THE PARTNERSHIP ORGANIZATION: AN APPRAISAL OF DOCTRINES AND PRACTICES*

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aa. The family partnership device

Aside from the tax code concept of "association" mentioned in the early part of this discussion, there is another significant phase in the tax statute in which a certain type of partnership relation has been the debated issue. Faced with the demand of the government for an ever increasing take in their earnings businessmen have developed the family partnership device. By this procedure the income-producing member of the family would form a partnership, probably with the wife [118] or the children, and make the income realized from the business appear as the separate income of such other members of the family. Of course the income realized would still be taxable as such, but in spreading the same among a number of recipients, for whose welfare any way the income is produced, much reduced tax expense may be obtained. Often times the new members may not have contributed any capital or services to the firm nor have any voice in the management of the enterprise. Such arrangement under state substantive law may easily be classified as a partnership organization [119] although in fact it is nothing but a scheme through which the producer of the income gratuitously allocates the same among the members of his family without essentially changing his economic position or without parting with all the im-

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* Continued from last issue.

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[118] Reference is made again to the United States Federal Internal Revenue Code. Section 11, *Internal Revenue Code*, imposes a tax "upon the net income of every individual" and section 12 states that income shall include "income derived from salaries, wages, * * * business, commerce, or sales or dealings in property * * * interests, rents, dividends, securities, or transaction of any business carried on for gain or profit or gains or profits and income from source whatever. Section 12(d), 51(b) permits split-income tax declaration for husband and wife such that a husband-and-wife business partnership may not be necessary for the purpose.

[119] Compare: *Frey, Cases and Statutes on Business Associations* (1935), 81—"When the question is raised, in a legal controversy, whether or not two or more persons are partners, the controversy usually concerns the liability of one of them for an obligation which he did not personally incur, i.e., whether or not the facts of his relations to the others empowered them to obligate him. Indeed, a single controversy is inconceivable in which the existence or non-existence of all of the attributes of a partnership, as heretofore described, is in issue. Hence, whenever the question of partnership is debated, the vital problem is not whether the associates are partners—there are not useful tests by which all the answers to such multiple questions might be determined. The real problem is whether the existing facts are those which the law recognizes as sufficient to produce the particular legal consequence in issue."

portant benefits thereof.[120] In *Helvering v. Horst* where the interest-earnings collected by the son were treated as part of the taxable income of the father-assignor, Justice Stone observed:

> "Underlying the reason in those cases [Lucas v. Earl, Blair v. Commissioner and Helvering v. Clifford] is the thought that income is realized by the assignor because he, who owns or controls the source of the income, also controls the disposition of that which he would have received himself and diverts the payment from himself to others as the means of procuring the satisfaction of his wants. The tax-payer has equally enjoyed the fruits of his labor or investment and obtained the satisfaction of his desires whether he collects and uses the income to procure their satisfaction, or whether he disposes of his right to collect it as a means of procuring them." [121]

The United States Supreme Court, in at least three important decisions, had occasion to deal with this problem wherein the government challenged the existence of a genuine partnership relation for income tax purposes. The Supreme Court in said cases was faced with two opposing views: the first being that which arises in a situation where the owner of a business attempts to transfer an interest in the business but retains such control thereon that he should continue to be taxable for the whole income realized; and the other is that which arises when the transfer is so complete and absolute that the income produced therefrom should be taxable to the transferee. In both instances the existence of a valid partnership under local statute was not considered decisive. A brief discussion of these decisions is given below.

One of them is the case of *Commissioner v. Tower.*[122] The essential facts are as follows: In 1927, Tower became heir to a manufacturing establishment located in Michigan. The business was incorporated in 1933 and of its 500 outstanding shares, Tower owned 445 and his wife 5. The business was a profitable one and on account of probable increased tax payments, Tower's counsel advised him that a partnership with his wife would result in some tax savings. Acting upon said advice, Tower donated 190 shares, valued at $57,000 to his wife who was supposed to place the assets represented by those shares as her contribution to the partnership to be organized. The corresponding tax for the gift of the shares was duly paid. The corporation was then dissolved and a limited part-

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[120] See: *Opinion of Justice Stone,* Helvering v. Horst (1940), 311 U.S. 112. Lucas v. Earl (1930), 281 U.S. 111; Blair v. Commissioner (1927), 200 U.S. 5; Helvering v. Clifford (1940), 309 U.S. 333. Helvering v. Eubank (1940), 311 U.S. 122—cases relating to gratuitous assignments.

In Helvering v. Clifford, *supra,* Justice Douglas stated: "We cannot conclude as a matter of law that respondent ceased to be the owner of the *corpus* after the trust was created. Rather the short duration of the trust, the fact that the wife is the beneficiary, and the retention of control by respondent all irresistibly lead to the conclusion that respondent continued to be the owner for purposes of section 22(a)" at p. 335.

[121] See further: Magill, *Taxable Income* (1945), 299-302.

[122] Commissioner v. Tower (1946), 327 U.S. 280.

nership was organized under the Michigan statute. The wife as a limited partner had no voice in the management, and under the partnership agreement, was to share in the profits and losses with her husband in the proportion of 39 percent and 51 percent, respectively. On the basis of these facts the Commissioner ruled that the share of the wife in the 1940 and 1941 profits which she received for personal and family purposes was actually an income of Tower and taxable to him. In sustaining the Commissioner's ruling the Tax Court made the following observation: "A careful analysis of the testimony of this proceeding leads to the conclusion that the petitioner did not make a valid gift of the corporate stock to his wife in that he did not absolutely and irrevocably divest himself of the title, dominion, and control of the subject of the gift * * * In view of the fact that the gift of the corporate stock by the petitioner to his wife was not valid and complete, it followed that she made no capital contributions to the partnership, and, since she admittedly rendered no services, it must be held that she was not a *bona fide* partner." [123] Reversed by the Circuit Court, the case was appealed to the Supreme Court. The Tax Court ruling was upheld on the issue of who earned the income and whether the husband and his wife really intended to carry on business as a partnership. Among the salient points embodied in the Court's opinion penned by Justice Black are: (a) that the tax tribunal in such a situation may properly invoke the tests found in the federal tax statute and is not under duty to look to the state partnership law for the purpose of ascertaining whether a valid partnership organization has been formed; [124] (b) that while an individual has the undoubted right to make arrangements as would minimize his tax expenses in the conduct of his business, the efficacy of such arrangements will depend on how sufficiently he has divorced himself from the income to accomplish his purpose; and that a partnership device avowedly intended as a tax-saving device adds support to the inference that the husband still controls the income and the earnings are actually his own; [125] (c) that in determining whether the wife becomes a partner for the purpose of the income tax statute, such factual circumstance as whether or not she has contributed capital, performed vital services and shared in the management, are of controlling weight; [126] and finally, (d) that the partnership arrangement on hand brought

[123] 3 T.C. 396, 402-405 (1946). It should be noted that the wife is a limited partner and under the law she is not supposed to have any voice in the management. See Note 34, *supra*.

[124] 327 U.S. 280, 287-288—"The statutes of Congress designed to tax income actually earned because of the capital and efforts of the individual members of a joint enterprise are not to be frustrated by the state laws which for state purposes prescribe the relation of the members to each other and to creditors."

Compare: In the Philippines, husband and wife are under disability to give donations to each other save in certain cases, and cannot enter into what is called a universal partnership as distinguished from a particular partnership. Article 1782, Civil Code of the Philippines.

[125] id. 288-289.

[126] id. 280, 290.

about no real change in the economic relation of the husband to the income subject to tax, a point which seems to be the basic concern of the statute.[127]

Lusthaus v. Commissioner,[128] decided at the same time as the *Tower* case, involved a substantially identical set of facts concerning a husband-and-wife partnership organized under the Pennsylvania statute. Justice Black, again writing the opinion for the Court, upheld the Tax Court ruling that no partnership has been created within the purview of the tax statute. As a general proposition both the Tower and Lusthaus decisions would make the tax status of the disputed member of this type of partnership depend mainly on whether or not that member performed vital services or contributed capital originating with her or him. Such formula has served as the foundation of a number of subsequent decisions promulgated by the Tax Court and the Circuit Court.[129]

The case of *Commissioner v. Culbertson*[130] presents quite a unique set of facts. Culbertson, from 1915 to 1939, had been engaged in the cattle business in partnership with one named Coon. The latter on account of ill health desired to liquidate the partnership while at the same time was interested in seeing the business continued. Coon wanted the four sons of respondent to join the enterprise and for that purpose a new partnership, under the name *Culbertson & Sons,* was created. The four new members were to have an individual interest in the firm, and this was accomplished by the sale of the assets to Culbertson who in turn sold to his sons the half interest. The first sale was financed by the father while the second was paid from a gift of $21,000.00 given by the petitioner to the sons and a note for $30,000.00 procured by *Culbertson & Sons.* The note was later paid out of the proceeds of the business. Of the four new members, the oldest served as a foreman of the newly organized partnership until he was called in the army; the second, after finishing his college work in 1940, went directly to the army without having any chance to work for the firm; while the last two worked in the ranch during summer since the rest of the year they were in school. At the time the new partnership was created, these four new members were 24, 22, 18 and 16 years old, respectively. The Tax Court refused a division of the income in accordance with the partnership arrangement and based its decision on the finding that none of the disputed members met the

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[127] *Id.* 291. Justice Reed, with whom the Chief Justice concurred, dissented and pointed out that petitioner made a completed gift of an interest in the business and consequently the wife's share in the partnership profits represented income from property of which she had become the absolute owner. At 293.

[128] 327 U.S. 293 (1946) Lusthaus v. Commissioner.

[129] See generally: Bruton, Cases and Materials on Taxation (1949) e.g. Moore v. Commissioner (1948) F. 2nd 191. Hitchcock (1949) 12 T.C. 22; Ritter 11 T.C. 324 (1948) Denison, 11 T.C. 686 (1948); Morrison 11 T.C. 696 (1948); Harrison 10 T.C. 818 (1948); Durwood 6. T.C. 682 (1946).

[130] 69 Sup. Ct. 1210 (1949). See Olson and Martin, *The Culbertson Case,* (1949) 27 Taxes 777; Manheimer and Mook, *A Taxwise Evolution of Family Partnership,* (1948) 32 Iowa Law Review 426.

requirement that each partner should contribute vital services or capital originating with him.[131] This ruling was reversed however by the Circuit Court on the ground that there was a bona fide understanding that the sons would contribute vital services in the future,[132] a situation presumably differentiating the case from the *Tower* and *Lusthaus* cases.

Reviewing prior relevant decisions, the Supreme Court, with Chief Justice Vinson speaking for the majority, indicated the error of the circuit court and at the same time pointed out that there was a misinterpretation of the *Tower* decision.[133] The opinion states that "the Tax Court's isolation of the original capital as an essential of membership in a family partnership indicates an erroneous reading of the Tower decision. We did not say that the donee of an intra-family gift could never become a partner through investment of the capital in the family partnership." [134] It would seem that if a complete and absolute gift is made and there is no evidence showing a scheme to form a partnership with the donor although later the donee on his account invests back the gift in such a partnership, the situation would probably be different and such a partnership arrangement sustained. Furthermore the Court observed that "the intent to provide the money, goods, labor or skill sometime in the future cannot meet the demands of section 11 and 22 (a) of the Code that he who presently earns the income through his own labor or skill and the utilization of his own capital be taxed therefor. The vagaries of human experience preclude reliance upon even good faith intent as to future conduct as a basis for the present taxation of income." [135] In summary, the majority states:

> "The question is not whether the services or capital contributed by a partner are of sufficient importance to meet some objective standard supposedly established by the *Tower* case, but whether, considering all the facts * * * the parties in good faith and acting for a business purpose intended to join together in the *present* conduct of the enterprise." [136]
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> "The cause must therefore be remanded to the Tax Court for a decision as to which, if any, of respondent's sons were partners with him in the operation of the ranch during 1940 and

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[131] 1947 P-H T.C. Mem. Dec. Serv. 47, 168.

[132] 168 F. 2nd. 978 (1948).

[133] Referring to the *Tower Case*, this Court pointed out that the decision "fully justified that the husband, through his ownership of the capital and the management of the business, actually created the right to receive and enjoy the benefit of the income and was thus taxable upon that entire income under sections 11 and 22(a). In such a case, other members of the partnership cannot be considered individuals carrying on business in partnership and thus liable for income tax * * * in their individual capacity within the meaning of section 181." 69 Sup. Ct. 1210, 1213, (1949).

[134] Id., 1216-1217.

[135] Id., 1213.

[136] Id., 1214-1215.

1941. As to which of them, in other words, was there a *bona fide* intent that they be partners in the conduct of the cattle business, either because of services to be performed during those years, or because of contributions of capital of which they were the true owners, as we have defined that term in the *Clifford, Horts* and *Tower* cases?" [137]

In connection with the subjective approach developed in the Culbertson case, it is believed that an inquiry along that line will produce differing results depending on what factual circumstances will appear controlling to the majority of the court. The question whether or not "the parties in good faith and acting for a business purpose intended to join together in the present conduct of the enterprise" will surely present such difficulty as, to use the language of the Supreme Court, "is ordinarily true of inquiries into the subjective." [138] For this reason, as previously noted, it is perhaps safe to predict that the intention test will not be considered as a single absolute criterion in determining the existence or non-existence of partnership relation even within the meaning of the revenue law. And since after all a *bona fide* plan to form a partnership would be nothing more than making a finding as to what the parties actually did, consideration of such factors as participation in the management, performance of vital services or contribution of capital, pointed out in the *pre-Culbertson* cases, will still be treated as significant, if not controlling in any particular determination.[139]

iii. Management and Control

Implicit in an ordinary partnership relation is that the members shall have an equal participation in the management and con-

[137] Id., 1216-1217—Justice Jackson would affirm the opinion of the Circuit Court since he believes that the ordinary common law tests for the validity of partnerships are the tests for tax purposes and that the same have been fully satisfied in the instant case. Compare: Justice Frankfurter's opinion in which it is stated, among others: "That there is no special concept of partnership for tax purposes." 1218-1220—Mechem, *Elements of the Law of Partnership* 4 (2nd ed. 1920) "Though usual and often said to be essential, it seems not to be indispensable that every partner shall make a contribution (footnote): Thus it is said by Jessel, M.R. 'you can have, undoubtedly according to English law, a dormant partner who puts nothing in, neither capital, nor skill, nor anything else. In fact, those who are familiar with partnerships know it is by no means uncommon to give a share to a widow or relative of some former partner, who contributes nothing at all, neither name, nor skill, nor anything else. Therefore, it is not quite accurate, as Chancellor Kent puts it, that they must contribute labor, skill or money, or some or all of them.'"

[138] See note 136.

[139] See: W.F. Harmon (T.C. 1949) CCH Fed. Tax Rep. S17, 196—where it was held that there was a *bona fide* intent to form a partnership with respect to the son who contributed services to the new firm prior to induction to the army. Theurkauf (TC. 1949) CC. Fed. Tax Rep. S17, 226—where the gift of stock to the wife was considered full and complete as to make her a partner in a firm engaged as a commission merchant and factor. Robinson, *The Allocation Theory in Family Partnership,* (1947) 25 Taxes 960.

duct of the business of the firm. Although any partner may have an interest only in the profits and not in the capital, his rights are involved in the proper conduct of the firm's affairs to the extent that profits may be realized. In the traditional language of the courts: "One partner cannot have an exclusive right to manage the affairs of the partnership unless such exclusive right be expressly granted in the partnership agreement, and, furthermore, that in the absence of such express agreement, it is gross misconduct for one partner to exclude the other from taking part in the management of partnership affairs." [140]

Indeed, full exposure to the hazards of the business makes it fair that the participants should share in the conduct of the enterprise and in that respect reduce as much as possible the financial risks which each partner may be made to respond.[141] Lindley's ancient words [142] are: "In the absence of express agreement to the contrary, the powers of the partners in an ordinary partnership are in all respect equal, even although their shares may be unequal; and there is no right on the part of one or more to exclude another from an equal management in the concern. * * * Indeed, speaking generally, it may be said that nothing is considered as so loudly calling for interference of the court between partners as the improper exclusion from taking part in the management of the partnership business. It need, however, hardly be observed that it is perfectly competent for the partners to agree that the management of the partnership affairs shall be confided to one or more of their number exclusively of the others; and that, where such agreement is entered into it is not competent for those who have agreed to take no part in the management to transact the partnership business without the consent of the other partners." To be sure, this sort of flexibility regarding management arrangement is one partnership norm which stockholders of the small business corporations would wish they posses as indicated in the earlier part of this discussion.

It is said that the right of a partner to a voice in the management of the business does not necessarily take the form of a right to *vote* although comparable to that in substance. This is particularly true in large partnerships managed by elected agents.[143] This latter situation is well illustrated in *McFadden* v. *Leeka*,[144] where by

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[140] e. g., Einstein v. Schachby, 1898) 89 Fed. 540, 550; Harris v. Harris, (1901) 132 Ala. 208, 31 So. 355; Drummond v. Batson, (1924) 162 Ark. 467, 259 S.W. 741; See: section 18 (e), Uniform Partnership Act.

[141] For a collection of cases: Rowley, *Modern Law of Partnership*, (1916) 359-397.

[142] *Lindley on Partnership* 540.

[143] Mechem, *Elements of the Law of Partnership* (2nd. ed. 1920) 160.

[144] 48 Ohio St. 513, 28 N.E. 874. Powell v. Finn 198 Ill. 567, 64 N.E. 1036—where the operating capital was divided into shares but with the proviso that no member shall cease to be liable unless the transfer is certified by the secretary and no purchaser shall be entitled to the rights and privileges of a member until he shall have signed the articles of association. Smith v. Virgen 33 Me. 148; Hotchkin v. Kent, 8 Mich. 526; Spraker v. Platt, 158 (N.Y.) 158 App. Div. 377, 143 N.Y. 440. Oliver's Estate, 136 Pa. St. 45, 59.

the constitution of the co-partnership the whole business of the company was to be done by a board of directors performing duties which, in most respects, were similar to those performed by the directors of a private corporation. The partnership agreement in this case provided for freely disposable shares with each share being entitled to a vote. Such an arrangement would obviously render more simple the operation of the firm, and prevent any possible want of concert which might otherwise happen in organizations with a fairly big membership. This arrangement indicates further how a group of enterprisers, under certain situations, would find it convenient and necessary to employ certain of the so-called corporate features without going through the process of incorporation.

By statute and court decisions, the concept of equal rights to control and management imports into the province of partnership law another equally confusing field, that of agency.[145] The many problems arising in connection with the right to management as implying a power to bind the firm and ultimately the co-partners may be grouped into: that in which a third party is seeking to hold the association including its members for transaction had with an acting partner; and that in which the acting partner would probably be looking for contribution or seeking to enforce similar rights against the other members of the enterprise. The statute, in such cases, gives the sweeping answer that a partner could bind the partnership by any act "for apparently carrying on the usual way the business of the partnership of which he is a member." [146]

[145] Section 9 (1) Uniform Partnership Act—"Every partner is an agent of the partnership for the purpose of its business, and the act of every partner, including the execution in the partnership name of any instrument, for apparently carrying on in the usual way the business of the partnership of which he is a member, binds the partnership, unless the partner so acting has in fact no authority to act for the partnership in the particular matter, and the person with whom he is dealing has knowledge of the fact that he has no such authority." See also, section 9 (2), *id.* *Story on Partnership* (7th ed. 1881), section 1.

"Partnerships for commercial purposes, for trading with the world, for buying and selling from and to a great number of individuals, are necessarily governed by many general principles which are known to the public which subserve the purpose of justice and which society is concerned in sustaining. One is that * * * a partner [certainly the Acting partner] has the power to transact the whole business of the firm, whatever that may be, and consequently to bind his partners in such transactions is entirely as himself. This is a general power, essential to the well-conducting of the business, which is implied in the existence of partnership. When the partnership is formed for a particular purpose, it is understood to be in itself a grant of power to the acting members of the company to transact its business in the usual way. If the business be to buy and sell, then the individual buys and sells for the company, and every person with whom he trades in the way of the business has the right to consider him as the company whoever may compose it. * * * The acting partners are identified with the company and have power to conduct its usual business in the usual way. This power is conferred by entering into the partnership, and is perhaps never to be found in the articles." Per Marshal, C.J. in Winshink v. Bank of the United States, 5 Pet. (US) 529, 8 L. ed. 216.

[146] *Id.* See nee note 84 *supra,* Kallison v. Harris Trust & Sav. Bank, (1949) 86 N.E. 2nd 858, 338 Ill. App. 33—where the partner's were estopped from denying as

On the basis of such statutory formula, courts have developed some kind of distinction between whether the acting partner is a member of trading or mercantile partnership or a non-trading firm in determining the extent of his power to affect his relations with the other partners. The decisions indicate that the power of one partner to bind the firm by a contract entered on its behalf will be implied by law only in the case of commercial partnership and that in other partnerships it would be a question of fact depending upon the provisions of the partnership agreement, custom of the business and other circumstances.[147] In the latter situation, the party-claimant in order to recover must affirmatively show that the acting partner possesses the requisite authority.[148] Such a dichotomy obviously serves no meaningful purpose except to tell us that probably a mercantile firm has a wider range of activities than, say, a firm whose goods consist principally in services.[149] But apart from the fact that even a non-mercantile firm may just as well be employing large aggregations of capital, and making use of such modern credit facilities through which the members of the firm are brought in constant touch with the outside world, such a distinction would simply be a subtle way of drawing into the partnership law the same confusion which the vanishing doctrine of *ultra vires* has caused in the corporate field.[150]

The same statutory provision has been criticized as ambiguous and misleading. Said provision may be taken to mean such activities as are within the apparent course of business as carried on by the acting partner's particular firm.[151] There are decisions, however, to the effect that not only the course of business of such particular firm may be relied upon as evidence of the authority, but the course of business of other firms in the same locality engaged in the same general line of business.[152] The suggestion has been given,

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against the bank authority of a co-partner in endorsing a check under a name formerly used by a said co-partner and which is similar to the firm's name.

[147] Rowley, *Modern Law of Partnership* (1916) 467-488.

[148] e. g., Hyland v. City Garbage and Contracting Co., (1941) 9 Wash. 2nd. 168, 114 P. 2nd 153; Chacker v. Marcus (1949), 89 N.E. 2nd 455. Compare: Dugert v. Hansen, (1948) 199 P. 2nd. 596, 31 Wash. 2nd. 858.

[149] Crane, *supra*, 192-193—"It appears that there are three kinds of evidence of authority: the agreement of the parties *inter se*, the course of business of the particular partnership, and the course of business of similar partnerships in the locality." 190.

[150] The distinction is no more than a mere convenient label, a snare probably for the unwary. In Georgia, a statute setting forth the power of the partners in general terms has been construed to do away with the distinction. Hoskins v. Thorne (1897) 101 Ga. 126; 28 S.E. 611; Selman v. Brown, (1886) 78 Ga. 332.

[151] Swanson v. Webb Tractor & Equipment Co., (1946) 167 P. 2nd 146 24 Wash. 631; M & C Creditor Corp. v. Pratt (1940), 17 N.Y.S. 2nd 240, *affirmed* in 255 App. Div. 838, 962; 24 N.E. 2nd 482; 281 N.Y. 804. Famestone Banking Co. v. Conneaut Lake Dock & Dredge Co., (1940) 14 A. 2nd. 325 Pa. 26.

[152] e. g., Irwin v. Villar 110 U.S. 499, 505—"If the contract of partnership is silent, or the party with whom the dealing was made has no notice of its limitations, the authority for each transaction may be implied from the nature of the business according to the usual and ordinary course in which it is carried on by those engaged

therefore, that since a restricted rule may impose an undue burden upon third parties to learn the business habits of a particular firm, together with the fact that the instant statutory provision is anyhow susceptible of such a restricted interpretation, the language of the counterpart provision of the English statute might well have been adopted: "... any act for the carrying on in the usual way business of the kind carried on by the firm." [153]

When no express agreement has been made, control over the formulation of partnership policies is normally exercised by all the partners acting in concert. In the event of any difference of opinion, the Uniform Partnership Act provides that "any difference arising as to ordinary matters connected with the partnership business may be decided by a majority of the partners; but no act in contravention of any agreement between the partners may be done rightfully without the consent of all the partners." [154] It is not clear, however, in what sense the term majority is used. Story asserts in positive terms that the term majority consists of a majority in number without regard to their financial interests in the enterprise,[155] an interpretation which is simply the reverse of the one-share-one-vote rule in situations where the stockholders are specifically empowered to have a voice in the corporate affairs. In *Markel v. Wilbur*,[156] the Pennsylvania court quoted with approval this majority-in-number proposition. In that case, plaintiffs brought action to restrain one of the defendants, majority in number, from acting as general superintendent of the enterprise, a coal mining concern, and to enjoin all said defendants in making any extension

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in it in the locality which it seats, or as reasonably necessary or fits for its successful prosecution * * *. Dealing in grain is not a technical phrase from which a court can infer, as a matter of law, authority to bind the firm in every case irrespective of its circumstnaces; and if by usage, it has acquired a fixed and definite meaning, as a word of art in trade, that is a matter of fact to be established by proofs." Swanson v. Webb Tractor & Equipment Co., (1946) *supra*, Gilmore, *supra*, (1949) 207-208.

[153] Crane, *Uniform Partnership Act*—A Criticism, *supra*, at 781. Lewis, *The Uniform Partnership Act—A Reply to Mr. Crane's Criticism*, supra: "Should the inquiry be: How did the partnership business appear to be carried on? Or, how are businesses of the kind carried on by the partnership usually carried? * * * The argument which finally led * * * to the present wording was that it emphasizes the fundamental reason why partnership is never bound by an act of a partner not authorized by his copartners, namely, that partners are bound because they held out to do that class of acts * * * (and) even if the contract was not one for carrying on in the usual way the business of the kind carried on by the firm, the partnership shall be held, if it was a contract for apparently carrying on in the usual way, the business of that particular partnership." 299-300.

[154] Section 18, (h) *Uniform Partnership Act*. Highly v.Walker (1910) 26 T. L. R. 685—where the chancery division construed the employment of the son of one of the partners, belonging to the majority, for the purpose of learning the business over the objection of the minority, as an "ordinary matter connected with the partnership business."

[155] Story, supra, section 123.

[156] 200 Pa. 457, 50 Atl. 207 (1901). Section 18 (h), Uniform Partnership Act, second clause. Mechem, *Cases on Partnership* (Mathews Revision 1935) 166.

of the mines, erecting any new breakers or machine shops or paying out any dividends. The complaint also sought to compel the majority to account for the cost of a tunnel built upon instructions of the defendants, salaries paid to employees, the cost of erecting a house for the superintendent and so forth. In rendering judgment for the defendants, the court pointed out that the only restraint on the activities of the majority acting within the scope of the partnership business is the requirement of good faith and the best interest of the firm.[157] In this connection, it may be argued that if what is preferred is that partners whose interests are most affected should formulate and execute the policies of the firm, a majority in interest construction will be the more reasonable one.[158]

In the case of disputed control, as when one partner in a firm of two, dissents to what the other contemplates to do apparently on behalf of the enterprise, or in any case of even division and such disagreement in either situation is known to the third party, the decisions are quite conflicting. There are decisions [159] which seem to hold that if, for example, goods purchased on credit are put into the firm's stock and used by the partnership notwithstanding the known dissent of one of the members, an indebtedness against the partnership and against each of the members will be created. If this conclusion is a sound one, it would appear that the right of dissent does not exist at all. A dissent by one partner would be merely formalistic and could be overruled and set at naught by the

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[157] It should be noted that the partnership involved in this case is a mining partnership. In Kahn v. Smelting Co., 102 U.S. 645, 26 L. ed., Justice Field observed: Mining partnerships, as distinct associations, with different rights and liabilities attaching to their members from those attaching to members of ordinary partnerships, evist in all mining communities. Indeed, without them sucessful mining would be attended with difficulties and embarrassments much greater than at present." Daugherty v. Creary, 30 Cal 290—members of a mining partnership, holding the major portion of the property, have power to do what may be necessary and proper for carrying on the business, and control the work, in case all cannot agree provided the exercise of such power is necessary and proper for carrying on the enterprise for the benefit of al concerned."

Bates on Partnership, section 329. Mining partnerships are not recognized in Pennsylvania. Bell, Exec. v. Johnston, (1924) 281 Pa. 57, 126 Atl. 187.

[158] Compare: Relevant provisions of the Civil Code of the Philippines: Article 1800—partners representing the controlling interest may revoke managing partners authority as conferred in the articles of association. Article 1801—managing partners without specification as to respective rights and duties shall not act without the consent of the others and in case of difference in any act of administration, the majority shall prevail. In the event of a tie, the vote of the partner owning the controlling interest shall be decisive. Article 1803—absent agreement as to management, no partner without the consent of all shall make any alteration, even though useful, in any immovable property of the partnership; but if the refusal is manifestly prejudicial to the interest of the partnership, judicial relief may be obtained.

[159] Campbell & Jones, v. Brown, 49 Ga. 417; Johnson, Clark & Co. v. Bersheim, 76 N.C. 139; Johnson v. Bersheim, 86 N.C. 329.

other. *Dawson v. Elrod* [160] states the opposite view regarding known differences of opinion between a firm composed of two partners: "It seems clear that notice that authority to bind did not exist in one partner would relieve from liability the other partner, just as after dissolution he is no longer bound. * * * It is notice that the implied agency had ceased. Nor do we think this rule is changed by the fact that goods came to the firm, and were used by the firm. This might have been the very thing that the appellee did not desire, and the very thing he undertook to guard against; yet if the acts of his partner, against his wishes and over his protest, in receiving the goods and using them, can bind the appellee to pay for them, then notice to appellant might as well not have been given. The effect of the notice if given, must be to place the seller on notice that * * * "if you sell over my protest, in no event will I be bound!"

This reasoning would seem to be implicit in the statutory provision mentioned before. A transaction made by one of the two partners made over the dissent of the other would be one not made by the majority. Consequently, such a contract, the third person knowing of the dissent, would not be partnership contract.[161]

iv. Allocation of risks: partners inter se and as regards third persons.

The whole problem relating to partners *inter se* relationships brings us again to a consideration of some of the basic partnership norms, a subject about which much ancient writings have been made although of course not in the same intriguing vein with which both courts and textwriters have been dealing with modern corporate practices.

In the first place, a successful partnership enterprise requires a high degree of intimacy and close cooperation. This implies that any member has the right to select his associates as well as to prevent his co-partners from bringing strangers into the firm without his consent. The choice of personnel in this type of association may spell the success or failure of the enterprise. Mechem thus observed that the partnership relation imposes upon the members a mutual sacrifice of freedom and that actually partners are too much at each other's mercy to risk the dominances of indifferent associates or the lack of confidence of the suspicious. In this respect, such conventional rights to mutually consult and to participate as articulated in court decisions clearly are attempts to adjust such differences of personality to the continuance of a cooperative enterprise.[162]

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[160] 105 Ky. 624, 49 S.W. 465. Yeager v. Wallace, 57 Pa. 365—sale by one partner over the protest of the other and with the knowledge of the purchaser, invalid. Mathews v. Dare, 20 Md. 248 "The adventure may be a losing one. It seems reasonable that, if a partner can limit liability by giving notice that he will not be bound, then he can make his known liability absolute at least so far as not to be dependent on whether the thing contracted for comes to the use of the firm. If he cannot he might as well have not dissented." Cargill v. Corby, 15 Mo. 425.

[161] Lewis, *supra*, at 299-300.

[162] Mechem, *supra*, 478-479.

Apart from the problem of the choice of associates, and the body of legal doctrines which has been developed about it, other important phases of the *inter se* relationship of the partners would probably be those which refer to: profit-sharing, co-ownership of specific partnership property, management and control, power to bind the firm, right to demand that co-partners conduct themselves in a manner appropriate to fiduciaries, and the right to contribution in the event that the individual payment of some partnership obligations has been made, or contributions for losses sustained by the firm.[163]

Underlying all this is the so-called fiduciary obligation of the partners to one another, a duty which imposes upon the partners a high degree of integrity and good faith.[164] Section 21 of the Uniform Partnership Act is explicit in this regard: "Every partner must account 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 of its property." This duty is extended to the surviving partner in liquidation as also to his own legal representative in the event of his death. Parenthetically, a similar sort of fiduciary obligation is imposed upon corporate directors. And with respect to managing partners as well as in regard to corporate directors, courts are faced with the same difficulty of formulating the proper standards of responsibility, or giving some concrete significance to that almost esoteric concept called *business judgment rule.* Crane writes: "A partner is not held to possess the degree of knowledge and skill of a paid agent. But he owes to the partnership the duty of faithful service to the best of his ability. In the absence of special agreements, no partner guarantees his own capacity. He is liable to the partnership for the whole burden of losses caused by errors of judgment and failure to use ordinary skill and care in the supervision and transaction of business." [165]

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[163] *Uniform Partnership Act,* pt. iv—relations of the partners to one another. Section 18—rules for determining, the rights and duties of the partners. Section 19—partnership books; Section 21—partners accountable as fiduciary. Section 22—right to an account. Section 23—continuation of partnership beyond fixed term. See Dodd, *supra,* 527.

[164] Baum v. McBride, (1950) 40 N.W. 2nd. 649; 152 Neb. 152; Stowe v. Watson (1950) 211 P. 2nd 591; 94 Cal. App. 2nd 678. The fact that relations between the partners are strained does not relieve them of the fiduciary obligation of acting in utmost good faith towards each other. Karle v. Sedar, (1950) 214 P. 2nd. 648. Nelson v. Agraham, (1947) 177 P. 2nd. 921; 29 Cal. 2nd 255; Caveney v. Caveney, (1940) 291 N.W. 218-234 Wis. 637—where purchases made in violation of partnership obligation were considered to have been made in trust for the enterprise and the guilty partner made to account for profits received.

[165] Crane, *supra,* 301. Collier v. Benjer, (1950) 73 A. 2nd. 21 Md. Thomas v. Milfelt (1949) 222 S.W. 2nd 359—generally, partnership losses occasioned by conduct or poor judgment of one partner will not be charged against him but will be borne by the firm in the absence of fraud, culpable negligence or bad faith on his part.

Compare: Judge Learned Hand's opinion in Hun v. Carey, (1880) 82 N.Y. 65; 37 Am. Rep. 546—as to standard of conduct of corporate directors.

As previously mentioned, the *inter se* relations of the partners from the formation stage up to the liquidation stage depend primarily on any private agreements [166] they may have made, and courts do treat the whole problem of interest adjustments in the light of an elaborate system of remedies, legal and equitable. Absent statutory prohibitions or definite public policy restrictions, the members of either general or limited partnership may as between themselves include in their articles of association any agreement they may like. They may probably make provisions regarding concentration of powers in a managing group, make stipulations to reduce the disastrous consequences of dissolution by death,[167] and of course include some carefully drawn provisions to cover clearly the terms regarding capital contribution, shares in profits and losses and the manner of distribution upon liquidation. Such arrangement would control the powers, duties and liabilities of the partners among themselves, and in the light of the declared preference of giving such a wide area for private volition in the field of commercial transactions as is compatible with other community goals, courts would have limited occasion to rewrite the parties' agreements. A practical solution to most partners' *inter se* disputes, a solution not of course new but on the contrary so obvious that it is often taken for granted, would rest in the care and skill in which the partners' agreements are put into written form. The main task of one entrusted with the preparation of the partnership articles would be, as Worcester states, "to ascertain what they (the parties) do wish, to think out in advance the typical problems that are likely to arise, to discuss these with them, to work out decisions as to how they are treated, and to set the results down in clear language. * * * Since a partnership is an extremely intimate relationship, perhaps the greatest potential problem is the risk of future disagreement among those who start out with the highest mutual regard." [168]

As far as third persons are concerned, the ordinary partnership relation implies the risk of full personal liability on the part of the members, in contract as well as in tort. It is commonly assumed that contracts made by a partner within the scope of his actual or apparent authority and on behalf of the firm, are binding on the partnership and all of its members. And certain partners will not on account of their special connection with the organization be

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[166] For a comprehensive discussion of the usual clauses contained in partnership agreements, see also *Lindley on Partnership* (10th ed. 1935) at pp. 487-547. The author discusses such clauses as: nature of business, date of commencement, firm name, duration, premium, capital and property of the firm, interest, and allowances, conduct and powers of parties, partnership books, accounts, retirement, dissolution, valuation of shares, transmission of shares and introduction of new members, prohibition against carrying on business, goodwill, getting in debts, assignment of shares, indemnity to outgoing partners, arbitration, penalties and liquidated damages.

[167] For a discussion of agreements made for the continuance of the partnership beyond the fixed term: Fuller, loc. cit. note 67, *supra*.

[168] See note 13, *supra*.

exempt from such liability.[169] This is of course subject to the qualification that the other party has no knowledge of the limitation placed upon the authority of the partner with whom he dealt with.[170] Rowley summarized the reason for the rule as follows: "All of this comes about by reason of the dependency of the law of partnership upon that of agency, persons associated together in the partnership relationship being antecedently principals and subsequently partners. Consequently, unless there is another limit upon the actual authority of the individual members of an ordinary partnership by an express agreement, this fact carries with it the presumption that the power of each partner to bind the firm is co-extensive with all acts ordinarily made necessary by the nature of the business." [171] The liability arising from tort is grounded upon similar doctrinal proposition.[172]

v. Termination: distribution and priorities

An equally important aspect, the last in this general survey, relating to the termination and winding up of a partnership organization is that which concerns the rules of distribution and priorities. It is of course undisputable that as between the partners themselves they may fix any specific method for the liquidation of the firm's assets, their respective priorities, how they shall allocate the losses among themselves; and that such procedure they may establish beforehand and include in their general articles of association or in a special dissolution agreement.

Obviously the problem will not be as uncomplicated as that when the rights of third persons are involved. The Uniform Partnership Act, in the absence of a contrary agreement, gives the following procedure: (i) assets of the partnership—(a) partnership property; (b) contributions of the partners necessary for the payment of liabilities. That the (ii) *liabilities* of the firm, in the order of payment, are (a) those owing to creditors other than partners; (b) those owing to partners other than for capital or profits; (c) those owing to partners for capital; and (d) those owing to partners in respect of profit.[173] The assets are to be applied for such

[169] Creditors are entitled to recover from all partners when discovered including secret and dormant partners though the debt was not originally charged to all and even though one partner holds himself out as sole owner. Schwaegler Company v. Marchesotti (1949) 199 P. 2nd 331, 88 Cal. App. 2nd 738.

[170] See note 146, *supra.*

[171] Rowlev, *Modern Law of Partnership* (1916) I—602-603.

[172] Wallan v. Rankin CA Cal, (1949) 173 F. 2nd 488. Longinotti v. Rhodes, (1949) 220 S.W. 2nd. 812; 215 Ark. 380—where the son of one of the partners was employed to handle disputes of the establishment with any of its patrons, assaulted a patron. Schauder v. Weiss, (1949) 88 N.Y.S. 2nd. 317; 95 N.Y.S. 2nd 914; 276 App. Div. 1022—slander committed by a private detective as a member of a partnership detective agency.

[173] Section 40, Uniform Partnership Act. This provision as well as the pertinent section of the Federal Bankruptcy Act have drawn courts and textwriters into a dialectic controversy regarding the aggregate and entity concepts of partnership. Liberty

payments in the order in which they are stated here. It is further provided that when the partnership assets and the separate properties of the partners are in the possession of the court for distribution, the creditors of the firm shall have priority on the partnership property and the separate creditors on the individual property.[174] Where a partner has become bankrupt or his estate insolvent, the claims against his estate shall be satisfied in the following order: those owing to separate creditors; those owing to partnership creditors; and lastly, those owing to partners by way of contribution.[175]

The above substantive provisions spell out the basis of the partnership section of the Federal Bankruptcy Act.[176] It may be said that as far as the bankruptcy administration of the partnership is concerned, neither the aggregate theory nor the entity theory as traditionally invoked by the courts will supply all the answers to the whole problem of distribution. If at all, any reference to either theory would be in different contexts and for the different purposes. Both the firm and the members have separate assets and separate creditors. For this purpose, the bankruptcy statute prescribes that separate accounts should be kept in a situation where both the firm and the partners are joined in the same proceeding.[177]

National Bank v. Bear, (1929) 276 U.S. 215—adjudication of the partnership as entity does not carry with it as an incident the bankruptcy of the partners against whom no petition is filed. Silberfield v. Lewis, (1948) 79 N.Y.S. 2nd. 380, 273 App. Div. 686—for purposes of marshalling assets equity regards partnership as a legal entity apart from its members. Rasmussen v. Trico Feed Mills, (1948) 29 N.W. 2nd. 641.

Compare: Francis v. McNeal (1913) 228 U.S. 695.

See: McLaunghlin, *Aspects of the Chandler Act to Amend the Bankruptcy Act,* (1937) 4 U. of Chi. L. Rev. 369. Shroder, *Distribution of Assets of Bankrupt Partnerships and Partners,* (1905) 18 Harv. L. Rev. 495. Hough, *Some Aspects of Partnership Bankruptcy under the Act of 1898* (1908), 8 Col. L. Rev. 599.

In the case of limited partnerships, the order of payment of liabilities would be: Cliams of third persons not partners; claims of limited partners for profits and return of capital; similar claims of general partners—Section 23, 17(4), Uniform Limited Partnership Act. Advances made by limited partners other than capital contributions are treated like an ordinary creditor's claim. White v. Hackett, (1859) 20 N.Y. 178; Denning's Appeal 44 Pa. 150 (1863).

[174] Section 40 (h), Uniform Partnership Act.

[175] Section 40 (i), id. Rogers v. Miranda, (1857) Ohio St. 17 "No better justification can be found for it than that it is a balanced symmetry and impresses one as being equitable. It is logically indefensible, in that it deprives the partnership creditor of his legal rights against the separate property of the partners at the very time when he needs them. In its practical application, however, its hardship may be avoided by the partnership creditor, upon extending credit to the firm, by insisting on an additional separate obligation of the individual partner whch will enable him to make double proof." Crane, supra, 420-422. See Shroder, supra. at 504; Brannan, The Separate Estates of Non-Bankrupt Partners under the Bankruptcy Act 1898 (1907), 20 Harv. L. Rev. 589, 592—firm creditors claim on individual assets stronger than separate creditor's claim firm assets, and the two classes should not be put on par.

[176] Section 5, 52 Stat. 845, 11 U.S.C. section 23 (supp. 1938).

[177] Section 5 e, 52 Stat. 845, 11 U.S.C. section 23 (supp. 1938).

It is likewise provided that the net proceeds of the partnership assets shall be appropriated to the payment of the partnership obligations while the net proceeds of the individual estate of the partners shall be used for the payment of their separate creditors.[178] Quite obviously, both the partners' and the firm's assets bear such a close relation that to explain the various problems relating to the bankruptcy and liquidation of insolvent partnerships in terms of either the separate or the entity concept alone would not be altogether meaningful.

The individual partners, and evidently their separate creditors, have no direct claim against the assets of the partnership but only on any surplus left after the settlement of firm liabilities.[179] The individual partners, to be sure, are directly answerable for the obligations of the firm, and such financial responsibility is not made any less by the rule that their separate property should be disposable first in favor of their personal creditors. In the last analysis, the balance of the separate estate of the partners after the satisfaction of the separate creditors would be available to meet the claims of partnership creditors, and in that sense, really a part of the firm's assets and may well be within the direct power of the *firm* trustee in bankruptcy to administer and liquidate.[180] In that respect a separate adjudication of the individual partners would appear to be merely formalistic.[181] If that conclusion is correct, it would follow that by the administration of both the firm and individual assets, the partners would be entitled to a discharge from the partnership obligation even in the absence of prior adjudication of the partners, the provisions of section 5 of the Bankruptcy Act to the contrary notwithstanding.[182]

The rules regarding distribution and priority when carried through a bankruptcy proceeding may well take a uniform and less confusing application if the courts would avoid any involved discussion of the doctrinal separateness of the firm. Justice Holmes observed: "Adjudication against the partnership must be based on the allegation and proof that the assets of its members, in excess of their individual debts, plus the assets of the partnership are insufficient to pay the partnership debts. Otherwise, there is no partnership insolvency notwithstanding the entity doctrine * * * (and when) the partnership and the individual estates together are not enough to pay the partnership debts, the rational thing to do, and one certainly not forbidden by the act" is to authorize the trustee to liquidate both firm and separate assets.[183] Certain unfair results springing from such theoretic separateness [184] could probably be eli-

[178] Section 5 g, id.

[179] Sections 22-28, Uniform Partnership Act. Crane, supra, at 158-160.

[180] In re Sugar Valley Gin Co. (N.D. 1923) 292 Fed. 508.

[181] But see: *Section 5 (j), 52 Stat. 845; 11 U.S.C. Section 23 (j), (supp. 1938)*, Library National Bank v. Bear, *supra, loc. cit.*, note 173.

[182] *Collier on Bankruptcy* (4th ed. 1940) section 5. 15. Comments: *(1929) 29 Col. L. Rev. 1134.*

[183] Francis v. Neal, loc. cit. at note 176, *supra.* Section 5, 52 Stat. 845; 11 U.S.C. sec. 23.

[184] Note 173, *supra.*

minated and the underlying preference respecting the whole process of distribution and priorities, namely, an efficient and inexpensive administration of the assets involved which shall insure for the creditors a satisfactory method of settlement, and for the debtor an ample opportunity for a new start, constantly projected and implemented.

vi. Conclusion

The foregoing general survey is intended merely to bring to the focus of attention such substantive problems involved in the partnership relation are as thought to be requiring continuing attempts at clarification. Describing the whole trend of the law of unincorporated organizations, of which the partnership is one, it has been said that this type of business associations, "with the exception of the almost negligible limited partnership, are formed by agreements and are dealt with by courts on common-law principles without important statutory modifications * * * (and) viewing the subject as a whole, it may fairly be said that although some important new problems have arisen, substantial changes in traditional doctrines have been few." [185] Of such traditional doctrines the so-called aggregate and entity concepts have continued to plague both courts and counsel. Their continuous employment in various partnership problems simply do becloud the issues and produce differing conclusions.[186] If in lieu thereof a problem on hand is worked out on its own merits, locating who the parties are—participants *inter se* or as involving third persons—what claims they assert, and their determinations expressed in terms of what relevant policy objectives deserve implementation, much of the existing confusion could probably be avoided.

A further generalization may be hazarded. Most of the recurring disputes involved in this branch of commercial law turn for their solution to the basic issue whether a given situation has resulted or not in the existence of a partnership relation. The problem comes about in various factual situations which may be roughly grouped into: *first,* where an individual by reason of some interest in a group enterprise is being sought to bear the usual risks of the

[185] Dodd, *supra.* at 262.

[186] Williston, *The Uniform Partnership Act and Some Remarks on other Uniform Laws,* (1915) 65 U. of Pa. L. Rev. 196-207: "There is perhaps no considerable subject in the law in which a single fundamental, but dispute principle makes so marked a difference in conclusions reached as in the case of the law of partnership. Very many of the troublesome problems involved in that branch of the law depend for their answer on whether what is called the entity theory of partnership, or the so-called aggregate theory is adopted." See also, Ballantine, *Adoption of the Uniform Partnership Act in California* (1929), 17 Cal. L. Rev. 623, 625.

Compare: Smith, *Legal Personality* (1928), 37 Yale L. J. 283—"The entity conception or theory of partnership as a legal person is hardly to be regarded as a sure and easy tool or solvent for the working out of all the various problems of partnership law. The conception is a convenient formula or metaphor to express a result of separation or insulation of group affairs, so far as it goes. But the various problems arising as to how much separation there will be in bankruptcy or in other situations must be worked out on their own merits."

partnership relation; *second,* where those who combined their investments through what ostensibly is a different form of business organization find themselves liable as if they are members of an ordinary partnership; and *third,* in situations where the community is asserting its claim through, for example, its power of taxation. It is obvious that the problems posed are to be dealt with in differing contexts. This indicates plainly the fallacy of the view that any of the so-called doctrinal tests, or even perhaps a combination of them, could serve as definite and conclusive guides which may well enhance the cause of clarity and predictability. In sum, an approach carried along some objective standards and having as a frame of reference clarified policy considerations would probably be a more helpful alternative.

It is to be noted finally that the partnership organization has one distinct advantage. Because it is freer from statutory regulations, it is in that sense more flexible than the corporate device and lends itself readily to modifications in the interest of profitability and efficiency. What modifications of the usual partnership norms, or in general, what partnership agreements would best serve the needs of the business men, would require of counsel an acquaintance with the basic aspects of the partnership relation. In this specific instance again, the profession bears as well the whole burden of clarification as the manipulation of sound alternatives for rational action.