An Overview of Partnerships and Limited Liability Companies

This article concerns only partnerships formed in California or under California law. A partnership is merely a commercial endeavor, undertaken by two or more people, each of whom is entitled to a share of its profits and authority in the management of its affairs. If there is no written agreement that specifies otherwise, each partner is presumed to have an equal share of profits and equal managerial authority. For a partnership can exist even where there is no formal understanding that it exists, much less a formal written agreement that specifies the rights and duties of each partner. Stated simply, a partnership is simply a business that is owned and managed by two or more people, unless the business has purposefully organized itself in some other form (such as a corporation, a joint venture, a limited liability company, or a limited liability partnership). On many occasions, moreover, a business will choose to designate itself formally as a partnership and will govern its affairs by a partnership agreement, but the first principle is that any business run by two or more people is presumptively a partnership, unless it elects to designate itself as something else.

Although it is not necessary for partners to keep a written partnership agreement, I cannot conceive of a single instance when it would be preferable for them not to do so. Even if there are only two partners in the business, and both devote themselves full-time to operating it, and even if the business is small and simple while the partners are close friends or relatives who trust one another implicitly, there should be at least a simple agreement that addresses the fundamentals, which I deem to be as follows:

- How are the profits allocated?
- How are costs borne?
- How are responsibilities shared?
- What happens if one partner dies or goes away?

What happens if the partners no longer agree on the essentials or wish for other reasons to disband the partnership? and

What if the business wishes to take on a new partner, or what if two or more partners wish to exclude another partner from the business?

Of course, a more complicated business will have many additional concerns, but every partnership must address the foregoing list of issues, or else these issues will be decided for it by the statutes and case laws of California: Where there is no written agreement, nor sufficient evidence of an oral agreement, a partnership in California will find itself governed by the "default provisions" of the California Corporations Code, which provides simple answers to each of the above issues, and decrees that these answers will govern the partnership unless it has made some other arrangement.

I will now briefly discuss each of the above issues, showing, I hope, why it is so important for any self-respecting partnership to determine in advance how they will be addressed.

Allocation of Profits. In many partnerships, there is an unequal division of labor and of contributions to the business. One commonplace scenario is that of the worker-investor partnership, in which one partner does most or all of the work, while the other does little or no work, but provides most or all of the initial funding for the business. Who in this business should receive what share of the profits? Should it be 50 - 50? Should the partner who works more receive a greater share of the profits, or should this fall to the partner who made the venture possible in the first place by risking his money?

In other partnerships, there are several partners, each of whom performs special tasks that cannot be compared to the special tasks performed by the other partners. For example, I know of a business in which one partner makes the product (hand-sewn clothing and accessories), the second partner is chiefly responsible for selling the clothing to retailers or directly to the public, and the third partner handles all the administrative matters. In this business, it is simply not possible to compare the work performed by each partner. How then to allocate the profits to the three different partners?

It is often advisable, moreover, to invest a certain portion of the profits into the business, so that it becomes more competitive, can expand, furnish better goods or services, and so on and so forth. What percentage of profits should be reinvested? Or how should this decision be made? What if one partner badly needs money but the others wish to reinvest the profits into the business?

Obviously, the allocation of profits that should be agreed upon and addressed in advance of the actual earning of profits. There are as many different ways to divide profits as there are businesses in the world, but the important point is to arrive either at a specific formula or a decision-making procedure before any profits are earned. For example, it could be agreed that each partner is entitled to an equal share of profits, but that before any profits are distributed, the partners will confer in person and agree in writing on the reinvestment of at least 5% of profits, but no more than 75% of them. This provision would of course be recited in the partnership agreement.

Defrayment of costs. How will the costs of the business be borne? Is there one partner who has the "deep pockets", and who provides not only all initial funding but also the first infusions of capital while the business struggles to establish itself? At what point must the business pay its own costs? What if the business is unable to meet its costs? Do all of the partners make equal contributions from their own finances to salvage the business? Obviously, the issue of costs should be addressed before any of these issues arise.

Performance of the Work and the General Fiduciary Duty. No business ever succeeded, but by the efforts of those charged with running it. The question, then, is what tasks will each partner perform and what responsibilities will each partner have? If it is not always possible or useful to enumerate in advance the specific tasks that each partner will perform, it is still usually

a good idea in most cases to charge each partner with broad responsibility for specified aspects of the business. For example, one partner might be made responsible for sales, while the other partner will be charged with managing administration and procurement, with no further elaboration of the tasks that either partner must perform. In other cases, particularly where the partners are not longtime associates or close friends, it might be helpful for them to agree in advance on the specific work that each must perform. The important point is that this issue, like the others mentioned in this section, should be worked out in advance, before the business is underway.

An important and related concept is that of the fiduciary duty, which each partner owes at all times to his other partners and to the partnership as a whole. This means that each partner owes the highest possible degree of care and loyalty to the partnership and to his partners, even if he must compromise his own private interests in order to fulfill his fiduciary duty. A partner will breach the duty, and become liable to the partnership as well as to each of his partners, if he furthers his own interest at the expense of the partnership: This is said to be an act of self-dealing, which, if proven, makes the offending partner liable to the others and to the business.

Thus the partner should determine in advance who will perform what tasks, and every partner should always be mindful (and perhaps reminded from time to time) that he owes a fiduciary duty to the partnership and his other partners.

Dissolutions. Sometimes partners wish to end their partnership: Perhaps the business has failed, or perhaps the partners wish to incorporate, or perhaps the partners have found that they are incompatible with one another, or perhaps they wish to end the current partnership so that they can form a new one with new partners.

In all of these instances, and in many others, it is necessary for the partnership to dissolve itself, which means that a legal dissolution must be performed. The mechanics of this are simple: A notice of dissolution (or articles of dissolution) must be filed with the California Secretary of State, and conformed copies must be mailed to all creditors and clients of the business (if the business remains in operation, the notice should be accompanied by an explanation and upbeat self-promotion - e.g., "We are pleased to announce that Smithers & Smithers has expanded, has incorporated itself to accommodate its larger operations, and will now conduct its business under the name of Smithers-Smithers, Inc.").

But if the mechanics of a dissolution are simple, its practical effects can give rise to various complications and disputes within the partnership. For example, if one partner has decided to leave a two-partner operation, both must agree upon a fair distribution of the partnership's assets as well as the future use of its name, clients, customer prospects, and suppliers. If the business is burdened with debts, there must be an allocation of responsibility for the debts, as each partner remains personally responsible jointly and severally for all debts of the partnership (see the subsection on "limited liability", which appears below). Often, a departing partner will demand that he receive fair compensation for his ownership interest in the business. In a two-partner operation, for example, the departing partner might allow the remaining partner to own

and run the entire business himself, so long as he receives just compensation for his 50% stake in it. The determination of just compensation is usually performed by an impartial appraisal.

The partnership will also wish to anticipate what it must do if one of its partners dies or becomes incapacitated (for example, the partner might become debilitated by illness, or maybe he has run off with his mistress and cannot be found, or perhaps he has been thrown into jail on felony charges and has sunk into irreparable disrepute in his community). When a partner dies or otherwise can no longer maintain his position, the partnership typically pays him or his estate the fair value of his ownership interest, which is usually determined by an impartial appraisal. On rare occasion, the departed partner is entitled to give his ownership interest to another under a will or other testamentary document, but this is usually a poor idea, as the newcomer might not prove acceptable to the other partners, who will therefore feel imposed upon and perhaps even unwilling to continue the partnership. Again, my point is that the partners should make arrangements in advance for the many contingencies and variables of a dissolution or departure of a partner.

Admissions and Exclusions. Suppose two partners form a business, then find that they need additional funding, which they can obtain from an investor who promises to provide it only on condition that he become a partner in the venture (often, partners who provide such investments become "limited partners" rather than "general" ones, and they have only limited say in the operation of the business, but no personal liability for the partnership's debts, unlike the general partners (see below).

But suppose the two original partners each wish to recruit a different investor. How should the matter be resolved? By a pre-arranged formula?, a mediation? a binding arbitration? fisticuffs in the company bathroom?

Or suppose that there are five partners, one whom wishes to bring into the partnership his nephew Winnifred, whose admission is opposed by two partners, approved by a third, and under consideration by the remaining partner, who in the end cannot make up his mind and therefore casts no vote either way. Should Winnifred's uncle be excluded from voting because he is the proposing partner, or because he is arguably laboring under a conflict-of-interest? If Winnifred is admitted, should his admission be governed by special terms and conditions (e.g., he should have only limited rights during an initial probationary period?) What percentage of ownership and profits will he receive? What responsibilities will he have? If he must purchase his entry into the partnership, how much must he pay for it?

Suppose that a business has four partners, one of whom embezzles 82% of its profits. Of course, the other partners should exclude the offender, then sue him for breach of fiduciary duty, self-dealing, breach of the partnership agreement, and conversion (or misappropriation if conversion cannot be pled). But before the offender can be excluded, the partnership must have a procedure by which the exclusion can be accomplished in a summary manner. When excluded, will the offender receive fair compensation for his interest in the business, with an offset for the amount that he has misappropriated? Or does his conduct entitle the partnership not only to exclude him, but also to deem his ownership interest forfeited to the other partners?

Or suppose that two partners in a ten-partner operation find that they cannot work together any longer, after one has married the woman whom both courted. But suppose that they both wish to remain in the partnership. How should the matter be decided?

The point is that there are countless situations in which the partnership must decide whether to admit a new member or exclude a present one, and, if so, how the admission or exclusion should be performed. Procedures should be in place before any such deliberation takes place. To revisit an example that appears above, a partner might be deemed excluded as a matter of course if he is imprisoned, disappears, becomes incapacitated or dies, with a dispensation to him or his estate to pay for his ownership interest in the partnership.

All of the foregoing matters must be treated by a partnership agreement, or they will be resolved by default according to the partnership statutes found in the California Corporations Code. But the partnership agreement, which is a contract that binds all members of the partnership, need not limit itself to these matters, but instead can make such provisions and arrangements as seem sensible and worthwhile to the partners. The possibilities are infinite, but this does not mean that you should include an infinity of provisions in your own partnership agreement, which in most cases best serves as a general charter or constitution that establishes the central principles of your partnership.

Stated more generally, the partnership agreement is a private contract between the partners that can recite whatever provisions the partners choose, so long as there is no violation of law or public policy. In most instances, the agreement should recite general principles, procedures, and guidelines that address each of the above-enumerated issues.

The Identity of Partners/Limited Partnerships. Who may become a partner? The answer is any individual who is legally competent, as well as another partnership, a corporation, a limited liability company, or any other recognized legal person. For example, John Smithers can form a partnership with General Widget Corporation, Boone & Boone Partners, and Jones LLC, and each member will be deemed one partner for all intents and purposes.

Every partnership is presumed to be a general partnership, whose partners enjoy such rights and privileges as are accorded by law or the partnership agreement. But it is possible for one or more partners to specify in advance that they will act and be treated as "limited partners" rather than as general ones. Limited partnership must be established by following the various statutory requirements set forth in the California Corporations Code, which include prerequisite filings with the California Secretary of State. A limited partner, once officially recognized as such, is entitled to the full benefits of limited liability, but in exchange is given no general authority to manage the business. Typically, the limited partner's role in the business is limited to investing funds in it: He places the investment, is thereafter entitled to a specified percentage of profits, has no say in management, and, unlike general partners, has no personal liability for the debts or other legal obligations of the business.

The Perils of Unlimited Liability, the Necessity of Insurance, and the Burdens of Limited Liability. Unlike a limited partner, each general partner is severally and jointly liable for every

debt and legal obligation of the partnership, including debts and obligations that arose after the partnership dissolved itself but before all of its affairs were "wound up".

Suppose you form a partnership with dishonest Georgy Smithers, who then arranges to have the partnership purchase on credit $144,000 worth of plane tickets, travel accommodations, and personal computer equipment, which he then uses for strictly personal reasons. In this instance, you will be personally liable, along with Georgy, for paying the entire amount owed to the various creditors. After Georgy announces to you by telephone that he will not be returning from his long-term accommodations at an overseas luxury resort that he has paid for and flown to on the partnership's credit, you find yourself personally responsible for paying all the sums owed to the different creditors who furnished the goods and services to him.

Or suppose your partner is honest, but a bumbler, who by carelessness or foolishness involves the partnership in $365,000 of pointless debt, which the partnership finds itself unable to pay. The creditors will turn to your careless partner, but also to you personally, to collect the debt.

Or suppose that you and your partner are both honest and competent, but your business has 47,000 crates of widgets on hand when the international price for widgets collapses by 50% because of a new technology that will render widgets obsolete within one year. The partnership, though well run until this unforeseen news, faces certain ruin, as it will be unable to pay its suppliers for the widgets, which it purchased on credit. Again, you and your partner will each be personally responsible for paying the supplier, who may obtain judgements against you personally, then enforce the judgment by seizing your property.

There are two different ways to insulate yourself from such exposure, and you should use them both. First, your partnership should always have general liability insurance that protects it from the ordinary perils that every business must expect to run (e.g., fire damage). The insurance policy can also include various "riders", each of which provides additional insurance for risks left unprotected under the general policy. It is almost always a mistake to operate your business without proper insurance in place.

The second method for avoiding unlimited or personal liability is so important that I have placed in it in its own section, which appears immediately below.

Limited Liability Companies. You can have most the benefits and privileges of a partnership, but avoid general liability, by organizing the partnership as a "limited liability company" under the California Corporations Code. These companies, which are usually called LLCs, are entitled to limited liability: The company alone is responsible for its debts and obligations, and the partners, who are called "members", have no personal responsibility, so long as the company is properly funded and organized, and on condition that the members have not improperly manipulated it to commit a fraud upon its creditors. The only downside to using the LLC procedure is that your business must pay a small yearly tax (presently $800), but otherwise LLCs operate exactly as classical partnerships, save that the members bear no personal liability! The LLC avoids the many burdens of incorporation, which include special rules and procedures on taxation, distributions, share issuance, and the like. Nor must an LLC

pay tax at two separate levels, as corporations are obliged to do: Profits are either reinvested and not taxed, or they are passed through to the members, who include them in their personal income, but there is no corporate tax on an LLC.

In other words, and as an ironical conclusion to this monograph, it no longer makes sense in California to have a classical partnership, though some businesses might prefer to avoid the annual tax of $800 by remaining a partnership. Instead, it now makes sense to organize your partnership as an LLC (or, if you belong to a qualified profession, as an LLP). But everything said in this article applies equally to LLCs, except that your agreement will be called a "membership agreement" and the partners will be called "members", which anyway is how they sometimes refer to themselves even in classical partnerships).

You should certainly understand the basics of partnership law before going into business with another, even if you rightly intend to form an LLC rather than a classical partnership, and I hope that I have provided them in a tolerably clear, succinct manner in this monograph.
