduciary duty to Guenther: (i) “[she] admitted receiving and spending Guenther’s share of the partnership proceeds;” (ii) she lent herself substantial partnership funds, without informing the other partners, without paying interest on the amounts borrowed, and without even signing promissory notes to evidence the loans; (iii) she instructed the partnership’s accountant to withhold partnership information from Guenther; (iv) she purchased for her own benefit the interest of two other partners without giving the remaining partners or the partnership the opportunity to purchase the interests; (v) she sold substantially all of the assets of the partnership without informing Guenther; and (vi) “[she] made immediate distributions to herself and to her husband while withholding funds from the other partners.”

Lyn Hawthorne appealed the exemplary damage award, arguing that there was no jury finding to support the award because the jury charge failed to ask if the breach of fiduciary duty “was done so intentionally, fraudulently, maliciously, or involved self-dealing.” The court agreed that an award of exemplary damages for a fiduciary breach required “a finding of an aggravating factor, whether it be intent, self-dealing, or mal-

32. Id. The court likely would have reached the same result under the TRPA, given the nature of the breaches, even though TRPA seeks to eliminate the strict fiduciary duties developed under Texas common law (TPRA § 4.04 states that partners are not trustees and do not owe the duties that trustees owe). The Texas Supreme Court undermined that legislative effort in M.R. Champion, Inc. v. Mizell, 904 S.W.2d 617, 618 (Tex. 1995), holding that principles applicable to a case under TRPA were the same as under TUPA with respect to fiduciary duties. For a discussion of Mizell and its misplaced reinstatement of traditional fiduciary duties into partnership law, see TEX. REV. CIV. STAT. ANN. art. 6132b cmt. (Vernon Supp. 1996) and Steven A. Waters, Partnerships, Annual Survey of Texas Law, 49 SMU L. REV. 1205, 1208 (1996).

33. Hawthorne, 917 S.W.2d at 934. TUPA § 21 says (1) Every partner must account to the partnership for any benefit, and hold as trustee for it any profits derived by him without the consent of the other partners from any transaction connected with the formation, conduct, or liquidation of the partnership or from any use by him of its property.

34. Hawthorne, 917 S.W.2d at 934.

35. Id. at 934-35. The court rejected Hawthorne’s defense that she withheld Guenther’s share based on the alleged arrangement with Guenther that allowed her to offset her losses from his investment recommendations with partnership asset sales. Id. at 935. The only supporting evidence was her testimony and her husband’s, who claimed that he eavesdropped on a telephone conversation between Lyn Hawthorne and Guenther when the matter was discussed. Id.

36. Id.
The trial court failed to include in the jury charge a question on the aggravating factor, but Hawthorne did not preserve any complaints about the charge, leaving for the court only the question of whether there was factually sufficient evidence in the record of Hawthorne’s intent. The court cited Lyn Hawthorne’s actions, noted above, as “some evidence” that she intended to gain an additional benefit for herself through the partnership, which the court found sufficient to support the exemplary damages award.

B. EXPULSION—Bohatch v. Butler & Binion

At issue in this case was whether a law firm and some of its partners breached the law firm’s partnership agreement and their fiduciary duties by expelling a partner and eliminating her monthly draw and year-end distribution. Perhaps the most interesting thing about the case is that the Texas Supreme Court has accepted it for review, as noted in more detail at the end of this discussion.

Bohatch involves a claim by a former law firm partner that she was expelled from the firm because she discovered and reported that the managing partner in her office was overbilling an important client of the firm. Bohatch maintained that the partnership and several named partners breached their fiduciary duty to her when they expelled her, and that they also breached the firm’s partnership agreement in a number of respects.

The trial court granted the partnership’s motions for summary judgment on Bohatch’s claims of wrongful discharge, breach of fiduciary duty for acts occurring on or after the date she was expelled and breach of the duty of good faith and fair dealing for acts occurring on or after that date. The trial court submitted to the jury the breach of contract claims and breach of fiduciary duty claims for acts occurring before expulsion. The jury awarded plaintiff actual damages of $57,000 for lost earnings, $250,000 for mental anguish, and $4 million in punitive damages based on a finding of breach of fiduciary duty “with an intent to gain additional benefit.”

Later, the trial court suggested a remittitur of the punitive damages award, which plaintiff accepted, and entered a second judgment leaving the actual damages award intact, but reducing the punitive damages to

37. Id. at 936.
38. Id.
39. Id. at 935.
40. Id. at 936.
41. Id. at 937.
42. 905 S.W.2d 597 (Tex. App.—Houston [14th Dist.] 1995, writ granted).
43. Id. at 599-600.
44. Id. at 600.
45. Id.
46. Id. The punitive damages were assessed evenly among three individual partners.

Id.
The partnership challenged all of the jury's findings on appeal.

A number of issues were considered on appeal, including the fiduciary duty owed to a partner being expelled from a partnership. In the absence of controlling Texas cases, the court relied on cases from other jurisdictions to hold that, when expelling another partner, partners have a fiduciary duty not to act in bad faith. In this context, that meant avoiding effecting the expulsion for self gain.48

The court found no evidence of bad faith in this case.49 For one thing, plaintiff's partnership interest was so small that the court found that the jury could not have "reasonably concluded" that she was expelled so the other partners could assume that interest.50 The other "self gain" allegation—that she was expelled because she raised the issue of overbilling the firm's important client and that her expulsion was to protect the managing partner's inflated distribution and the firm's relationship with that client—was severely undermined by the client's statements that they found the firm's billings to be acceptable.51

The plaintiff had more success on her claim that the partnership breached the partnership agreement in its treatment of her, although she was unsuccessful in claiming that she had been constructively expelled when her year-end distribution was eliminated and her future distribution percentage was reduced to zero.52 The court found that the partnership could establish draws and distributions pursuant to the partnership agreement, and that the provisions relating to that issue were independent of the expulsion provisions.53 The court did, however, find that the firm had breached the partnership agreement by failing to follow the stated requirements to give notice and an explanation relating to change in the plaintiff's distribution percentage.54 For that breach, the court upheld the award of actual damages of $35,000.00 in past lost earnings, and $225,000.00 in attorney's fees, plus interest.

Bohatch appealed to the Texas Supreme Court, which granted writ on six points of error and, because it granted writ on Bohatch's application, on the Partnership's cross-application.55 The following are the points of error on non-procedural issues that will be considered by the Texas Supreme Court:

47. Id. at 601.
48. Id. at 602.
49. Id. at 603.
50. Id. at 604.
51. Id. at 600. Plaintiff's doubts regarding the client's request that her work be supervised were likewise severely weakened by confirmation of the client's concerns. Id.
52. Id. at 605.
53. Id. at 605-06.
54. Id. The agreement provided: "Upon written notice from the management committee stating the reasons therefore, a partner's tentative distribution percentage can be reduced for good cause at any time." Id.
**Point of Error No. 1**

The Court of Appeals erred in finding that there was no evidence that the Respondents' expulsion of Bohatch was in part motivated by "self gain."

**Point of Error No. 3**

The Court of Appeals erred by reviewing the legal sufficiency of the evidence to support the jury's finding of a breach of fiduciary duty under a definition of fiduciary duty different from that submitted to the jury.

**Point of Error No. 4**

The Court of Appeals erred in defining "breach of fiduciary duty" more narrowly than the Texas Supreme Court. The Court of Appeals erred in holding that the only fiduciary duty that partners owe one another when expelling another partner is not to do so for self gain.

**Point of Error No. 5**

The Court of Appeals erred in failing to hold that the fiduciary duty that the partners owe when expelling another partner requires that they act fairly, honestly, in the utmost good faith, with undivided loyalty, and disclose all material information.

**Point of Error No. 6**

The Court of Appeals erred by failing to recognize that the fiduciary duty law partners owe one another prohibits expulsion of a partner in retaliation for fulfilling his ethical responsibility to report the wrongdoing of another partner.56

Perhaps the results of the Texas Supreme Court's review will be reported here next year.

### III. POWER AND AUTHORITY TO WAIVE ATTORNEY-CLIENT PRIVILEGE IN BANKRUPTCY—United States v. Campbell57

As a general rule, each partner in a general partnership is an agent of the partnership and has the power and authority to bind the partnership.58 It follows that, typically, a partner is the appropriate authority to waive the attorney-client privilege on behalf of a partnership. The question in this case was whether a bankruptcy trustee can waive the privilege on behalf of a partnership in bankruptcy.59

Campbell was the general partner of a limited partnership called 3700 WFA Limited (the Partnership), and Campbell's personal attorney,

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56. Id. at 28-29.
57. 73 F.3d 44 (5th Cir. 1996).
58. TRPA § 3.02; TUPA § 9. Exceptions apply if the partner does not have the authority to act for the partnership in a particular matter and the person with whom the partner is dealing has knowledge of that fact.
59. Campbell, 73 F.3d at 44.
O'Connor, was the sole limited partner. On June 30, 1986, the Partnership filed a Chapter 11 bankruptcy petition signed by Rogers, the Partnership's attorney. Subsequently, Campbell engaged in a number of questionable transactions involving the Partnership's bank account and the account of a separate business entity.

On October 27, 1987, the bankruptcy court entered an order converting the Partnership's proceeding to a Chapter 7 case and appointed Cage as the bankruptcy trustee.

After Cage investigated the transfers from the bankrupt estate, Campbell was indicted and convicted of bankruptcy fraud, in part based on the testimony of Rogers. At the trial, Campbell argued that Rogers should not have been allowed to testify over Campbell's objection that the testimony was privileged as an attorney-client communication.

The district court allowed Rogers to testify because (i) a personal attorney-client relationship between Rogers and Campbell had not been established and (ii) Rogers' contact with Campbell was based solely on her capacity as the Partnership's attorney. Pursuant to a hearsay rule exception, the court also admitted testimony of Rogers and a letter from Cage to Rogers as evidence of waiver of the privilege.

Campbell appealed his bankruptcy fraud conviction on the basis that there were hearsay rule violations and that harmful evidence was admitted when the district court erroneously concluded that Cage could waive the attorney-client privilege on behalf of the Partnership. Campbell argued that limited partnerships were more like a natural person than a corporation and that, therefore, the holding of the United States Supreme Court in Commodity Futures Trading Commission v. Weintraub, that a bankruptcy trustee may waive the privilege on behalf of a

60. Id. at 45-46.
61. Id. at 46. The court notes that Rogers did not establish a personal attorney-client relationship with Campbell at any time. Id. at 47.
62. Id. at 46.
63. Id. Campbell deposited into the Partnership's account a check from the account of the separate business entity containing insufficient funds to cover the check. Id. Before the check was returned for insufficient funds, however, Campbell arranged a wire transfer to a bank from the Partnership's account to make a payment on the mortgage against Campbell's personal residence. Id. Interestingly, O'Connor, who was a limited partner, later sent a letter questioning Campbell about the transactions, explaining that, as an attorney, he had to avoid any appearance of impropriety with respect to transferring funds out of the Partnership's bankruptcy estate. Id.
64. Id.
65. Id. Campbell never responded to Cage's letter requesting an explanation for the transfer to the Partnership's account. Id.
66. Id. Aside from her testimony related to the alleged waiver of attorney-client privilege by Cage, the nature of Rogers's testimony is not clear from the facts stated in the opinion. See id.
67. Id.
68. Id.
69. Id. at 45.
70. Id. at 47.
corporation, was inapplicable to a limited partnership.\textsuperscript{72}

The Supreme Court, in dicta, had distinguished the waiver of the privilege by an individual in bankruptcy from that of a corporation because an individual can act for himself but a corporation, controlled by management, can only act through its agents.\textsuperscript{73} The Fifth Circuit explained that the Supreme Court's holding with respect to corporations was based on the similarity of the duties of the bankruptcy trustee to those of the officers and directors of a solvent corporation, who have the power to waive the privilege on behalf of the corporation.\textsuperscript{74}

Based on Commodity Futures Trading Commission, the Fifth Circuit affirmed the district court's judgment, holding that "[a] limited partnership, like a corporation, is an inanimate entity that can act only through its agents. Accordingly, the same rule that applies to corporations in bankruptcy should apply to a bankrupt limited partnership,"\textsuperscript{75} The court concluded that the district court did not err in holding that Cage, as bankruptcy trustee, had the authority to waive the attorney-client privilege on behalf of the Partnership.\textsuperscript{76}

IV. BANKRUPTCY—CREDITOR CLAIMS AGAINST BOTH PARTNERSHIP AND PARTNER IN BANKRUPTCY—

\textit{In re El Paso Refining, Inc.}\textsuperscript{77}

In this case, El Paso Refining, Inc. (EP Inc.) executed an unconditional guaranty in favor of the predecessor-in-interest to Scurlock Permian Corporation (Scurlock),\textsuperscript{78} guaranteeing payment of loans made by Scurlock to El Paso Refinery L.P. (EP L.P.), a limited partnership in which EP Inc. was the sole general partner.\textsuperscript{79} Subsequently, EP L.P. and EP Inc. filed for bankruptcy—in October, 1992 and October, 1993, respectively.\textsuperscript{80}

In addition to determining whether EP Inc., as a bankruptcy debtor, was liable for interest accruals on the guaranteed obligation and whether the guaranteed obligations had been satisfied,\textsuperscript{81} the court considered the liability of partners and a partnership for the debts of the other when both are in bankruptcy.\textsuperscript{82} Specifically, the court considered whether

\textsuperscript{72.} Campbell, 73 F.3d at 47 (citing Weintraub, 471 U.S. at 358).
\textsuperscript{73.} Id. (citing Weintraub, 471 U.S. at 356).
\textsuperscript{74.} Id. (citing Weintraub, 471 U.S. at 348, 351, 358). The court also cited opinions by the Fifth and Eighth Circuits to support the rationale that corporations and partnerships should be treated the same with regard to attorney-client privilege matters.
\textsuperscript{75.} Id. Certainly, the strong modern trend, evidenced in the TRLPA and TRPA, is to treat partnerships more as distinct entities, and much less as an aggregate of individuals (as was the case for the TUPA).
\textsuperscript{76.} Id. The applicable standard of review was whether the district court's finding of a waiver was clearly erroneous. \textit{Id.} at 46.
\textsuperscript{77.} 192 B.R. 144 (Bankr. W.D. Tex. 1996).
\textsuperscript{78.} Id. at 145.
\textsuperscript{79.} Id. at 145-46.
\textsuperscript{80.} Id. at 146.
\textsuperscript{81.} Id.
\textsuperscript{82.} Id.
§ 723(c) of the United States Bankruptcy Code\textsuperscript{83} barred creditor Scurlock's claim against general partner EP Inc., in the letter's capacity as a guarantor.\textsuperscript{84}

The court explained that § 723(c) was enacted to overrule the "jingle rule" of priority,\textsuperscript{85} which provided that a partnership's assets were first distributed to partnership creditors and a partner's assets were first distributed to the partner's creditors.\textsuperscript{86} Only after their respective creditors' claims were satisfied would any distributions be made to the creditors of the other party.\textsuperscript{87} The court noted that in recognition of the principle that a general partner is equally liable for its own obligations and the partnership's obligations, "Congress drafted § 723 to provide that when a partner enters bankruptcy the unsatisfied partnership's creditors share in the partner's estate at the same level as the partner's own creditors."\textsuperscript{88} The court explained that pursuant to § 723(c), the partnership trustee—and only the partnership trustee—may bring a claim against the partner's estate for the entire amount of "unsatisfied claims" against the partnership.\textsuperscript{89}

Following its "unsatisfied claims" concept, the court held that § 723(c) did not bar Scurlock's claim against EP Inc.\textsuperscript{90} The court found that § 723(c) did not apply to that claim because Scurlock had already settled with the EP L.P. estate, leaving "no unsatisfied portion against the part-

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\textsuperscript{83} 11 U.S.C. § 723(c) (1995) provides:
Notwithstanding section 728(c) of this title, the trustee has a claim against the estate of each general partner in such partnership that is a debtor in a case under this title for the full amount of all claims of creditors allowed in the case concerning such partnership. Notwithstanding section 502 of this title, there shall not be allowed in such partner's case a claim against such partner on which both such partner and such partnership are liable, except to any extent that such claim is secured only by property of such partner and not by property of such partnership. The claim of the trustee under this subsection is entitled to distribution in such partner's case under section 726(a) of this title the same as any other claim of a kind specified in such section.

\textsuperscript{84} El Paso, 192 B.R. at 146.

\textsuperscript{85} Id. at 147.

\textsuperscript{86} Id.

\textsuperscript{87} Id. TUPA contains a state law "jingle rule." Section 40(i) provides that the claims of separate creditors of a bankrupt or insolvent partner have priority over partnership creditors with respect to separate property. TUPA § 40(i). Primarily because preemptive federal law has eliminated the jingle rule, TRPA does not contain a similar provision; rather, a partner is required to contribute the amount necessary to satisfy partnership obligations, unless the applicable creditors agreed to be satisfied only with partnership property without recourse to individual partners. TRPA § 8.06(c).

\textsuperscript{88} El Paso, 192 B.R. at 147.

\textsuperscript{89} Id. Section 723(c) intends to prevent double recovery on claims. Id. The court does not explain its consistent reference to "unsatisfied" claims with respect to the application of § 723(c). The statute refers to "claims of creditors allowed in the [bankruptcy] case concerning the partnership." 11 U.S.C. § 723(c). There is no specific statutory prerequisite that requires a claim to be "unsatisfied" for the trustee to assert it. Logic, however, suggests that the parties have no continuing interest in a claim that has been settled.

\textsuperscript{90} El Paso, 192 B.R. at 147.
The court then held that "[b]ecause there is no longer a claim which the [EP] L.P. trustee may assert on Scurlock's behalf, Scurlock's claim [against the general partner-guarantor] for the post-settlement deficiency on the guaranteed obligation [of the partnership] does not pose a danger of double recovery [from the partnership estate]." Therefore, § 723(c) did not bar Scurlock's claim on the guaranty against EP Inc. In a footnote, the court explained that it did not disagree with Professor Kennedy's view that a creditor may not prosecute a claim against a partner-guarantor when there remains an unsatisfied portion of the creditor's claim against the partnership. The court then elaborated with the following example:

[I]f a creditor does not settle with a partnership on the creditor's $1,000 claim but instead receives a 50% payout from the partnership estate, then even though the creditor obtained a separate guaranty against the partner, it is likely that the partnership trustee alone has the ability to claim a deficiency ($500) against the partner. However, if the partner's guaranty allows the creditor to settle with the partnership without waiving his rights against the partner then the creditor may settle with the partnership for $500, and then assert his own claim for the $500 deficiency (based on the guaranty) directly against

91. Id. The court does not discuss the terms of or circumstances surrounding the settlement between Scurlock and EP L.P. See id. (noting only that Scurlock had settled his claim against the EP L.P.).

92. Id.

93. Id.

94. Id. at 147 n.1. (citing Frank R. Kennedy, Partnerships and Partners under the Bankruptcy Code: Claims and Distributions, 40 WASH. & LEE L. REV. 55, 70-71 (1983)). Professor Kennedy does not use the concept of "unsatisfied claims"; rather, he explains that "the trustee of the partnership has a claim against the estate of the general partner for the full amount of all claims of creditors allowed in the partnership case." Kennedy, supra, at 70. The court apparently concluded that, because Scurlock did not make a claim against the partnership case of EP L.P., no claim by Scurlock had been allowed. Professor Kennedy notes that "[t]he claim of a partnership creditor against the partner's estate is ordinarily limited to the amount of his claim against the partnership. A qualification on this limitation is recognized when the creditor has a security interest in the property of the partner but not the partnership's property." Id. at 70-71. It follows that the court relied on the fact that the settlement effectively eliminated Scurlock's claim against the EP L.P.'s property, leaving it, from the guaranty of EP Inc., only a claim against the property of the partner. Arguably, Professor Kennedy would agree that § 723(c) did not apply because there was no longer a threat of double recovery for a single claim by Scurlock. See id. at 71. Professor Kennedy has specifically noted that

The purpose of requiring the disallowance of the claim against the partner is to protect the partner's estate against double proof of what is essentially a single claim by the partnership creditor. The result is that the partnership creditor who has taken the precaution to obtain the personal obligation of a partner has no advantage over any other partnership creditor in the event of concurrent administration of the partnership and partner's estates.

Id. (citations omitted). The court did not discuss the fact that, contrary to the purpose of § 723(c) to prevent double recovery, ultimately, Scurlock will be allowed to recover from both the EP L.P. and EP Inc. and may receive, proportionately, more than other creditors of EP L.P. and EP Inc. Whether this was intended under the statute is not clear from El Paso or Kennedy's article; but, El Paso does appear to allow creditors to circumvent § 723(c) by settling with a debtor partnership and then recovering from the partner guarantor.
PARTNERSHIPS

The key issue presented in this case was whether a partnership was an indispensable party to the litigation.\(^9^7\) If it was, then diversity would be destroyed and the case would have to be remanded to state court, which both parties acknowledged in their briefs while arguing that the partnership was not an indispensable party.\(^9^8\) The case involved an allegation by the trustee of two Texas trusts (whose trustee and beneficiaries were Texas citizens) that were limited partners (Trustee),\(^9^9\) that general partner Simon Enterprises, Inc. (Simon)\(^10^0\) violated their March 1, 1986 partnership agreement and breached its fiduciary duty to Trustee by attempting to transfer its interest as a general partner to an outside party without Trustee's consent.\(^10^1\) Initially, Trustee had also sued Simon Property Group, L.P. (whose role is not mentioned in the opinion) and the Partnership, but filed a voluntary nonsuit as to them to achieve diversity jurisdiction and remove the action to federal court.\(^10^2\) In his petition, Trustee requested a declaratory judgment or, alternatively, a decree dissolving the partnership, an accounting and damages against Simon.\(^10^3\)

The court agreed with the parties that joinder of the Partnership, a Texas limited partnership, would divest the court of its diversity jurisdiction because a partnership is considered a citizen of each state in which its general and limited partners (e.g., Simon and Trustee) hold citizenship.\(^10^4\) Thus, the crucial issue for the court was whether the Partnership was an indispensable party—if it was, its joinder would be required, and the federal court would have to remand the case to state court. The answer depended on whether Trustee's claims were derivative or direct claims.\(^10^5\)

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95. \textit{El Paso}, 192 B.R. at 147 n.1. The court set another hearing to decide the value of the suit that EP L.P. settled against Scurlock so it could determine the amount, if any, still owed by EP Inc., as guarantor, to Scurlock. \textit{Id.} at 149.


97. \textit{See id.} at 1009 (noting that the court directed both parties to file briefs on (i) whether Hurst Mall Company, a Texas limited partnership (Partnership), should be joined as an indispensable party pursuant to Bankston v. Burch, 27 F.3d 164, 167-68 (5th Cir. 1994), and (ii) whether joinder would destroy diversity).

98. \textit{Id.}

99. \textit{Id.} at 1008. The two trusts collectively owned a 20 percent limited partner's interest in the Partnership. \textit{Id.}

100. \textit{Id.} Simon owned the remaining 80 percent interest, 50 percent as general partner and 30 percent as a limited partner. \textit{Id.}

101. \textit{Id.} at 1009.

102. \textit{Id.}

103. \textit{Id.} at 1008.

104. \textit{Id.} at 1009 (relying on the United States Supreme Court case of Carden v. Arkoma Assocs., 494 U.S. 185 (1990)).

105. \textit{Id.}
Relying on Bankston and Mallia v. PaineWebber, the court enunciated the following general rules: (i) "[a] limited partnership is an indispensable party to a derivative action brought by a limited partner to enforce the rights of the partnership;" (ii) if "a limited partnership [has] not [been] joined as a party to a derivative action and its joinder would destroy complete diversity, the action must be remanded to state court;" and (iii) "the citizenship of a limited partnership may be disregarded for diversity purposes in a direct individual action brought by a limited partner against a general partner."

Simon and Trustee argued that Trustee's claims were direct. The court stated that whether the claims were derivative or direct required a determination of the "nature of the wrongs" rather than the intent of the parties. The court explained that if the right sought to be enforced is a right of the partnership, then the partnership is the real party in interest and the claim is derivative. Conversely, "a plaintiff bringing an individual, direct action must be injured directly or independently of the corporation or partnership." Moreover, if a limited partner claims that wrongs to the limited partnership indirectly damaged the limited partner by decreasing the value of his partnership interest, the partner's claim is derivative.

The court relied on cases establishing that Trustee's claims of breach of fiduciary duty and diminution in the value of the Trustee's limited partner's interest were derivative claims. Although recognizing that case law also establishes that the Trustee's request for an accounting was a direct claim, the court noted that the derivative claims overwhelmed Trustee's individual claim for an accounting. In addition, the court observed that Trustee's original petition identified claims of injury to both Trustee and the Partnership, which would necessitate a conclusion that at least the claims of injury to the Partnership were derivative.

106. 27 F.3d at 167-68.
107. 889 F. Supp. 277, 281-82 (S.D. Tex. 1995). See Waters, supra note 32, at 1212-15, for a discussion of Mallia and Bankston, and as support that Moore reconciles the two cases correctly.
109. Id. (citing Bankston, 27 F.3d at 168).
111. Id.
112. Id. at 1009-10.
113. Id. at 1010 (quoting Mallia, 889 F. Supp. at 283).
114. Id.
115. Id. (citing Mallia, 889 F. Supp. at 282, and Lenz, 833 F. Supp. at 380, as authority that a claim of diminution in value is a derivative claim, and 7547 Corp. v. Parker & Parsley Dev. Partners, 38 F.3d 211, 221 (5th Cir. 1994), as authority that a general partner's breach of its fiduciary duty is a derivative claim).
116. Id. at 1011 n.3 (noting that Bankston recognized that a claim for an accounting is a direct claim).
117. Id.
118. Id. at 1010. Specifically, Trustee alleged that (i) if the attempted transfer of Simon's interest were to occur, then Simon would be in breach of its fiduciary duties to both
Weighing the four factors required under Federal Rule of Civil Procedure 19(b) to determine whether the Partnership was indispensable, the court determined that: (i) given the derivative nature of Trustee’s claims, the exclusion of the Partnership would prejudice its ability to protect its interest; (ii) protective measures or other relief would not lessen or avoid the prejudice; (iii) failure to join the Partnership could subject Simon to duplicative litigation; and (iv) Trustee would have an adequate remedy in state court. Based on its evaluation of these Rule 19(b) factors and the derivative nature of the Trustee’s action, the court held that the Partnership was an indispensable party. Therefore, complete diversity did not exist and the court was required to remand the case to state court.

The court was unpersuaded by an additional argument by the parties that the court, relying on Delta Financial Corp. v. Paul D. Comanduras & Associates and Curley v. Brignoli should find that the Partnership was not an indispensable party under Rule 19(b) because all of the limited partners were before the court. The parties argued that, with all interests represented in this case, the Partnership itself could not be an indispensable party. The court declined to follow Curley because the ruling there was made in a post-trial context. The court believed Delta to be “against the weight of authority” and distinguishable because the defendant in that case “failed to establish that the interests of the partnership were distinct from the interests of the partners.” Instead, the court held that the interests of the Partnership and the partners were different because Trustee sought dissolution and Simon was charged with damaging the Partnership. Therefore, the Partnership was an indispensable party regardless of the fact that all partners were before the court.

To bolster its holding, the court analogized a partnership to a corporation with “a legal existence independent of its constituent partners,” stating the Partnership and Trustee, and (ii) injuries to both the Partnership and Trustee were the basis of the Trustee’s right of relief. Id. at 1011. The four factors the court must weigh are: (i) “to what extent a judgment rendered in the person’s absence might be prejudicial to the person or those already parties;” (ii) “the extent to which, by protective provisions in the judgment, by the shaping of relief, or other measures, the prejudice can be lessened or avoided;” (iii) “whether a judgment rendered in the person’s absence will be adequate;” and (iv) “whether the plaintiff will have an adequate remedy if the action is dismissed for nonjoinder.” Fed. R. Civ. P. 19(b); see also Moore, 919 F. Supp. at 1011.
ing that, like a shareholder in a corporation, a limited partner enjoys limited liability in exchange for surrendering the right to bring claims for damages against the limited partnership itself. Instead, a limited partner must bring such claims derivatively on behalf of the partnership.

130. Id.
131. Id.