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# Not Our Grandparents' Partnership Statute

By Mark Anderson

*Synopsis:* Idaho has an updated partnership statute which treats a partnership as an entity rather than a group of co-owners. This change has important practical consequences for partners, partnerships and clients dealing with partnerships, especially when a partner dies or withdraws from the partnership.

On July 1, 2001 Idaho completed its transition to a new partnership statute. For most of the 20th century, Idaho partnerships had been governed by Idaho's version of the Uniform Partnership Act (1914). (For simplicity the repealed statute will be referred to as the "UPA." The current statute will be referred to as the Revised Uniform Partnership Act or ("RUPA.") The UPA had been in force for so long, in so many places, and governed so many partnerships, that it affected the way lawyers and clients thought about the basic characteristics of partnerships. The RUPA continues many of those characteristics and alters others. A short article such as this cannot exhaustively catalog all of the changes. It will, however, identify some of the basic rules which have not changed, discuss the fundamental conceptual change made by the RUPA, explain how that change plays out in some important provisions of the RUPA, and outline some practical steps lawyers can take to protect clients who are partners, partnerships, and persons dealing with partnerships.

## Partnership: Default Business Organization

Some characteristics of partnerships have not significantly changed. A partnership is still the default form of a multiple owner business organization. If two or more owners form a business organization and do not file anything with the state, they are partners.<sup>1</sup> No formal steps or magic words are necessary to form a partnership, so people can become partners without realizing they have done so. The default rule is that partners are personally liable for the debts of the partnership.<sup>2</sup> This default outcome can be altered by becoming a limited liability partnership.<sup>3</sup> Usually a partner carrying on in the ordinary course of the partnership's business has the default authority to bind the partnership.<sup>4</sup> As we shall see, however, the RUPA creates a new way to limit this authority, especially in real estate transactions. A partner who is willing to pay the price can get out of a partnership whenever he or she wants, even if this violates the partnership agreement.<sup>5</sup>

## The Aggregate Theory of the UPA

Although RUPA left many characteristics of a partnership the same, it made a major conceptual change. The UPA was based on what is known as the aggregate theory of partnership. Under the aggregate theory, the partnership is not considered an entity separate from its owners. By contrast, the classic example of a business entity that is separate from its owners is a corporation. Under the UPA, a partnership was not an entity, rather it was just an aggregation of its owners. The aggregate theory of the UPA had important consequences. One of the most dramatic consequences was that the partnership dissolved whenever a partner wanted to

leave the partnership or died.<sup>6</sup> This was so even if the partnership agreement was for a term which had not expired. This stands in stark contrast to corporations which do not end when a shareholder wants to leave or dies. Of course, as a practical matter, the business of partnerships often continued after one or more partners left or died. However, under the UPA this required a technical reformation of a new partnership to carry on the business of the former partnership.

The aggregate theory of the UPA also made it difficult to conceptualize who owned the partnership property. If an entity did not exist, then it could not own the property. If only an aggregate existed, then the partners must own the partnership property. However, if partners owned the property, then what happened when one of them attempted to assign his or her interest in that property or had an individual creditor who wanted to execute on the partnership property for payment of an individual debt? An assignee of a partner's interest in the partnership property or a creditor executing on that interest could severely disrupt the business of the partnership by asserting claims to the partnership's inventory or equipment. The UPA dealt with this by creating a special tenancy in the partnership property called a tenancy in partnership.<sup>7</sup> It was this tenancy that was owned by the individual partners. The incidents of this tenancy were such that the only right it gave a partner was to possess the partnership property for partnership purposes.<sup>8</sup> The partner's interest in partnership property was not separately assignable or subject to execution on behalf of individual creditors.<sup>9</sup>

## The Entity Theory of the RUPA

The RUPA avoids all of these problems by expressly adopting an entity theory. "A partnership is an entity distinct from its partners."<sup>10</sup> This avoids the issues associated with the tenancy in partnership of the UPA since, under the RUPA, the partnership entity owns the partnership property.<sup>11</sup> Treating the partnership as an entity also means that it can survive the departure of one or more of the partners. The survival of the partnership entity after the departure of one or more partners is perhaps the most significant change resulting from the adoption by the RUPA of the entity theory. It requires substantial changes in the rules governing the exit of partners.

### (a.) Dissolution Under the UPA.

Under the UPA the partnership dissolved upon any of a series of specified events.<sup>12</sup> The most important of these were the death of a partner or any partner expressing the will to leave the partnership. A partnership was viewed as a personal relationship that would only last as long as all of the partners survived and wanted to remain partners. The UPA anticipated that partners would sometimes agree to remain partners for a specified time or until a particular undertaking was accomplished.<sup>13</sup> However, if a partner expressed the will to dissolve prior to the expiration of the

term or the accomplishment of the undertaking, a dissolution of the partnership still occurred.<sup>14</sup> Thus, under the UPA some dissolutions were rightful since they did not involve a partner expressing the will to dissolve prior to the end of an agreed upon term or undertaking. Other dissolutions were wrongful, since they did involve a partner expressing the will to dissolve in violation of an agreement. If the partnership dissolution was rightful, partners had a right to force a liquidation of the partnership if the former partners did not agree otherwise.<sup>15</sup> If the dissolution was wrongful, the partner who caused the wrongful dissolution suffered a series of important consequences.<sup>16</sup> These included the obligation to pay the rightful partners damages. Also, if all of the rightful partners wanted to continue the business until the end of the term, they could do so either by themselves or with others. If they did so, they could use the partnership property and the partnership name. The continuing partners would have to pay to the wrongfully dissolving partner the value of his or her interest on the date of dissolution, less damages associated with the wrongful partner's acts, or post a bond in this amount. This calculation would not count goodwill.

In summary, under the UPA, partnerships could be at will or for a term. In either at will or term partnerships death of a partner caused a dissolution. In either at will or term partnerships a partner could cause a dissolution by expressing the will to dissolve. If the partnership was for a term, the rightful partners could continue the business after a wrongful partner caused a dissolution by expressing the will to dissolve, but only if all of the rightful partners agreed to continue. Any rightful partner in a wrongful dissolution could cause a liquidation by refusing to consent to the continuation of the business.

#### (b.) Significance of Rules Governing Exit of Partners.

Before discussing the rules adopted by the RUPA governing the exit of partners, it pays to consider why rules governing exit are so important. Small businesses often involve personal relationships among the owners. The owners and their family members often work for the business. When these personal relationships change by death, divorce, or personal discord, the business relationships often suffer. When one faction has legal or practical control of the business, the other faction wants to know whether they can force a liquidation of the business or at least force the controlling faction to buy them out and if so at what price. Under corporate law it is often impossible for the losing faction to force a liquidation or a buyout. Under the UPA the losing faction had the power to force a liquidation by expressing the will to dissolve in a partnership at will or waiting for one of the partners to die in a partnership for a term. In a partnership for a term, a dissident partner could at least express the will to dissolve and get out of the partnership. In that case they would have to pay damages and would not get the value of the goodwill of the business but they would at least get the value of their interest less damages and goodwill paid to them or secured by a bond.<sup>17</sup> The fact that the losing faction had these rights gave its members leverage to negotiate a buyout with the controlling faction. When the RUPA changed the rules governing the exit of partners from partnerships, it changed these power dynamics.

#### (c.) Dissociation Under the RUPA.

Because the RUPA adopts the entity theory and anticipates that sometimes a partner will leave a partnership without causing a dissolution, it needed a word other than "dissolution" to identify

this scenario. The word used by the RUPA for a partner exiting a partnership without causing a dissolution is "dissociation". The RUPA identifies a series of events which result in a partner being dissociated from a partnership.<sup>18</sup> It then identifies a different series of events which result in a dissolution of a partnership.<sup>19</sup> If an event on the dissociation list occurs but that event is not on the dissolution list, then the partner is dissociated but the partnership entity continues and is not dissolved. If a partner dissociates but the partnership continues, the dissociated partner is entitled to a buyout of his or her interest at a price equal to what the partner would have received had the partnership been dissolved.<sup>20</sup> This buyout price is the greater of liquidation or going concern value. If a partner dissociates by expressing the will to withdraw from a partnership for a term prior to the expiration of the term, the wrongfully dissociating partner is liable for damages.<sup>21</sup>

Under RUPA, both death of a partner and the expression of the will to leave the partnership constitute a dissociation.<sup>22</sup> Death of a partner does not cause a dissolution of the partnership. Under Idaho's version of the RUPA, the expression of the will to leave the partnership by a single partner causes a dissolution only in one situation. Idaho adopted a non-uniform provision regarding expressions of the will to dissolve. The version of the RUPA adopted by the National Conference of Commissioners on Uniform State Laws provides in §801(1) that a partnership at will is dissolved by the express will of a partner to withdraw as a partner. However, Idaho did not adopt this rule. Instead, Idaho's version of §801(1) provides that a partnership at-will is dissolved by the express will of at least half of the partners to dissolve.<sup>23</sup> Therefore under the Idaho provision, the express will of a single partner dissolves a partnership at will only in a two-person partnership. In such a partnership, a single partner constitutes half of the partners and therefore could cause a dissolution. If an Idaho at-will partnership consists of three or more partners, a single partner does not constitute at least half of the partners and therefore cannot cause a dissolution. Since the partnership is at-will, a partner who does not want to continue may, of course, rightfully dissociate and be bought out.

In a partnership for a term under the RUPA, a dissociation by death of a partner or the expression of the will to withdraw does not necessarily lead to a dissolution, but does allow the remaining partners to the right to reactively dissociate. Under Idaho's version of RUPA if a partner dies or wrongfully dissociates in a partnership for a term, the partnership will dissolve unless within ninety days a majority in interest of the partners agree to continue.<sup>24</sup> If the partnership does continue, partners who want to withdraw are not trapped. After a dissociation by death or wrongful expression of the will to withdraw, the remaining partners in a partnership for a term may rightfully reactively dissociate for ninety days after the initial dissociation.<sup>25</sup> This gives the remaining partners a ninety-day window to get out of the partnership without themselves becoming wrongfully dissociating partners. If they miss this ninety-day window, they may still dissociate. However, their dissociation will be wrongful and make them liable for damages since the partnership is for a term and is continuing as an entity.

#### (d.) Consequences of Dissociation.

Under RUPA, the right to reactively dissociate from a term partnership that is continuing after a previous dissociation will

leave some partners worse off than under the UPA. Under the UPA, a rightful partner after a dissolution of a partnership for a term could force a liquidation by refusing to agree to the reformation of a new partnership. Under the RUPA, the partner can reactively dissociate, but cannot force a liquidation of the partnership if a majority in interest choose to continue. By reactively dissociating, the partner can leave the partnership without having to pay damages and gets a buyout. However, the buyout price is very hard to determine. The valuation of an interest in a small business is notoriously difficult. Also, in a liquidation the partner may be able to capture more of the goodwill of the business than if the business is not liquidated.<sup>26</sup>

### Formation of the Partnership Under the RUPA

In addition to the practical consequences of the adoption of the entity theory, the RUPA allows partners and partnerships to file documents with the state that can have important practical consequences. It is possible to form a partnership without filing anything with the state. The RUPA, however, allows filings with the secretary of state for certain purposes.<sup>27</sup> The most important statement that a partnership can file is a statement of qualification as a limited liability partnership.<sup>28</sup> The possibility of becoming a limited liability partnership predates the adoption of the RUPA.<sup>29</sup> The RUPA allow for the filing of a statement of partnership authority.<sup>30</sup> Such a statement can state that a partner has specified authority or can state a limitation on the authority of a partner. Third parties are "deemed to know of a limitation on the authority of a partner to transfer real property held in the name of the partnership if a statement containing the limitation has been filed in the office of the secretary of state."<sup>31</sup> Obviously, third parties receiving a transfer of real property held in the name of a partnership would be well advised to check with the Secretary of State for any statement limiting the authority of the partner purporting to act on behalf of the partnership.

Filed statements can affect the authority and liability of partners after a dissociation. In certain situations a dissociated partner can bind the partnership and can be bound for debts of the partnership incurred after dissociation.<sup>32</sup> However, if a statement of dissociation is filed, this authority and liability is terminated ninety days after the statement is filed.<sup>33</sup> It is therefore in the interest of both the dissociated partner and the partnership

to file a statement of dissociation as soon as possible. Third parties, of course, have an interest in checking for such statements to see if the person they are dealing with is still a partner and if other persons who they believe to be partners are still partners.

### Conclusion

In summary, the RUPA leaves many of the characteristics of partnerships unchanged. It did expressly adopt the entity theory which has important consequences. Clients need to know that both in partnerships at will and for a term they cannot force liquidations in as many situations as they could under the UPA. They will be allowed to dissociate and receive a buyout, but the valuation they receive is only an estimate without the market check of the prospect of a partnership liquidation. In addition to the adoption of the entity theory, the RUPA allows for the filing of statements which can affect partners, former partners, and third parties dealing with partnerships in important ways. Filing such statements and checking whether such statements have been filed are practical steps which partners, partnerships, and persons dealing with partnerships will now find to be important.

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### Endnotes

1. Idaho Code §53-3-202.
2. Idaho Code §53-3-306(a).
3. Idaho Code §53-3-306(c).
4. Idaho Code §53-3-301(a).
5. Idaho Code §53-3-601(1).
6. Former Idaho Code § 53-331.
7. Former Idaho Code §53-325-1.
8. Former Idaho Code §53-325-2.a.
9. Former Idaho Code §53-325-2.b and c.
10. Idaho Code §53-3-201.
11. Idaho Code §53-3-203.
12. Former Idaho Code §53-331.
13. Former Idaho Code §53-331-1.b.
14. Former Idaho Code §53-331-2.
15. Former Idaho Code §53-338-1.
16. Former Idaho Code §53-338-2.
17. If the exiting partner was not paid right away, in addition to the required bond, he or she was entitled to interest or a share of the profits of the business until they were paid. Former Idaho Code §53-342.
18. Idaho Code §53-3-601.
19. Idaho Code §53-3-801.
20. Idaho Code §53-3-701.
21. Idaho Code §53-3-602(e).
22. Idaho Code §53-3-601(1) and (7)(i).
23. Idaho Code §53-3-801(1).
24. Idaho Code §53-3-801(2)(i). The current version of the RUPA as adopted by the National Conference of Commissioners on Uniform State Laws reverses the default rule and provides that the partnership will continue unless at least half of the partners express the will to dissolve. §801(2)(i). It is also worth noting that the Idaho provision refers to a majority "in interest" of the partners rather than a simple majority of the partners.
25. Idaho Code §53-3-602(b)(2)(i).
26. The inability of a withdrawing partner to force a liquidation also affects withdrawing partners in a partnership at will under Idaho's non-uniform provision requiring at least half of the partners to force a liquidation in a partnership at will. Idaho Code §53-3-801(1).
27. Idaho Code §53-3-105.
28. Idaho Code §53-3-1001.
29. Former Idaho Code §53-343A.
30. Idaho Code §53-3-303.
31. Idaho Code §53-3-303(c).
32. Idaho Code §§53-3-702 and 703.
33. Idaho Code §53-3-704(c).

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