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***57** BREAKING PARTNERSHIP DEADLOCK

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GPR -- General Practice Approaches, Articles & Issues

IT SEEMS FAIR to generalize that partnerships are formed and partnership agreements are drafted to operate in a beneficial business environment and without a great deal of regard for bad times. In the past several years, we have found the axiom that the drafter does not know the ***58** worth of her documents until a major problem is posed, to be particularly applicable to partnership agreements. We have learned a great deal--in fact most of what we know--about remedies for partnership defaults and disagreements in the recent real estate market downturn. The main lesson we have learned is that the (seemingly) carefully drafted provisions of our partnership agreements are not especially workable or practical. This is particularly true for the project that is troubled not just because of disputes between the partners but because of the economic environment or particular project problems.

This article discusses the effectiveness of a number of the remedies and dispute resolution mechanisms we include in our partnership agreements as well as the potential for using other remedies outside the provisions of the documents.

DEFAULT REMEDIES AND DEADLOCK RESOLUTION

MECHANISMS In general, the provisions of the partnership agreement will determine the rights and remedies that are available to a partner upon the breach or default of another partner or upon the inability of the partners over whether or not to take certain action. Very limited rights and remedies will be available to the partners in the absence of specific provisions. Moreover, a partner's rights to exercise certain remedies for the default of one of the other partners may be substantially limited by the courts' views of public policy.

Severe Default Remedies Common

Many partnership agreements provide relatively drastic results for a partner's default, particularly for a failure to contribute required capital, which tends to be the most commonly occurring default event. Clearly, the partnership may suffer serious and irreversible harm if it fails to meet its monetary obligations as a result of a partner's inability or unwillingness to contribute capital. The partners typically anticipate this problem and use it to justify inclusion of severe remedies in the agreement for such defaults.

Deadlock Without Default

We have discovered that some significant partnership problems never achieve the status of a partner default. This is because the management provisions of the agreement typically grant veto power to one or more partners over whether to make contributions or to make the funding decisions for which contributions will be required. (Budget revisions are an example.) As a result, a problem may never trigger default remedies because of the way the agreement is drafted, and the agreement may present no other solutions for the deadlock.

LOANS AND SQUEEZEDOWNS When one partner defaults on a required capital contribution the non-defaulting ***59** partners may want to continue the partnership relationship. They may thus decide to loan needed capital to the partnership or to contribute the capital on behalf of the defaulter. If the other partners make a contribution on behalf of the defaulter, the agreement typically permits the non-defaulters to reduce the defaulter's percentage interest in the partnership (a "squeezedown"). This remedy is probably enforceable if the result of the reduction formula does not cause a total forfeiture of the defaulting partner's interest and bears some reasonable relationship to the parties' relative investments. (For some of the

relevant cases in this area, see the Appendix.)

Calculating the Squeezedown

The squeezedown can be accomplished through numerous calculation formulas. If the formula adjusts based on historical capital contributions alone, it is likely to be undeservedly severe, at least for a highly leveraged project. This is because the formula does not give credit for the defaulter's share of partnership liabilities. In other words, using a smaller number in the denominator of the calculation will cause a much greater readjustment than may be warranted.

Alternative Bases

The partners need to consider other bases for calculation, including determination of the relationship between the required additional capital contributions and the total cost of the project--that is, debt plus equity financing, or the appraised value of the project. (These alternative values would be inserted in the calculation's denominator.) The approach of using an appraised value may be too expensive and time-consuming to accomplish, and the partners may decide instead to set "deemed equity" figures for purposes of the calculation. To assure that the recalculation results in a sufficient deterrent, it may then be necessary to include some multiplier or factor in the numerator of the calculation.

Questionable Remedy

The squeezedown may represent only an interim solution for a problem project. It also may not produce the desired result because although it can cure the default it will probably preclude exercise of other remedies. In leaving the partnership intact, the remedy may have no continuing benefit, especially if additional capital needs are anticipated. Moreover, because most partnerships provide for the first distributions of income or capital proceeds to go to preferential returns of partners' capital and interest on that capital, a partner's percentage interest may only affect the residual interest to be received upon liquidation. If the project is in financial trouble, the value of that residual return may be minimal.

*60 Interest-Bearing Loans to Partnership

A nondefaulting partner also may have the option to make interest-bearing loans to the partnership or the other partner. The partners may negotiate the use of a nonrecourse loan payable only out of distributions to which the defaulter is entitled.

Drafting Tip

In drafting such a provision, carefully consider how an optional loan may affect a loan guaranty or an indemnity or cost completion guaranty on the part of only one partner. The agreement may need to specify that an optional loan in this circumstance will be the repayment obligation only of the partner with the guaranty obligation.

Secured Loans to Other Partners

Some agreements provide that a partner's loan to another partner will be secured by the borrowing partner's partnership interest. This amounts to a personal property security interest that could be foreclosed following a loan default. As a practical matter, this type of security must be pledged and perfected at the inception of the partnership (since upon default no partner is likely to deliver the necessary instruments). But few prospective partners aggressively pursue this possibility at inception when they are optimistic about the partnership's success.

Foreclosure Uncertain

More importantly, there are legal uncertainties relating to the method of foreclosure on the interest, and a court may refuse to enforce a foreclosure because it could result in a total forfeiture of the partnership interest as a result of a monetary default that may be small relative to the value of the interest. In addition, depending on how the security interest is documented, foreclosure is likely to transfer only the partner's interest in distributions and not in management.

Loans to Partnership

A partner's loan to the partnership itself may provide a more acceptable alternative. These loans should be interest-bearing and payable from the first subsequent distributions. The lending partner would also prefer that the entire contribution (not just

(Cite as: 39 NO. 1 Prac. Law. 57)

the defaulter's share) be funded as a loan to assure maximum priority of the sums funded. However, it should be noted that under the Uniform Partnership Act a loan from a general partner (but not necessarily a loan from a limited partner) will be subordinate in priority of return to any loans from third parties. (Note that the Revised Uniform Partnership Act, if adopted as currently drafted, will permit partners' loans to be of equal priority to those of third parties.)

***61** Balancing Flexibility and Repayment

It may be equally critical to provide for optional loans in non-default situations, especially if capital contributions or the underlying action demanding capital require an unachievable majority vote. Of course, loans are workable only if the parties feel that they are not putting good money after bad and there is some reasonable possibility that the loans will be repaid. As a result, in drafting a partnership agreement, provide for absolute priority of these loans over capital to assure the greatest possible likelihood that funds needed in an overrun or similar situation will be available.

Include Option To Make Loan

Recent experience with problem projects demonstrates the wisdom of drafting into the partnership agreement an option on the part of either party, at least after a capital contribution has been called for and declined, to loan funds needed for project costs, including amounts demanded by a lender. Otherwise, the partnership may be irreversibly harmed and the partner with equity to preserve may seem to have no option other than putting money into the project without the hope of repayment.

THE BUY-SELL Some agreements include no remedies for partner defaults but do include a "buy-sell" or "put call" provision. These provisions generally permit a party to terminate the relationship if it proves to be unworkable.

Beware of Deadlock

In any case, include some solution to the partnership deadlock that arises either because the agreement requires unanimity or an affirmative vote on some major decisions that cannot be achieved or because it is difficult to prove a default. In bad economic times, the partners frequently find that their interests are more divergent than originally expected. For this reason, deal with the deadlock problem in advance.

Deadlock Avoidance

Measures to avoid deadlocks could include making at least preliminary decisions on such matters as project budgets and leasing and financing guidelines, adopting arbitration or mediation procedures, and providing for a buy-sell solution.

Setting the Asset Price

The buy-sell begins when one partner selects a price for the partnership assets, and then permits the other partners to either buy the initiating partner's interest or sell their own interests to the initiator based on their perception of the true value of partnership assets relative to the selected price. The buy-sell theoretically always achieves a fair result because the responding partners can decide ***62** whether the price is high or low and accordingly decide whether it is best to buy or sell.

Unfair Result

A significant problem may arise, however, when one partner has ready access to cash and the other does not have similar assets, because the cash-rich partner can assume it is a buyer and propose a low price (or "low-ball" the other partner). As a result, some partners may decide that it is preferable to try to avoid later challenges to the fairness of the price by basing the price on an appraisal or the results of agreement or arbitration. These procedures are, of course, more time consuming and costly to pursue.

Drafting Tip

The price to each partner must be carefully calculated before the buy-sell option is exercised to assure that each party achieves the result that would be expected to occur upon liquidation. The partnership agreement also must provide any other terms of the purchase, such as the effect of events that may occur before closing (including the obligation to make any additional capital contributions, the right to receive any distributions, and the effect of damage or destruction on the

obligation to purchase) and the effect of obligations subsequently discovered. If possible, in most jurisdictions it would be preferable to structure the buy-sell as a purchase of the entire partnership assets rather than the partner's interest for proper deeds and title insurance to be obtained. On the other hand, issues of transfer tax and reassessment must also be considered, and such taxes may be avoidable if only personal property (the partnership interest) changes hands.

Exercising Buy-Sell

A critical consideration in determining whether to exercise the buy-sell or other buy-out right is whether the partners' remaining partnership obligations are disproportionate; for example, whether individual partners have guaranties to a lender or the partnership or obligations to fund cost overruns. Absent express agreement, these obligations probably would not continue once the partner is bought out, and therefore must be taken into account in determining the appropriate price to be paid to the terminated partner. Such adjustments must be explicitly provided for in specifying the price to be paid to a selling partner.

Expect Resistance

In any buy-sell or buyout procedure, unless the process is fair, or unless the other partners agree to follow the rules, the initiator can expect a challenge with the resulting delay and need to negotiate to conclude a termination. The initiating partner can also expect legal challenge if adverse tax consequences could follow from a resulting dissolution, which will be considered *63 a sale or exchange of the partnership property or discharge of indebtedness. As a result, the buy-sell or buyout is only partly effective as a "hammer" to force negotiations in the buyout/workout process. It may only be a first step in a prolonged proceeding with an unwilling seller.

Getting Things Moving

Either an agreement of the parties or the force of a judicial proceeding may be necessary to conclude the sale. In addition, in deciding whether to remove another partner, an initiating partner must think about how the restructuring will affect management, the other partners, any due-on-sale clause in the loan documents, and other practical matters. If the selling partner is a loan guarantor, the guaranty must be replaced, and the partners would be wise to anticipate this result and negotiate consent to transfers under the buy-sell and replacement guaranties at inception of the transaction. Also, if more than two partners are involved, coordinate the buy-sell mechanism to assure an understanding of who will be selling and who will be buying.

THE BUYOUT OR OPTION TO PURCHASE A favored remedy in the partnership context, for both monetary and non-monetary defaults, is an option on the part of the non-defaulter to purchase the interest of the defaulter. In some cases, the defaulting partner is entitled to receive the full appraised value of its interest, subject to reduction for damages it has caused. In other situations, the price could be based on a pre-established formula or be only a percentage of the value of the interest.

Challenges to the Remedy

Depending on how it is drafted, this most important remedy should be generally enforceable but will be subject to challenge on public policy grounds: the bought-out partner may allege that the purchase results in an unlawful forfeiture, achieves an unconscionable result, or involves invalid liquidated damages. (See the Appendix for a partial bibliography of cases in this area.)

Defensive Drafting

Sometimes appropriate language in the agreement stating that any reduction in value would be considered liquidated damages will enhance enforceability. However, such language cannot be relied on, particularly if alternative remedies are available under the agreement.

Buyout as an Alternative

Consider providing for the partnership buyout as an alternative solution to a deadlock to avoid its characterization as a default remedy. For example, the agreement might provide that if the partners cannot agree on financing terms or even if they do not

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proceed with development within a certain period of time, the partners *64 electing to proceed may purchase the other partners' interests, perhaps at a specified price, such as invested capital plus some return. The use of a minimum return also may alleviate enforceability problems with the default remedy.

Buyouts and Bankruptcy

In the event of a partner's bankruptcy, a buyout or other removal right is particularly suspect under the Bankruptcy Code. The buyout can be structured as an installment sale, for example, with an initial downpayment of only 10 per cent of the purchase price and a five-year payment term. In this case, the well-advised partner will negotiate a provision for some type of security for the unpaid price.

INACTIVE PARTNER/LIMITED PARTNER STATUS One of the more effective remedies for the problem of partners who are unable to agree may be to provide that the defaulting partner becomes an inactive partner or even a limited partner, losing all management rights in the partnership.

Bringing in a New Manager

Of course, in that case the non-defaulting partners must be willing to hire a manager or step up to any management role occupied by the defaulter. The laws of certain states may limit the reasons for or extent of suspension of voting and management rights.

Defining the Role

In addition, the new managers must be concerned about whether they acquire special duties to the other partners by virtue of the change in status, that is, whether the non-defaulting partners now owe a different duty to the partners they have displaced. Note that if a partner or its affiliate's construction or management obligations are covered by separate agreements, you should include a cross-default provision in the partnership agreement.

Negotiating the Remedy

For any partner who has ongoing liability or responsibility for cost overruns, the ability to require inactive status will be heavily negotiated and may be rejected entirely absent relief from further liability.

Options

Some negotiated solutions include:

- A right to remove from management only if the partner is also bought out or liability is relieved;
- Establishment of priority for the inactive partner's investment;
- A right that would only be exercisable after a default called by the lender due to the particular partner's conduct or inaction; and
- The removed partner's right to participate in the selection of an alternative manager.

*65 The fact that a developer partner's incentives in a partnership may be fee-based also affects not only the ability to negotiate this type of provision but, when it does become applicable, the ability to exercise the right without litigation. Thus, while conversion to limited partner or inactive status might achieve the best result, it is impractical without the consent of the defaulting partner. The same will be true for the right to remove the property manager or construction contractor that is affiliated with the developer or defaulting partner.

THE PARTNER AS LENDER An extra word of caution should be given to the partner who also acts as a real property secured lender. The law on recharacterization of transactions that have both debt and equity components--and lender liability issues--is evolving. As a result the lender/partner may find that the other partner attempts to avoid either the exercise of the secured lender's foreclosure remedy or the partnership remedies based on an argument to recharacterize the relationship.

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Characterizing Transactions

In determining how to characterize the transactions, a court will look to whether the lender's interest and the partner's interest have been separately and properly documented and will attempt to determine the parties' true intent from the documents (including initial drafts of the documents) or their actions. The bankruptcy courts may be especially prone to recharacterizing a transaction. In any case, foreclosure by a lender/partner will not be easy if the defaulting partner would achieve a better result from exercise of the partnership remedies.

DISSOLUTION AND ACCOUNTING A partner can always decide to dissolve the partnership in accordance with applicable statutory law and cause termination of the partnership business and sale of its assets. In fact, unless the partners have otherwise agreed, the only remedy generally implied at law for the benefit of one partner upon a default of another is the right to obtain a judicial dissolution of the partnership and an "accounting," forcing the sale of partnership assets.

Roadblocks to the Remedy

But to assure continuity of the relationship almost any carefully drafted agreement will prohibit the partners from exercising this right to dissolve. Note that although such a prohibition restricts the partner's right to dissolve, it does not eliminate the ability or power to dissolve if a partner is willing to be liable for damages resulting from the dissolution.

Effects of Dissolution

The partner threatening dissolution or declaring that a dissolution has occurred should be concerned with the effect of the election on the partners' relationships with third parties. Under the Uniform Partnership Act, a dissolution can terminate the business of the partnership. In addition, typical loan documents will provide that a mere dissolution (even without winding up or termination of the partnership) will constitute a default or trigger a due-on-sale clause under the mortgage. By law, death or bankruptcy of a partner will typically result in the partnership's dissolution, at least unless the agreement provides otherwise.

LITIGATION AND ARBITRATION In general, partners may not sue each other for claims arising from partnership business until after a dissolution and the commencement of an accounting.

Equitable Remedies

In certain instances, however, it may be possible to force a partner to perform by bringing a judicial action for specific performance or other equitable relief. In addition, if a partner could also be considered to hold a third party contractual relationship with the partnership, for example, as a manager or lender, the ability to bring a personal action may be enhanced. Under the Revised Uniform Partnership Act, partners will be entitled to sue each other even during the partnership term.

Arbitration Drawbacks

It is unlikely that an arbitrator will be able to resolve major disputes under the agreement. The agreement is probably complex and an arbitrator is not likely to be able to quickly understand the relationships and concerns of the parties. In addition, some investors resist or absolutely prohibit any third party from making partnership decisions. Broad arbitration clauses will restrict the right of a partner to obtain restraining orders and would foreclose an appeal to the courts. It is also arguable whether arbitration reduces the cost or the time necessary to resolve a dispute.

ADR's Role

On the other hand, in certain areas the need for rapid decisions may enhance the usefulness of alternative dispute resolution ("ADR"). Partner/managers or their affiliates may desire arbitration of the issue of the manager's termination for cause based in part on the desired expertise of an arbitrator over whether the manager fulfilled ordinary standards of conduct.

Calling in the Accountants

Also, certain matters may be properly decided by accountants, including calculations of distributions and capital accounts and the availability of cash flow to fund costs or distributions. The parties may choose to have valuation of partnership interests,

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especially on a buy-sell or buyout, or *67 the quantification of prospective liabilities at that point performed by an independent accountant.

SYNDICATION AND TRANSFER The most practical solution for a partner presented with a project in which capital is required but not available to that partner, or who has a significant difference of opinion with other partners, may be the right to syndicate or sell all or a portion of its partnership interest, whether to raise funds or to remove itself entirely. If control and management do not change and there is no dilution of financial capability, the other partner may consent to a partial transfer. Even if the other partners consent to the transfer, the parties need to consider whether the transfer will run afoul of due-on-sale clauses and other covenants in mortgages or other agreements.

BANKRUPTCY CONSIDERATIONS A bankruptcy filing by one of the partners may present additional significant problems in the enforcement of remedies or in continuing the business of the partnership. Upon the withdrawal or bankruptcy of one general partner, a general partnership may be dissolved and required to be liquidated. Most agreements, at least in three-party partnerships, permit the continuation of the partnership business following withdrawal or bankruptcy, but this continuation need not be enforced in the bankruptcy courts. Use of the limited partnership structure may enable the partners to avoid liquidation. Even without liquidation, however, a general partner's bankruptcy probably will cause a technical dissolution of the partnership, which, under most partnership agreements and at law, will inhibit the ability of the partnership to continue to conduct its business. In particular, a dissolution probably will inhibit a lender from going forward with any loan modification or restructuring.

If the partners desire to exercise remedies against a bankrupt partner, as noted above, the bankruptcy courts are likely to carefully review the exercise and will almost certainly reject any that impose any level of forfeiture on the bankrupt partner.

CONCLUSION A partner should generally only resort to any remedy as leverage against another partner. But it also can be unwise for partners to delay action. Partners should always look for early warnings of potential defaults provided for by various provisions of a partnership agreement. Regular management and financial reports, copies of loan draw requests and correspondence with or notices from lenders and contractors, and annual and revised budgets are all proper subjects for ongoing review. The rights to hold meetings, engage in inspection of the property and the books of the partnership, and review the status of leases or sales all deserve *68 regular exercise. And the manager's failure to provide regular reports or other management-related defaults should be treated as a true default, permitting the early initiation of appropriate remedies.

APPENDIX Enforcing Partnership Remedies I. Statutes

A. Uniform Acts

1. Uniform Partnership Act ("UPA")

-- UPA s22 -- Right to an Account. "Any partner shall have the right to a formal account as to partnership affairs . . . (b) (i) if the right exists under the terms of any agreement, . . . (d) (w) whenever other circumstances render it just and reasonable. See also Cal. Corp. Code s15022.

-- UPA s43 -- Accrual of Actions. "The right to an account of his interest shall accrue to any partner, or his legal representative, as against the winding up partners or the surviving partners or the person or partnership continuing the business, at the date of dissolution, in the absence of any agreement to the contrary." See also Cal. Corp. Code s15043.

2. Draft Revised Uniform Partnership Act

-- Proposed RUPA s406, Remedies of Partnership and Partners. "A partner may maintain an action for legal or equitable relief, including an accounting as to partnership business, to . . . (5) enforce a right of a partner under the partnership agreement; or (6) otherwise protect the rights and interests of a partner."

3. Uniform Limited Partnership Act

-- ULPA s10 -- Rights of a Limited Partner. "(1) A limited partner shall have the same rights as a general partner to . . . (b) (h)ave . . . a formal account of partnership affairs whenever circumstances render it just and reasonable." See also Cal. Corp. Code s15510; N.Y. Partnership Law s99(1)(b).

***69** B. State Statutes

1. California

-- Cal. Code Civ. Proc s872.730, Partition of Partnership Property. "To the extent that the court determines that the provisions of this title are a suitable remedy, such provisions may be applied in a proceeding for partnership accounting and dissolution, or in an action for partition of partnership property, where the rights of unsecured creditors of the partnership will not be prejudiced." In general, a court overseeing a partnership dissolution and liquidation has the discretion of dividing the partnership assets among the partners on an equitable basis or selling the assets and then distributing the proceeds.

-- The court has the discretion to appoint a receiver to manage the partnership property during the pendency of the accounting and dissolution proceedings.

2. Delaware

-- Del. Code Ann. tit. 6, s17-1101(c), Construction and application of chapter and partnership agreement.

"It is the policy of this chapter to give maximum effect to the principle of freedom of contract and to the enforceability of partnership agreements."

-- Del. Code Ann. tit. 6, s17-1101(c), Remedies for breach of partnership agreement by general partner. "A partnership agreement may provide that (1) a general partner who fails to perform in accordance with, or to comply with the terms and conditions of, the partnership agreement shall be subject to specified penalties or specified consequences, and (2) at the time or upon the happening of events specified in the partnership agreement, a general partner shall be subject to specified penalties or specified consequences."

-- Del. Code Ann. tit. 6, s17-1101(c), Remedies for breach of partnership agreement by limited partner. "A partnership agreement may provide that (1) a limited partner who fails to perform in accordance with, or to comply with the terms and conditions of, the partnership agreement shall be subject to specified penalties or specified consequences, and (2) at the time or upon the happening of events specified in the partnership agreement, a limited partner shall be subject to specified penalties or specified consequences."

***70** 3. Texas

-- Texas Revised Limited Partnership Act ([Tex. Rev. Civ. Stat. Ann. art. 6132a-1](#)) s 5.02(c), Liability for Contribution Obligations. "A partnership agreement may provide that the partnership interest of a partner who fails to make a payment of cash or transfer of property to the partnership, whether as a contribution or with respect to a contribution previously made, required by an enforceable promise is subject to specified consequences. A consequence may take the form of a reduction of the defaulting partner's percentage or other interest in the limited partnership, subordination of the partner's partnership interest to that of nondefaulting partners, a forced sale of the partner's partnership interest . . . the lending of money to the defaulting partner by other partners of the amount necessary to meet the defaulting partner's commitment, a determination of the value of the defaulting partner's partnership interest by appraisal or by formula and redemption or sale of the partnership interest at that value, or other penalty or consequence"

II. Case Law

A. General

1. In general, partners are free to enter into agreements containing whatever terms they wish. [Blount v. Smith, 12 Ohio St. 2d 41, 231 N.E.2d 301 \(1967\)](#).

2. In general, a court will enforce a liquidated damages clause if it finds that (i) the injury caused by the breach was difficult or impossible to accurately estimate, (ii) the parties intended to provide for damages rather than a penalty, and (iii) the stipulated sum represented a reasonable pre- estimate of the probable loss.

B. Judicial Dissolution and Accounting

(Cite as: 39 NO. 1 Prac. Law. 57)

1. The General Rule: As a general rule, partners cannot sue each other at law for acts relating to the partnership, unless there is an accounting, prior settlement, or adjustment of the partnership affairs. The proper remedy is a suit for dissolution and for an accounting. See:

-- Goodwin v. Mac Resources, Inc.,

540 N.Y.S.2d 477, 149 A.D.2d 666 (1989).

-- Bullard v. Kinney, 10 Cal. 60 (1858).

-- Martyn v. Leslie, 137 Cal. App. 2d 41, 290 P.2d 58 (1955).

-- *71 Dukes v. Kellogg, 127 Cal. 563, 60 P. 44 (1900).

-- In re Estate of Pokrass, 105 A.D.2d 659, 481 N.Y.S.2d 861 (1984).

-- Driskill v. Thompson, 141 Cal. App. 2d 479, 296 P.2d 834 (1956).

-- Johnstone v. Morris, 210 Cal. 580, 292 P. 970 (1930).

2. Exceptions to the General Rule

(a) No complex accounting involved; single, segregable transaction:

-- Agrawal v. Razgaitis, 539 N.Y.S.2d 496 (App. Div. 1989).

-- St. James Plaza v. Notey, 463 N.Y.S.2d 523 (App. Div. 1983). "In the instant case, plaintiffs seek to enforce a provision of the partnership agreement which will not necessitate an examination of the partnership accounts. According to the agreement the court need only determine the 'book value' of defendants' interest as of the first day of the year This value may be determined by use of the partnership's annual financial statement." *Id.* at 526.

(b) Third-Party Contractual Relationships

-- Bull v. Coe, 77 Cal. 54 (1888): "And it seems plain that a loan from one partner to another is not a partnership transaction, notwithstanding the fact that the borrower intends to put the money into the firm, and does so. Accordingly, it is well settled that the lender in such a case can maintain an action for the recovery of the money, although there has been no settlement of the partnership accounts."

-- Montgomery v. Riess, 176 Cal. App. 2d 711 (1959): "Partners can sue each other at law on claims growing out of transactions which are not connected with the partnership business, just as though they were strangers to the partnership relation, even though an action for partnership accounting is pending between the parties." *Montgomery* at 717.

-- RULPA s107: "Except as otherwise provided in the partnership agreement, a partner may lend money to and transact other business with the limited partnership and, subject to other applicable law, has the same rights and obligation with respect thereto as a person who is not a partner." See also Cal. Corp. Code s15617.

(c) Fraud, Conversion and other Intentional Torts

*72 See, Olivet v. Frischling, 104 Cal. App. 3d 831, 164 Cal. Rptr. 87 (1980)

(d) Repudiation of Partnership Agreement

-- Gherman v. Colburn, 72 Cal. App. 3d 544, 140 Cal. Rptr. 330 (1977).

-- Laughlin v. Haberfelde, 72 Cal. App. 2d 780, 165 P.2d 544 (1946).

C. Forfeiture Provisions

(Cite as: 39 NO. 1 Prac. Law. 57)

1. Courts are split on the enforceability of a clause providing for the total forfeiture of a partnership interest upon a default by a partner. Courts typically apply the traditional "penalty analysis" and refuse to enforce an absolute forfeiture provision.

-- [Hill v. Hearron](#), 113 Cal App. 2d 763, 249 P.2d 54 (1952). The court held that "the policy of the law against forfeitures and penalties . . . (dictates that) the forfeiture provision of this contract cannot be enforced without regard to the calculation of the damages actually caused by the breach."

2. Some courts, however, enforce forfeiture provisions on "freedom of contract" theories.

-- See [Blount v. Smith](#), 12 Ohio St. 2d 41, 231 N.E.2d 301 (1967).

3. Other courts appear willing to enforce "forfeiture provisions" under limited circumstances, such as a material breach by a partner which makes it impossible to proceed with the venture, particularly at its inception.

-- [Brooks v. Muth](#), 144 Cal. App. 2d 560, 301 P.2d 404 (1956). "A joint venturer may of course forfeit his rights by a material breach which, committed 'at the very threshold of the enterprise,' renders it impossible for his associates to proceed; or when he fails to furnish materials essential to the enterprise and stipulated as a condition of the creation of the enterprise, or when he defaults in a material respect and abandons the enterprise."

-- [Martin v. Burris](#), 57 Cal. App. 739, 208 P. 174 (1922).

-- [Alfinito v. Slater](#), 246 Cal. App. 2d

362 (1966). In [Alfinito](#), the court suggested that non-performance would work a forfeiture only if it constituted a breach of a condition precedent to the formation of the venture.

D. Squeezedown Provisions

*73 1. In general, courts view squeezedown provisions as liquidated damages clauses. Accordingly, courts tend to enforce squeezedowns if the recalculation formula represents a reasonable endeavor on the part of the partners to estimate a fair compensation for the loss that may be sustained by the partnership as a result of the failure of the defaulter to contribute capital. To enhance the enforceability of the squeezedown provision, the parties should craft a formula which bears a reasonable relationship to each partner's relative investment in the venture and should include liquidated damages language in the partnership agreement. However, as the [Stanton](#) case (discussed below) illustrates, partners must also be cognizant of their fiduciary obligations when exercising a squeezedown provision.

-- [In re Stanton](#), 38 B.R. 746 (BAP 9th Cir. 1984). Ruled that the partner breached his fiduciary duty by failing to notify his co-partner that her share was in jeopardy by virtue of his continuing to exercise the squeezedown provision.

-- [Neustadtler v. United Exposition Service Co.](#), 82 A.2d 476 (1951). The court found the effect of the reduction to be a forfeiture "not favored in equity." Like [Stanton](#), it is unclear whether the provision would have been enforced had timely notice been given.

2. Other courts view squeezedown provisions as alternative promise clauses and uphold the clauses if they find that the parties actually bargained for the option of whether or not to perform.

-- [Feiger v. Winchell](#), 205 Cal. App. 2d 123 (1962) (enforcing a squeezedown clause providing for a 20 per cent reduction in partnership interest for a failure to contribute capital).

E. Buy-Out Provisions

-- [Tankersley v. Superior Court](#), 146 Ariz. 402, 706 P.2d 728 (Ariz. App. 1985). "The trial court's decision was apparently based on a literal application of the general rule, frequently applied to joint ventures, that one partner cannot sue another partner at law, as distinguished from an action in equity, with respect to partnership transactions except after a full accounting and balance has been had. . . . Without expressing any opinion as to the continuing validity of this rule or the propriety of its application to joint ventures . . . we hold simply that the rule does not apply automatically where, as here, the parties have by contract otherwise agreed."

(Cite as: 39 NO. 1 Prac. Law. 57)

-- *74 *Brewer v. Tehuacana Venture, Ltd.*, 737 S.W.2d 349 (Tex. App. 1987).

-- *Raymond v. Brimberg*, 99 A.D.2d 988, 473 N.Y.S.2d 437 (1984).

3. Other cases suggest that a forced buy out provision will be subject to the same "penalty analysis" as applied in the "squeezedown" cases.

-- *Malkus v. Gaines*, 476 So. 2d 220 (Fla. Ct. App. Dist. 1985). In reversing the trial court's determination that the provision constituted an unenforceable penalty, the appellate court found that:

"(w)hether or not a particular clause in a contract is a valid provision or one that constitutes a penalty is to be determined as of the date of the agreement There is no reason to hold that the provisions under the facts of the instant case are a penalty, particularly in light of the fact that (the defaulting-partner) knew the purpose for the . . . (buy-out remedy) was to secure the warranties (which he knew at the time he signed the agreement were false)." 476 So. 2d at 222.

-- *G & S Investments v. Belman*, 145 Ariz. 258, 700 P.2d 1358 (1984).

-- *Keyes v. Hurlbert*, 43 Cal. App. 2d 497 (1941). Held that a buy-out option exercisable by the surviving partners upon the death of a deceased partner is specifically enforceable.

-- *Logan v. Logan*, 36 Wash. App. 411, 675 P.2d 1242 (1984).

-- *In re Randall's Estate*, 29 Wash. 2d 477, 188 P.2d 71 (1947). Upheld a purchase price of less than one-fourth of the value of the decedent's interest.

-- *Gabay v. Rosenberg*, 29 A.D.2d 653, 287 N.Y.S.2d 451 (1968), aff'd 23 N.Y.2d 747, 296 N.Y.S.2d 795, 247 N.E.2d 267 (1968). Upheld a nominal purchase price of \$100 when the partnership owned two parcels of improved land. In holding for Gabay, the court stated that "(i)n our opinion, partners as between themselves may agree to dispose of partnership assets on the termination of the partnership in any method they wish" *Gabay*, 287 N.Y.S.2d at 453.

F. Limited Partner/Inactive Partner Status

-- *Meinhard v. Salmon*, 249 N.Y. 458, 164 N.E. 545 (1928).

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