THE DYSFUNCTIONAL FAMILY LIMITED PARTNERSHIP: LITIGATION ISSUES RELATING TO FAMILY LIMITED PARTNERSHIPS

PRESENTED BY:

JACK W. LAWTER, JR.
Lawter & Lawter, L.L.P.
5615 Kirby, Suite 930
Houston, Texas 77005
(713) 522-9400

WRITTEN BY:

JACK W. LAWTER, JR.
DIANNE W. LAWTER
Lawter & Lawter, L.L.P.
5615 Kirby, Suite 930
Houston, Texas 77005
(713) 522-9400

14th Annual Wills & Probate Institute: Focus on the Fundamentals

Houston, Texas
September 14-15, 2000

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BY: JACK W. LAWTER, JR. AND DIANNE W. LAWTER
LAWTER & LAWTER, LLP

I. Introduction

When bank robber, Willie Sutton, was captured, he was asked, "Why do you rob banks?" Willie answered, "That's where the money is."

The location of the money is also the driving force behind a recent increase in litigation relating to family limited partnerships. This trend will likely continue as long as wealthy people can reduce transfer taxes by creating a family limited partnership.

The family limited partnership is one of the most effective and useful estate planning tools. More and more wealthy clients are creating limited partnerships as more estate planning lawyers include the family limited partnership as a part of their recommended estate planning devices. In a happy family, a limited partnership can be great. However, we do not yet know all of the potential problems which can arise when a family limited partnership is used in an unhappy or litigious family. The authors believe that the family limited partnership can be used as a tool to prevent litigation if careful thought is given to the structure at the beginning.

As family limited partnerships become more common and more wealth is transferred to these entities, more litigation will arise relating to these entities. For instance, a savvy, unscrupulous person may use undue influence or duress to force an elderly person to sign a family limited partnership instead of a will. Many of the protections built into the probate code and the law of wills do not exist with regard to a partnership agreement.

When a family limited partnership is used, instead of suing a negligent executor or trustee, "beneficiaries" will be bringing suit against their general partner. Often when a family limited partnership is created, the executor of an estate is holding little except a partnership interest. Many times, problems in the family will be exacerbated if one person is given broad management authority after the death or incapacity of the patriarch or matriarch. We will review the current status of Texas law regarding suits against a general partner and actions to set aside or terminate partnership agreements.

The driving force behind the move to family limited partnerships is the possibility of substantial transfer tax savings. In this environment, fiduciaries such as guardians, trustees, agents and executors will want to form family limited partnerships. We will explore the issues relating to the creation of a family limited partnership by a person who is serving as a fiduciary.

As more family limited partnerships are created by wealthy individuals, more family litigation will move to the partnership arena. We will attempt to address the issues that are likely to arise and attempt to make suggestions to avoid some of the problems. Except in passing, this outline does not deal with tax issues relating to family limited partnerships or related tax litigation. This presentation deals with Texas state law issues which may arise in connection with a family limited partnership.

II. Financial Advantages of Family Limited Partnerships

A client can obtain numerous advantages by creating a family limited partnership. Of course, the primary advantage is transfer tax savings. However, additional benefits can be derived from a family limited partnership. The following comprehensive list of financial advantages of a family limited partnership unrelated to transfer tax savings was set forth by S. Stacy Eastland in his outline "The Art of Making Uncle Sam Your Assignee Instead of your Senior Partner: The Use of Partnerships in Estate Planning":[1]

A. The ability to transfer capital without killing the transferee's productivity and initiative.

Many successful clients fear that substantial gifts to descendants may hinder their productivity and initiative. In particular, clients with a substantial portfolio of stocks and bonds believe that giving a child or grandchild a readily marketable asset would not be doing that child any developmental favors. Most clients believe that no one understands their children better than they do. By creating a family limited partnership and transferring only a limited partnership interest to a descendant, a donor controls the marketability of the wealth transferred because the interest effectively cannot be sold and because the donor can reinvest the partnership's cash flow rather than making distributions to the partners. This retained, indirect power to affect the marketability of the transferred partnership interest does not subject the transferred interest to estate taxes on the donor's death.[2] By contrast, a retained power as trustee to determine the amount of distributions to trust beneficiaries may subject the trust assets to estate tax on the donor's death

B. The pooling of partnership assets will lower operating costs and increase diversity.

Families often have many members, and often several trusts have been created over time in conjunction with prior gifts. Keeping up with investments for multiple parties can be frustrating and expensive. By consolidating assets into one partnership, however, these problems over the long term are solved. It is easier and cheaper for a partnership to diversify investments because the size of the portfolio is larger. Likewise, it is easier and cheaper to diversify across several money managers because larger accounts generally are less expensive on a percentage basis and because minimum size requirements are more easily met. This is why unrelated individuals have used the partnership form of ownership for their

[1] The authors wish to express their appreciation to S. Stacy Eastland and John W. Porter of Baker & Botts, L.L.P. for their assistance and permission to use their descriptions of the financial advantages of a family limited partnership. For an excellent outline on tax court litigation relating to family limited partnerships, see "Defending the Family Limited Partnership: Litigation Perspective" by John W. Porter presented to the Dallas Estate Planning Council on September 9, 1999.

[2] *See United States v. Byrum*, 408 U.S. 125, 92 S.Ct. 2382, 33 Led. 2d 238, 30 A.F.T.R.2d 72-5811, 72-2 USTC P. 12, 859 (U.S. Ohio, 1972). The Service held in Tech. Adv. Mem. 91-31-006 (Apr. 30, 1991), citing Byrum, that in a typical family limited partnership, the managing partner will not be considered as having retained an I.R.C. §2036(a)(2) or I.R.C. §2038 power over the transferred limited partnership interest. *See also* Rev. Rul. 81-15, 1981-1 C.B. 457; P.L.R. 94-15-007 (Jan. 12, 1994); P.L.R. 93-10-039 (Dec. 16, 1992), and P.L.R. 90-26-021 (Mar. 26, 1990); G.C.M. 38,984 (May 6, 1983); G.C.M. 38,375 (May 12, 1980).

investment clubs.[3] Related individuals also like forming "investment clubs". Thus, over time, the pooling of assets will lead to greater value and wealth for all of the partners. When the partners decide to terminate the partnership agreement because of asset diversity and cheaper per-unit operating costs, a significant comparative advantage could exist for each partner in comparison to their situation if they had not pooled their assets. For investors who are not concerned with short-term lack of control and marketability, and who wish to realize long-term growth of their assets for themselves and their family, the family partnership is an excellent institutional tool.

C. Simplify annual giving.

Many assets are extremely difficult to value and are not prone to gifts of undivided fractional interests. Good examples of such assets are rural land and closely held unincorporated businesses. Contributing those assets to a family limited partnership, however, allows a donor to assign partnership interest to a descendant with the use of a simple form. A fractional interest is given away, yet there is no immediate risk of partition, and management of the asset remains consolidated. If a client wishes to transfer part of his limited partnership to his issue, it generally will qualify for the annual exclusion.[4]

D. Keep assets in the family.

Family partnership agreements often are drafted with certain buy-sell provisions to ensure that the partnership's assets will stay in the family. Under such provisions, if any partner attempts to assign his or her interest in the partnership to a person outside of the family, the other partners or the partnership itself may acquire that interest on the same terms, or, in the case of a gratuitous transfer, at its fair market value. Secondly, even without buy-sell provisions, no outsider can have any rights as a partner unless all of the partners admit that outsider as a partner (and can only be an assignee with limited distribution rights).

E. Provide some protection against future unforeseeable creditors.

A family partnership can be a flexible vehicle to provide some protection of an individual's assets from future creditors. The principal remedy of a partner's "outside" creditors, as distinguished from the partnership's "inside" creditors, is to receive a "charging order" against the partner's interest in the partnership. Under many states' limited partnership laws, unless a partner has made a fraudulent conveyance to the partnership or a conveyance deemed to be fraudulent, his or her creditors cannot reach the partnership's assets. Instead, a creditor may obtain a charging order against the partner's interest in the partnership, which does not give the creditor any management rights but entitles the creditor only to the partner's share of partnership distributions (i.e., an assignee's interest). In addition, the partnership agreement can be drafted so that an involuntary transfer of a partnership interest to a creditor or any other third party triggers buy-sell provisions which allow the other partners or the partnership itself to purchase that interest at its fair market value. Since the fair market value of a limited partnership interest is usually much less than the underlying asset value the creditor effectively is paid with less money, and the family assets are more likely

[3] *See* Rev. Rul. 75-523, 1975-2 C.B. 257; Rev. Rul. 75-525, 1975-2 C.B. 350.

[4] *See* Tech. Adv. Mem. 91-31-006 (Apr. 30, 1991). *But see* Tech. Adv. Mem. 97-51-003 (August 28, 1997).

to survive the creditor's claims. Furthermore, partnership agreements can be drafted to prohibit the pledging of partnership interests for the debts of a partner.

F. Protect assets against failed marriages.

The risk of a gift to a descendant being awarded to his or her spouse upon divorce can affect an estate plan, and prenuptial or postnuptial agreements may be distasteful or impractical in many situations. In particular, stocks and bonds are very prone to being commingled with assets of the marriage and in community property states effectively might become community property. Limited partnership agreements, however, can be drafted so that gifts of limited partnership interests are protected from the risk of divorce. Many jurisdictions will not award separate property to a divorced spouse or will limit that award. A partnership provides a convenient means of segregating a descendant's separate property so that commingling is avoided. In addition, a partnership agreement can provide that an involuntary transfer of a partnership interest required by a divorce court will trigger buy-sell provisions under which the other partners or the divorced partner can buy that interest at its fair market value. Because the fair market value of the limited partnership interest is usually less than the underlying asset values, a divorced partner is protected even if a court awards his or her interest to a former spouse.

G. Partnership agreements are flexible.

In comparison to an irrevocable, unamendable trust, a limited partnership is a very flexible arrangement. If all of the partners agree, the partnership agreement may be amended or the partnership may be terminated, and usually all of the partners are family members. By contrast, an irrevocable trust generally may not be amended or terminated without court participation and participation by a guardian or an attorney ad litem for certain beneficiaries. As compared to corporations, a partnership requires fewer formalities and may be terminated without the potential adverse tax consequences associated with the termination of a corporation.

H. Business judgment rule offers flexibility in management.

The "prudent man" rule applicable to trustees is a stricter standard than the business judgment rule applicable to the managing partners of a partnership.[5] Many financial investments, such as options and commodities, and many business decisions, such as wildcat oil drilling, may be reasonable in terms of normal business judgment but could be considered imprudent under trust law. Most families want to protect the family member who is charged with the responsibility of making investment decisions. In particular, families often want that family member to be protected from the "20/20 hindsight" of a court or jury.

I. Arbitrate family disputes rather than litigate.

Recent history is replete with examples of highly publicized intrafamily litigation involving the management of family assets. It is extremely difficult to replace a trust beneficiary's right to sue his trustee with a commitment to binding arbitration: the state law right of a beneficiary to sue his or her trustee in many jurisdictions may not be removed by a trust agreement. Because a partnership agreement is a mere contract,

[5] Although the partnership agreement can provide that the business judgment rule is applicable, case law applies a higher standard. *See* Section VII Suing or Defending the General Partner of a Family Limited Partnership, *Supra*.

however, it can be written so that all of the partners agree to settle disputes by arbitration. When compared to a jury trial, arbitration is usually preferable especially in the family context. The publicity associated with family disputes can provide an unfair advantage to the person bringing a lawsuit against the family's decision maker. With a well-drafted partnership agreement, such publicity can be avoided through the arbitration process and enforced by a confidentiality provision. In addition, an experienced business person or financial advisor may serve as arbitrator and fact finder. Thus, where the client determines there is an advantage to arbitration, the partnership vehicle is clearly superior to the use of a trust in many jurisdictions.

J. Apply the "English" rule to disputes (loser pays).

Under the trust law, frivolous actions can be difficult to prevent and may be brought by beneficiaries just to provoke a resignation or distribution by the trustee. It is difficult to charge a trust beneficiary with the costs associated with a legal action. Furthermore, even though a trustee may be reimbursed for legal costs out of the trust's properties, the other beneficiaries of the trust suffer because of that reimbursement. By contrast, a partnership agreement can require a partner who brings an unsuccessful arbitration action against the management of the partnership to pay all of the costs associated with the arbitration. Thus, a family limited partnership more easily avoids frivolous claims and harassment actions.

K. Institutionalize communication on financial matters.

One of the more enjoyable aspects of a family limited partnership is that it can serve to institutionalize the education of younger family members on the family's wealth management philosophies. Many people see nothing wrong with wealth *per se*, but fear that it can be abused and therefore want to oversee the financial experiences of younger family members. In addition, prudent investment can generate employment and serve other altruistic purposes. The collectivism provided by a partnership agreement institutionalizes this educational process.

L. Lower out-of-state probate costs.

Many people in our mobile society own passive real estate investments, including vacation property, outside of their home state. Contributing that property to a family limited partnership avoids the costs associated with out-of-state probate of those assets. Also, if the home state jurisdiction does not have a basic inheritance tax, the basic inheritance tax of the ancillary jurisdiction may be avoided in certain instances through the use of a family limited partnership.

M. Indirectly allow trustee partners to follow modern portfolio theory.

A trustee may have difficulty following modern portfolio theory because there is a natural conflict between the investment philosophies of income beneficiaries, who prefer current income to growth, and remainder beneficiaries, who prefer growth to current income. In general, modern portfolio or asset allocation theory teaches that rational investors should seek to achieve the highest rate of return consistent with their tolerance for risk, *from whatever source.* For example, sometimes stocks, may be preferred to bonds, and at other times the reverse is true. One type of trust, known as a "unitrust", pays current beneficiaries a percentage of the value of the unitrust's assets, thus allowing the trustee to follow modern portfolio theory; however most trusts are not unitrusts. A limited partnership, on the other hand, can serve as a "wrapper" around family assets and allow those assets to be managed like a unitrust. The managing partner can invest in a way that produces the highest rate of return consistent with his or her tolerance for risk, whether the source of that return is appreciated or current income. The managing partner then may distribute the percentage of the partnership's assets that he or she deems appropriate to the current "beneficiaries" (*i.e.,* partners) of the partnership.

N. A partnership has one level of income tax.

Partnerships are "pass through" entities that do not pay income tax. Since the repeal of the General Utilities Doctrine, "C" corporations and business trusts have become very inefficient tax entities because there will always be two levels of income tax, even on unrealized gains.

O. In many jurisdictions there is no franchise tax or intangibles tax to pay with the use of partnerships.

III. Additional Advantages of a Family Limited Partnership When Family Litigation is Expected

A. A temporary administrator or temporary guardian does not control the assets.

Often one of the biggest areas of contention when a will contest is filed is the appointment of a temporary administrator. In many cases, the temporary administrator will have control of all of the assets of the estate. A similar struggle often occurs when a temporary guardianship is instituted. In addition to the possibility of a substantial contest about the identity of the temporary administrator or a temporary guardian, a family also faces the risk that the court will appoint an independent third party to administer the Estate. This often results in substantial fees and management by a person not familiar with the property or business. A family limited partnership holding most or all of the assets of the client will usually avoid the risk that a temporary administrator or temporary guardian will have control of the assets.

B. No court control of assets or management.

If assets are held in a family limited partnership, the court in which an administration or guardianship is pending will not have control over the assets. The family limited partnership can continue to operate without control by the court in most instances. This can be important when litigation is pending because the contestant will not have a venue to express opinions about management of the assets. This should also make it more difficult for the contestant to frustrate his opponent by causing delays in financial decisions or even preventing the implementation of financial decisions by objecting in court.

C. Disclosure is controlled by the partnership agreement.

One of the problems faced by a family business when litigation is pending is the disclosure requirements in a litigation context. Often, contesting beneficiaries will make numerous demands for documents and information. A partnership agreement may be drafted to restrict the information which must be provided to partners. Arguably, non-partners would not be entitled to any information based on an informal request. Obviously, subpoenas and other discovery requests can still be used by litigants, but the partnership agreement should control informal requests for information and may have an impact on the court when it is considering the amount of information which must be produced by a family partnership in discovery and the confidentiality of financial information.

D. The partners can choose their partners.

One of the important aspects of a partnership is that the partners cannot be forced to be partners with someone. Consequently, a contestant or other litigant cannot be assured that victory in family litigation will result in becoming a partner. In fact, litigation with other family members will probably assure that the contestant will never become a partner.

E. Control of the estate does not equate to control of money to fund litigation.

When a client's property has been placed in a family limited partnership, the only asset held in a probate or guardianship estate will be a limited partnership interest. The executor, administrator or guardian will not inherit any general partnership management rights in most instances. Consequently, the representative will not have the power to compel distributions from the partnership. The general partner will continue to have the power to decide when and if any distributions are made.

F. Business cannot be disrupted as easily.

One of the biggest problems when litigation is filed is a disruption of family business and investments. Even a claim which lacks merit can disrupt a family business or a family investment strategy. If all of the family business and investment assets are held in a family limited partnership, the impact of a will contest or other litigation is lessened.

G. Potential contestants can be excluded from ownership of a partnership interest.

A family limited partnership can be drafted to prohibit ownership by potential contestants. The buy-sell provisions could specifically provide for a buy-out of a partnership interest which was assigned to a particular family member. If the partnership agreement is drafted carefully, the agreement can limit or eliminate the upside potential from a contest or other litigation. At the very least, the provision which prohibits ownership by a particular person would cause the contestant to have to set aside the provision in a trial or arbitration.

H. Community property concerns.

The family limited partnership can help keep separate property separate. Commingling of community and separate property is more difficult if separate property is placed in a family limited partnership. The owner of the separate property who contributes such property to a partnership owns a partnership interest rather than the assets contributed to the partnership. It is difficult to imagine how a partnership interest could be commingled with community property. This is in stark contrast to bank accounts and brokerage accounts which almost always become commingled. Partnership income which is not distributed is generally not community property of the partners.

The community or separate nature of each partner's interest in the partnership property depends on the source of the property. If a married partner contributes community property, then the interest is community property. On the other hand, if a married partner contributes separate property, his interest in the partnership is separate property to that extent, and any appreciation in its value as a result of general economic conditions, as distinguished from labor and effort beyond that required for preservation of the separate property, remains separate property. *Smoot v. Smoot*, 568 S.W. 2d 177 (Tex. Civ. App. - Dallas 1978, no writ). In *Roach v. Roach*, 672 S.W.2d 524 (Tex. App. - Amarillo 1984, no writ), the court held that where husband conveyed his separate property to the partnership without expressing any prior or contemporaneous intention that the property would not be the partnerships property, husband and wife, as the only partners, became co-owners of the property holding as tenants in partnership, but their rights in the property were not community property.

I. Removal of general partner is difficult.

One of the tactics frequently used in family litigation is an action to remove an executor, trustee or guardian. A beneficiary of an estate or trust has a substantial advantage in a removal action because of the fiduciary duties owed by the fiduciary. In addition, the Texas probate code provides for recovery of attorneys fees in a removal action. Attorney fees also may be recoverable under the trust code in an action to remove a trustee. To the contrary, in most family limited partnerships, removal of the general partner is difficult. Removal of a general partner by a non-partner would be extremely difficult. In most instances, attorney's fees would not be recoverable in an action which attempted to remove a general partner.

J. Duties are owed only to partners.

If the potential contestant is not a partner (or is a partner with very limited rights), the general partner will owe no duties or limited duties to the potential contestant. One of the difficult aspects of family litigation in an estate, trust or guardianship is that often fiduciary duties are owed to the person bringing the lawsuit. If the contestant is not a partner, no duties will be owed to the contestant, or only duties owed to an assignee of a partnership interest will be owed. The duties owed to an assignee of a partnership interest are limited under state law and can be defined in the partnership agreement and limited even further. An assignee of a partnership interest is generally entitled only to the assignee's share of any distributions if a distribution is made.

K. Becoming executor is not very attractive.

After the death of the patriarch or matriarch of the family, it is often very important to have control of the estate if litigation is probable. However, if all or substantially all of the assets of the estate are held in a family limited partnership, the executorship is not very attractive. In that instance, the executor would own a valuable partnership interest but would have no right to compel distributions. Consequently, the executor would owe a large estate tax and would have no way to fund administration expenses and the estate tax without the cooperation of the general partner or through a sale of the partnership interest. Of course, the other partners are the only realistic purchasers of a partnership interest held by an estate. Thus, the role of executor is not as attractive when the assets are held in a family limited partnership.

L. It is more difficult for a contestant or litigant to force a partition, termination or distribution of partnership assets.

The family limited partnership agreement will control the termination, partition and distribution of the partnership. A contestant cannot effectively bring suit to force a partition or distribution of a limited partnership in most instances. On the other hand, actions can be brought to compel distributions or force a partition of the estates and trusts. In some instances, a complete termination of a trust can be obtained through court action.

M. Arbitration clause with a loser pays provision can reduce the risk of frivolous cases.

As mentioned above, the partnership agreement can be drafted to include a provision requiring arbitration of all disputes related to the partnership. Arbitration clauses are generally enforceable in Texas. *See e.g.*, *Prudential Securities Inc. v. Marshall*, 909 S.W. 2d 896 (Tex. 1995). Because the law of contract applies to a partnership agreement, the courts are likely to enforce the terms of the partnership agreement. A provision which requires the loser to pay all expenses and attorney fees of an arbitration is a large disincentive to any claim which is designed solely to harass the opponent. This provision also tends to make both sides more reasonable on difficult issues because neither party will want to go to an arbitration if a substantial risk exists that he or she will lose and will have to pay all of the costs and fees.

IV. <u>The Family Limited Partnership to Avoid a Will Contest</u>.

A. No Contest Clauses.

A will with a no-contest clause is not a very satisfactory way to avoid family litigation. Courts are extremely reluctant to enforce a forfeiture clause. The provisions are strictly construed. *Sheffield v. Scott*, 662 S.W. 2d 674, 676 (Tex. App. - Houston [14th Dist.] 1983, writ ref'd n.r.e.] The courts create exceptions such as the policy of not enforcing a no-contest clause when a will contest or other litigation is brought in good faith and with just cause. *Calvery v. Calvery*, 55 S.W. 2d 527, 530 (Tex. 1932); *See also, First Methodist Episcopal Church South v. Anderson*, 110 S.W. 2d 1177 (suit was not a contest but good faith/probable cause exception discussed with approval). Furthermore, the clause is only effective in situations in which the contestant has a great deal to lose. Finally, contestants are often able to use various other devices or causes of action to avoid the no-contest clause or to otherwise cause enough trouble and expense to the rest of the family to cause the other members to settle even when the circumstances do not justify a settlement.

B. The use of the family limited partnership as an addition to or alternative to a no-contest clause.

In many situations, the client or the estate planning attorney will know that litigation is likely. For instance, litigation is expected when a wealthy client writes a will under which a child receives substantially less than an equal share or the client excludes his or her children in favor of a second, third or fourth spouse. A better alternative to a will with a no-contest clause may be the use of a family limited partnership. Many of the problems with no contest clauses could be avoided.

1. The case law relating to the strict interpretation of no contest clauses would not be applicable.
2. The reluctance of the courts to enforce a forfeiture provision could be avoided through the use of mandatory binding arbitration in the limited partnership agreement.
3. The upside potential for the contestant can be eliminated through the use of provisions relating to control of the partnership and buy-sell provisions.

C. Structure of the family limited partnership as a substitute for a no-contest

clause.

The following structure could be employed to use a family limited partnership as a substitute for (or addition to) a will with a no contest clause:

1. A family limited partnership would be created holding substantially all of the assets of the client.

2. The client's intended primary beneficiaries would be made class A partners and perhaps general partners along with the client. The class A partners would share in the profits and losses of the partnership and would be entitled to distributions deemed appropriate by the general partner.

3. The partnership agreement would provide that only the intended primary beneficiaries, their descendants and charities could ever own the class A interests in the partnership.

4. The partnership agreement would provide for purchase of any interest assigned to the "contestant" at a substantial discount or even a nominal price. Alternatively, the partnership could provide that any attempt to transfer or assign an interest (voluntary or involuntary) to the "contestant" is void. The provisions would need to provide for a default provision stating that the ownership of any attempted assignment to the contestant would pass to the intended primary beneficiaries or a charity.

5. The contestant would be given a class B partnership interest which would provide for guaranteed payments to the contestant. The guaranteed payments would be conditioned upon no litigation being filed by the contestant. The class B interest would have very limited rights or access to information about the partnership and would have no rights to enforce any of the partnership provisions other than the guaranteed payment. The guaranteed payment could be as large or as small as the client desires but should be enough to cause the contestant to hesitate before he or she sues.

6. The partnership agreement would contain a provision which states the partners intent that no litigation be instituted in any proceeding by any of the limited partners against the partnership, any of the general or limited partners or the estate of any of the partners (including a will contest) and that any partner who files an action forfeits his or her interest. An exception can be made for actions approved by the general partners or approved by all partners.

7. The partnership agreement would provide for binding arbitration of any disputes.

8. The partnership agreement would provide that the loser pays the attorneys fees relating to any litigation or arbitration.

D. Example.

Mr. Jones has a $50 million estate and is interested in a family limited partnership. Mr. Jones has two sons, his favorite son, Goldenboy Jones, and his other son, Blacksheep Jones. Mr. Jones would like to leave all or substantially all of his estate to Goldenboy Jones, but he is fearful that his other son, Blacksheep, will sue after his death and will cause a great deal of trouble for Goldenboy. Mr. Jones is competent, in good health and is willing to go to great lengths to see that his intentions are followed after his death. Mr. Jones comes to his lawyer, Joe Estateplan, and asks for advice. What should Joe suggest?

Joe suggests a limited partnership with two classes of partnership interests. Mr. Jones contributes all or substantially all of his assets to the partnership. Goldenboy and Mr. Jones acquire all of the class A limited partnership interests in the partnership. The class A limited partners participate in the profits and losses of the partnership. In addition, Mr. Jones and Goldenboy Jones acquire the general partnership interests. Mr. Jones also obtains the class B limited partnership interests in the partnership. The class B interest is a $500,000 interest which pays an 11% return annually by a guaranteed payment as long as the class B interest holder does not bring any suit against the partnership, any of its partners, or a partner's estate (including a will contest). The class B partners are entitled to no information about the partnership business as long as the annual guaranteed payment is made. A small fraction of the class B interest ($10,000 worth) is given to Blacksheep Jones by Mr. Jones when the partnership is formed. The partnership provides that if any class A interest is acquired by Blacksheep, the partnership may redeem the interest for $1.00. The partnership agreement also provides that if any partner brings suit against any other partner, a partner's estate or the partnership, such partner forfeits his share of the partnership and such forfeited share passes to the American Red Cross. Mr. Jones also writes a will with a no contest clause which leaves all of his general partnership interest and Class A interest to Goldenboy and his Class B interest to Blacksheep. The partnership agreement also provides for arbitration of any disputes and provides that the loser pays the cost of the proceeding and all attorney's fees. Finally the partnership agreement provides that an assignee of a partner can never be admitted to the partnership without the unanimous consent of all class A partners.

This structure should allow Goldenboy to control the partnership after Mr. Jones' death and should help prevent a will contest or other litigation by Blacksheep. If Blacksheep were to prevail in a will contest or other litigation and be in a position to acquire an interest in either a general partnership or class A interest, the provisions of the partnership would allow Goldenboy to enforce a forfeiture of Blacksheep's share of the partnership. The partnership agreement would allow the partnership to acquire any interest which would pass to Blacksheep for $1.00. The default provision on the class B interest to the American Red Cross will help make the forfeiture provision more palatable and would help avoid any adverse income tax consequences from the forfeiture. The law of contract should control rather than the law of wills. In addition, Goldenboy may be able to force Blacksheep to arbitrate any dispute with the threat of having to pay the winner's attorneys' fees. If Blacksheep accepts the gift of the class B interest, Goldenboy should be able to assert an estoppel has arisen against Blacksheep as to the validity of the partnership. This arrangement has an additional benefit for Goldenboy because the provisions in the partnership agreement designed to prevent litigation are an excellent non-tax business reason for the existence of the partnership. This should assist Goldenboy on an estate tax audit.

Query: Would Blacksheep have to face most of the obstacles set forth above if Mr. Jones was not healthy and competent and thought he was John Hancock signing the Declaration of Independence when the limited partnership agreement was executed? The answer should be no, but as a practical matter, it is likely that a court or arbitrator will enforce a partnership agreement until it is set aside. The risk of abuse is substantial. However, to borrow from the NRA, partnerships don't abuse people, people do.

V. The Family Limited Partnership as a Substitute for a Prenuptial Agreement.

A. Prenuptial Agreements are Difficult to Use.

Although a valid prenuptial agreement can be prepared, the agreements are difficult to use and difficult to enforce. Many clients will not approach their future spouse about a prenuptial agreement. The entire subject is not very romantic. In addition, to be enforceable, both future spouses need to be represented by counsel and the negotiations may get the marriage off to a bad start. Sometimes the parties cannot reach an agreement but get married anyway. Finally, courts are reluctant to enforce prenuptial agreements and a substantial risk always exists that an agreement will not be enforced. The spouse whose rights are limited by the prenuptial agreement often will be able to assert misrepresentation, duress or coercion as grounds to set aside the prenuptial agreement.

B. A Family Limited Partnership As a Substitute for a Prenuptial Agreement.

A family limited partnership created prior to marriage can serve many of the purposes of a prenuptial agreement. Clearly, any property contributed to a partnership prior to marriage is separate property. Consequently, the partnership interest received in exchange for the contribution of assets to the partnership is separate property. Property held in a partnership is partnership property rather than the property of any individual partner. The entity nature of a limited partnership is now well established. *See Haney v. Fenley, Bate, Deaton and Porter*, 618 S.W. 2d 541 (Tex. 1981) and comments to Texas Revised Limited Partnership Act, Art. 6132a-1. Consequently, the partnership property cannot become community property of any partner by adding income earned to a partnership account or investing or reinvesting any of the funds.

Commingling of bank accounts and brokerage accounts should not be a problem in most cases. The spouse who contributes to the partnership will own only a partnership interest which cannot be commingled with community property. The banking and brokerage activities of the partnership will have no effect on the community property of the partners.

If the partner spouse receives a reasonable salary for any time he or she spends on the partnership business and business formalities are generally followed, the partnership interest should remain the separate property of the partner spouse. In most instances, this would include any retained income and appreciation in the partnership during marriage. The use of a family limited partnership should keep separate property separate, avoid the most common commingling issues, provide a vehicle for management of partnership property and provide a vehicle to make testamentary gifts to a spouse without damaging the family business.

C. Example.

Mr. Stooge is 65 years old, single, healthy, competent and the owner of a $50 million estate made up primarily of marketable securities. Mr. Stooge has three sons from a previous marriage, Mo, Larry and Curly. Mr. Stooge comes in to visit his attorney Joe Estateplan and tells Joe that he plans to get married soon to a twenty-five year old exotic dancer known as Boom Boom

Johnson. Mr. Stooge is in love, but realizes that the marriage may not work. He is also concerned that Boom Boom may not get along very well with Mo, Larry and Curly. Mr. Stooge does not want to approach his bride-to-be about a prenuptial agreement and does not believe that Boom Boom would agree to a prenuptial agreement anyway. What should Joe suggest?

Joe Estateplan could suggest the creation of a family limited partnership with Mo, Larry and Curly. The partnership would be created and completely funded prior to marriage with all of Mr. Stooge's assets except his homestead. The partnership agreement would provide for Mr. Stooge to be the general partner and Mr. Stooge and his sons the class A limited partners. The class A limited partners would share in all profits or losses of the partnership. The partnership agreement would provide that no person could be admitted as a Class A limited partner or general partner without the approval of all Class A limited partners. A class B limited partnership interest also would be created with $5 million of capital and held by Mr. Stooge. The Class B interest would entitle the holder to a guaranteed payment of 9% per year and would have very limited rights to information about the partnership.

Joe advises Mr. Stooge that this plan will avoid the risk of commingling his separate property investments with community property. This will also assure that his investments will be controlled by his sons after his death. The Class B interest will provide Mr. Stooge and Boom Boom with cash flow during marriage and if the marriage works Mr. Stooge can use the Class B interest to provide for his spouse in his will without having to give her any management authority. If Mr. Stooge continues to be concerned about disputes between Boom Boom and Mo, Larry and Curly, he can draft a widow's election will which would require Boom Boom to elect between a gift of the Class B partnership interest and her community property rights.

If the marriage does not work, the limited partnership should insulate the partnership assets from community property claims by Boom Boom. Separate property is clearly identified and cannot be commingled if the partnership is run properly. The guaranteed payment to Mr. Stooge on the Class B interest should avoid any claims that he has not been properly compensated for his time, toil and talent. Although all of the risks of divorce are not eliminated, Mr. Stooge has reduced his risks of a disastrous result.

VI. <u>Challenging or Defending the Validity of the Creation of a Family Limited Partnership</u>

A. Mental Capacity.

With the more frequent use of a partnership to reduce transfer taxes, more elderly people are forming limited partnerships. Traditionally, people in their seventies or eighties would not be forming many new business ventures, but in today's world, an elderly person is the most likely candidate for a family limited partnership. The law of contracts applies to the creation of a partnership. *Park Cities Corp. v. Byrd*, 534 S.W. 2d 668, 672 (Tex. 1976). Consequently, a partner must have the capacity necessary to enter into a contract in order to form a valid partnership. A party has mental capacity to contract if he appreciates the effect of what he is doing and understand the nature and consequences of the acts and business being transacted. *Mandell and Wright v. Thomas*, 441 S.W. 2d 841 (Tex. 1969).

B. Undue Influence.

A contract, including a partnership

agreement, may be set aside because of undue influence. Undue influence in the execution of an instrument is present when dominion and control is exercised over the mind of the person executing the instrument, under facts and circumstances then existing, to overcome his free agency and free will and to substitute the will of another so as to cause him to do what he would not otherwise have done but for such dominion or control. *Seymour v. American Engine & Grinding Co.*, 956 S.W. 2d 49 (Tex. App. - Houston [14th Dist.] 1996, writ denied); *Bailey v. Arlington Bank & Trust Co.*, 693 S.W. 2d 787 (Tex. App. - Fort Worth 1985, no writ); *B.A.L. v. Edna Gladney Home*, 677 S.W. 2d 826 (Tex. App. - Fort Worth 1984, writ ref'd n.r.e.). "Overreaching" is tricking, outwitting or cheating a person into doing an act he would not have otherwise done. *B.A.L. v. Edna Gladney Home*, supra.

C. Duress.

Duress or coercion are grounds to set aside or rescind a contract. To recover for duress or coercion, a party to a contract must prove that the other party threatened to do some act which it had no right to do, that the threat was of such a character as to destroy the free agency of the other party, that the threat overcame the free agency of the other party and caused the other party to do that which it was not otherwise legally bond to do, that restraint was imminent and that the complaining party had no means of protection. *Tennessee Gas Pipeline Co. v. Lenape Resources Corp.*, 870 S.W.2d 286 (Tex. App. - San Antonio 1993, affirmed in part, reversed in part by, 925 S.W.2d 565 (Tex. 1996)). Duress will invalidate a contract if undue or unjust advantage has been taken of another person's economic distress or necessity to coerce him into making an agreement. *Brown v. Cain Chemical, Inc.*, 837 S.W.2d 239 (Tex. App. - Houston [1st Dist] 1992, writ denied). Intimidation may be sufficient to constitute duress. *Windham v. Alexander, Weston & Poehner, P.C.*, 887 S.W.2d 182 (Tex. App. - Texarkana 1994, writ denied).

D. Fraud and Misrepresentation.

As a general rule a party is not bound by a contract procured by fraud. *Formosa Plastics Corp. U.S.A. v. Presidio Engineers and Contractors, Inc.,* 960 S.W.2d 41, 41 Tex. Sup. Ct. J. 289 (Tex. 1998). The legal duty not to fraudulently procure a contract is separate and independent from the duties established by the contract. *Id.* The law is well settled that a person who has been induced to enter into a contract because of misrepresentations or concealments of material facts to his detriment, upon the discovery of the fraud perpetrated upon him, has a choice of two remedies: 1) he may affirm the contract and sue for his damages; or 2) he may rescind the contract. *Dallas Farm Machinery Co. v. Reaves*, 158 Tex. 1,207 S.W. 2d 233 (1957).

E. Mistake.

A mutual mistake of fact will allow rescission of a contract. A partnership agreement, like any other agreement or relationship, may be rescinded when proper grounds exist. *Volpe v. Schlobohn*, 614 S.W. 2d 615 (Tex. Civ. App. - Texarkana 1981, no writ). When parties to an agreement have contracted under a misconception or ignorance of a material fact, the agreement will be avoided. *Williams v. Glash*, 789 S.W.2d 261 (Tex. 1990). A mistake of law does not relieve a party to a contract from being bound by its terms. *Oak Hills Properties v. Saga Restaurants, Inc.*, 940 S.W.2d 243 (Tex. App. - San Antonio 1997, no writ). A unilateral mistake of fact will usually not be sufficient to set aside a contract unless the party complaining can show that the mistake was of such great consequence that to enforce the contract would be unconscionable; the mistake related to a material feature of the contract; mistake was made regardless of exercise of ordinary care and parties can be returned to status quo such that rescission of the contract would not result in prejudice to the other party except for the loss of the bargain. *Seymour v. American Engine & Grinding Co.*, 956 S.W.2d 49 (Tex. App. - Houston [14th Dist.] 1996, writ denied).

F. Agreement is Too Complicated to Understand.

Family limited partnerships used in estate planning are extremely complicated, sophisticated documents. It is likely that parties will attempt to question whether the partners (particularly elderly partners) understand the agreement. The law does not favor this attack on a contract. A person is presumed to know and understand the contents of a contract. *R. Conrad Moore & Associates, Inc. v. Lerma*, 946 S.W.2d 90 (Tex. App. - El Paso 1997, writ denied). Even failure to read the contract is not grounds for avoiding the contract. *Estes v. Republic Nat. Bank of Dallas*, 462 S.W.2d 273 (Tex. 1970). It appears that the complexity of the agreement cannot provide a defense unless it is combined with a more traditional defense such as lack of mental capacity or fraud.

G. Comparison with Will Contest.

1. No witnesses required for a partnership agreement.

2. Testamentary capacity is a slightly lower level than the capacity required to enter into a contract.

3. The burden of proof is on the party seeking to set aside the partnership agreement (the plaintiff) on all issues. In a will contest before a will has been admitted to probate, the proponent of the will has the burden on capacity and lack of revocation.

4. Few formalities are required for a partnership agreement to be valid.

5. Undue influence and duress claims are similar in a will contest and an attack on a partnership.

6. Fraud claims are similar in a will contest and an attack on a partnership. However, fraud and misrepresentation claims may arise more often in a partnership context because the transaction involves business matters and mutual promises.

7. Registration with the state is required for a limited partnership and is a public record. *See* Article 2 of the Texas Revised Limited Partnership Act. Tex. Rev. Civ. Stat. Ann. art. 6132a-1 (Vernon Supp. 1999). A will is a private document (often privileged) document until submitted for probate.

8. Estoppel is available as a defense in both types of action. A person who accepts a partnership interest or benefits from a partnership interest is estopped to challenge the validity of the partnership. *Adams v. Petrade, Intern., Inc.* 754 S.W. 2d 696 (Tex. App. - Houston [1st Dist.] 1988, writ denied). A similar defense is available in a will contest.

VII. Suing or Defending the General Partner of a Family Limited Partnership

A. Texas Revised Limited Partnership Act §4.03

Sec. 4.03. (a) Except as provided by this Act or a partnership agreement, a general partner of a limited partnership has the rights and powers and is subject to the restrictions of a partner in a partnership without limited partners.

(b) Except as provided by this Act, a general partner of a limited partnership has the liabilities of a partner in a partnership without limited partners to persons other than the partnership and the other partners. Except as provided by this Act or in the partnership agreement, a general partner of a limited partnership has the liabilities of a partner in a partnership without limited partners to the partnership and to the other partners.

Tex. Rev. Civ. Stat. Ann. art. 6132a-1 Sec. 4.03 (Vernon Supp. 1999)

B. Duties of General Partner

Although changes have been made to the Texas Revised Partnership Act in recent years, it appears that the courts will continue to treat the relationships between the partners of a partnership as a relationship in the nature of a fiduciary relationship. *M.R. Champion, Inc. v. Mizell*, 904 S.W.2d 617, 618 (Tex. 1995). Traditionally, in a limited partnership, the general partner acting in complete control stands in the same fiduciary capacity to limited partners as a trustee stands to beneficiaries of a trust. *McLendon v. McLendon*, 862 S.W.2d 662, 676 (Tex. App., - Dallas 1993, writ denied). A managing partner of a general partnership owes his co-partners the highest fiduciary duty recognized by law. *Huffington v. Upchurch*, 532 S.W.2d 576, 579 (Tex. 1976). Partners owe to each other a fiduciary duty of (1) full disclosure of all matters affecting partnership, (2) accounting for all partnership profits and property, i.e. refraining from self-dealing, and (3) refraining from competition with partnership. *Hawthorne v. Guenther*, 917 S.W. 2d 924 (Tex. App. - Beaumont 1996, writ denied). It appears that the courts will continue to treat the relationships between partners as something like a fiduciary relationship in the absence of a provision in the partnership agreement.

C. Mismanagement.

A managing partner has a duty to administer the partnership affairs solely for the benefit of the partnership. *Crenshaw v. Swenson,* 611 S.W. 2d 886, 890 (Tex. Civ. App. - Austin 1980, writ ref'd n.r.e.). Included in the fiduciary duty which the trustee (general partner) owes to the beneficiaries (limited partners) is the duty of loyalty. Not only is it his duty to administer the partnership affairs solely for the benefit of the partnership, he is not permitted to place himself in a position where it would be for his own benefit to violate this duty. Scott, Trusts (3d Ed.) Sec. 170; *Southern Trust & Mortgage Co. v. Daniel*, 143 Tex. 321, 184 S.W.2d 465 (Tex. 1944).

In *Watson v. Limited Partners of WCKT, Ltd.*; 570 S.W.2d 179 (Tex. Civ. App. - Austin 1978, writ ref'd n.r.e.) the limited partners brought an action against the general partner to recover their capital investment on the theory that the general partner breached his fiduciary duties by failing to properly manage partnership affairs. The court rendered judgment that the limited partners recover the amount of their contributions to capital, together with interest, from the general partner because the general partner failed to manage the affairs as a fiduciary resulting in loss of the limited partners' contributions to capital.

D. Self Dealing.

1. Texas Revised Limited Partnership Act §1.10

Sec. 1.10. Except as otherwise provided by the partnership agreement, a partner may lend money to and transact other business with the limited partnership and, subject to other applicable law, has the same rights and obligations with respect to those matters as a person who is not a partner.

Tex. Rev. Civ. Stat. Ann. art. 6132a-1 Sec. 1.10 (Vernon Supp. 1999)

2. Case Law

A managing partner may not place himself in a position where it benefits him to violate his duty to administer the partnership affairs solely for the benefit of the partnership. *Crenshaw v. Swenson*, 611 S.W. 2d 886, 890 (Tex.App. - Austin 1980, writ ref'd n.r.e.). Public policy precludes a fiduciary from limiting his liability for (1) self-dealing; (2) bad faith; (3) intentional adverse acts; and (4) reckless indifference about the beneficiary and his best interest. *Grider v. Boston Co., Inc.*, 773 S.W. 2d 338, 343 (Tex.App. - Dallas 1989, writ denied).

In *McLendon v. McLendon*, 862 S.W. 2d 662 (Tex.App. - Dallas 1993, writ denied), the beneficiaries sued the co-executors of the estate for mismanagement of the estate. The co-executors were general partners of a limited partnership in which the estate was a limited partner. The co-executors and general partners amended the limited partnership agreement as follows:

"Should any partner contest by legal action, judicial proceeding or otherwise any management decision or action made or taken by the managing partner [Bart] in his role as sole and exclusive manager of the partnership business, then the managing partner may, by written notice to such partner (the "Expulsion Notice"), expel such partner from the partnership, such expulsion and the termination of such partner's status as a partner in the partnership being effective as of the date of the Expulsion Notice. No such expulsion shall cause a dissolution and termination of the Partnership and, upon any such event, no one shall have the right to compel the termination and liquidation of the Partnership.

Upon expulsion, the expelled partner receives an amount equal to the book value of his or her partnership interest, payable by a ten-year installment note." *McLendon v. McLendon*, 862 S.W. 2d 662, 666 (Tex.App. - Dallas 1993, writ denied).

The beneficiaries sued challenging the co-executors management of the estate and contesting the validity of the amendment to the partnership agreement. The beneficiaries sought a declaratory judgment that the partnership amendments were invalid based on a breach of fiduciary duty and void as against public policy.

The beneficiaries presented expert testimony that after the amendments, the partnership interest would have no value to third-party buyers. The beneficiaries also presented expert testimony that the amendments removed the ability of any partner to terminate the partnership and amounted to a removal of rights of partners.

The Executors presented expert testimony that the value of the estate's interest in the partnerships increased after the execution of the amendments. The expert testified that before the execution of the amendments, the estate had an assignee interest and after the amendments the assignee interest was elevated to a partnership interest. Therefore, the executors' expert concluded that the amendments benefitted the estate because a partnership interest is more valuable than an assignee interest.

While the trial court did not find that the amendments to the partnership agreements were invalid, the jury found that the co-executors and general manager breached their fiduciary duties and awarded actual damages and exemplary damages. There was evidence that the general manager and co-executor intentionally withheld partnership investment reports from the beneficiaries without just cause, paid himself about $673,000 from the partnerships over a four year period and the beneficiaries received no distribution during that same period and took money from the partnership to pay for renovations of a non-partnership property.

E. Lack of Disclosure.

Among the duties that a partner owes its co-partners is the duty of "full disclosure of all matters affecting the partnership". *Hughes v. St. David's Support Corporation*, 944 S.W. 2d 423 (Tex.App. - Austin 1997, writ denied). In a limited partnership, the general partner owes the same duty of full disclosure to the limited partners. *Huie v. Deshazo,* 922 S.W. 2d 920, 923 (Tex. 1996) ("Trustees and executors owe beneficiaries a fiduciary duty of full disclosure of all material facts known to them that might affect (the beneficiaries' rights.' ") (quoting *Montgomery v. Kennedy*, 669 S.W. 2d 309, 311 (Tex. 1984).

In *Hughes v. St. David's Support Corporation*, 944 S.W. 2d 423 (Tex. App. - Austin 1997, writ denied), the limited partners brought suit alleging that the general partner breached its fiduciary duty by not notifying them of a sale of the assets of an operating partnership. The Austin court of appeals held that even though the limited partner's interest was small they were at least entitled to notice before the operating partnership assets were sold. The court of appeals concluded that the general partner breached its fiduciary duty by failing to give them prior notice of the sale.

In *Johnson v. Buck*, 540 S.W. 2d 393 (Tex.Civ.App. - Corpus Christi 1976, writ ref'd n.r.e.), a partner sued the managing partner to rescind a sale of the partner's interest to the managing partner. The partner alleged and the trial court found that the managing partner made misrepresentations and concealments of material facts which induced the co-partner to sell his interest in the partnership properties for less than what they were actually worth and that but for such misrepresentations and concealments the co-partner would not have sold same to the managing partner at the agreed price. It is a rule of long standing that each partner in a partnership business is a confidential agent of the other partner, and each is required to make full disclosure of all material facts known to him with respect to partnership affairs. Partners do not deal with each other at arm's length, and in a sale by one partner to another of his interest in the partnership, an absolute duty of full disclosure of all material facts and information to the buying partner is imposed upon the selling partner; such a sale, when challenged, will be sustained only when it is made in good faith, for a fair consideration and on a full and complete disclosure of all information as to value. *Johnson v. Peckham*, 132 Tex. 148, 120 S.W. 2d 786 (1938). The Court in *Johnson v. Peckham* also held that there was no legal duty on the part of the co-partner to make any investigation as to the truth or falsity of the representations made to him by the managing partner. Therefore, the statute of limitations did not begin to run until the actual discovery of the fraud by the co-partner.

F. Exculpatory Clauses in Partnership Agreement.

One of the basic tenets of contract law and the Texas Revised Limited Partnership Act is that the contract of the parties controls. Most modern family limited partnerships provide specifically what powers the general partners possess and limitations on the rights of limited partners and assignees of limited partners to bring actions against the general partners. Generally, the partnership agreement should control. However, one could envision many scenarios in which a court might be tempted to not enforce the provision if a general partner takes actions which substantially prejudice the limited partners or unfairly benefits the general partner on the grounds of public policy.

Section 4.03 of the Texas Revised Limited Partnership Act allows the partners to vary the liabilities of the general partner. The power to vary the liabilities is apparently limited only by public policy. The comments to section 4.03 suggest that the limits on indemnification of a general partner set forth in section 11.02, 11.03 and 11.05 of the Texas Revised Limited Partnership Act may provide some guidance as to the public policy limits of an exculpatory clause. Such sections provide as follows:

Sec. 11.02 If provided in a written partnership agreement, a limited partnership may indemnify a person who was, is, or is threatened to be made a named defendant or respondent in a proceeding because the person is or was a general partner only if it is determined in accordance with Section 11.06 of this Act that the person:

(1) acted in good faith;

(2) reasonably believed:

(A) in the case of conduct in the person's official capacity as a general partner of the limited partnership, that the person's conduct was in the limited partnership's best interest; and

(B) in all other cases, that the person's conduct was at least not opposed to the limited partnership's best interests; and

(3) in the case of a criminal proceeding, had no reasonable cause to believe that the person's conduct was unlawful.

Tex. Rev. Civ. Stat. Ann. art. 6132a-1 Sec. 11.02 (Vernon Supp. 1999).

Sec. 11.03 Except to the extent permitted by Section 11.05 of this Act, a general partner may not be indemnified under Section 11.02 of this Act with respect to a proceeding in which:

(1) the person is found liable on the basis that the person improperly received personal benefit, whether or not the benefit resulted from an action taken in the person's official capacity; or

(2) the person is found liable to the limited partnership or the limited partners.

Tex. Rev. Civ. Stat. Ann. art. 6132a-1 Sec. 11.03 (Vernon Supp. - 1999).

Sec. 11.05 A general partner may be indemnified under Section 11.02 of this Act against judgments, penalties, including excise and similar taxes, fines, settlements, and reasonable expenses actually incurred by the person in connection with the proceeding, except that if the person is found liable to the limited partnership or the limited partners or is found liable on the basis that the person improperly received personal benefit, the indemnification:

(1) is limited to reasonable expenses actually incurred by the person in connection with the proceeding; and

(2) shall not be made in relation to a proceeding in which the person has been found liable for wilful or intentional misconduct in the performance of the person's duty to the limited partnership or the limited partners.

Tex. Rev. Civ. Stat. Ann. art. 6132a-1 Sec. 11.05 (Vernon Supp. 1999)

VIII. Issues Relating to the Creation of a Family Limited Partnership by a Fiduciary.

Now that it is well established that creation of a family limited partnership can result in substantial transfer tax savings, many times family members want to form a family limited partnership. Sometimes, the creation of the entity will be motivated by the other concerns such as a desire to consolidate various family investments or entities. Often, some or all of the assets to be contributed to the partnership are held in a business entity, trust, guardianship, estate or other entity giving rise to a fiduciary duty. Difficult issues arise when a fiduciary wishes to invest in a family limited partnership unless every person with an interest consents to the investment.

A. Fiduciary Relationships

Some of the more common fiduciary relationships in which issues relating to family limited partnerships may arise are set forth below:

1. Guardian

A guardian owes a duty to his or her ward and generally cannot change the structure of the guardianship's investments without court approval. *State v. Whitaker*, 638 S.W. 2d 189 (Tex. App. - Waco 1982, no writ). However, the Texas Probate Code provides for a procedure for the establishment of an estate plan for the ward for the purpose of minimizing taxes to the ward's estate. Texas Probate Code §865. Some of the requirements of §865 may lead to substantial litigation in a litigious family, but approval of the estate plan by the court after compliance with §865 should help protect the fiduciary from claims of breach of fiduciary duty for implementing the approved estate plan.

2. Trustee

A trustee owes fiduciary duties to the beneficiaries of the trust. *Thigpen v. Locke*, 363 S.W. 2d 247 (Tex. 1963). The trust instrument controls the rights and powers of the trustee. Most trust instruments give the trustee the power to invest in a partnership, but usually do not provide specific authorization to invest in a partnership with all of the attributes of a family limited partnership used in estate planning. The beneficiaries may release a trustee from a fiduciary obligation. Texas Property Code 114.005.

3. Executor/Administrator

An executor or administrator owes duties to the beneficiaries of an estate and generally owes the same fiduciary duties as a trustee. *Humane Society v. Austin National Bank*, 531 S.W. 2d 574 (Tex. 1995), cert. Denied 425 U.S. 976. The rights and powers of an executor will be determined by the will. Usually the powers are similar to those given to a trustee and may leave one with questions as to whether a partnership with the attributes of a family limited partnership is an authorized transaction. A fiduciary in a dependent administration would merely need court approval of an investment in a limited partnership. An independent executor would need to make the determination concerning an investment in a limited partnership without the assistance (or protection) of the court. A declaratory judgment action would be available to an independent executor to have a court address any issues that are troubling the independent executor.

4. Agent/Attorney-in-fact

An agent or attorney-in-fact owes duties to his or her principal. The powers of the agent or attorney-in-fact will be determined by the document appointing the agent or attorney-in-fact. Usually, the document is a power of attorney. Some powers of attorney used by estate planning lawyers are comprehensive and authorize many types of estate planning transactions. In the absence of specific authority in the controlling instrument, difficult fiduciary liability issues may arise.

5. Partnership or Joint Venture

General partners and joint adventurers owe one another the same fiduciary duties owed by a trustee of a trust to a beneficiary.

Johnson v. Peckham, 120 S.W. 2d 786 (Tex. 1938). The sole general partner of a limited partnership owes fiduciary duties to the limited partners. *Watson v. Limited Partners of WCKT, Ltd.,* 570 S.W. 2d 179 (Tex. App. - Austin 1978, writ ref'd n.r.e.). A decision to form a family limited partnership by a general partner will involve consideration of fiduciary duties to the other partners in any existing partnership. For example, a partner of a business partnership may want to form a new partnership or invest in a new partnership to reduce estate taxes on the death of one of the partners. Fiduciary duties would need to be considered.

6. Corporation

Certain parties in a corporate relationship may wish to form a family limited partnership. The officers and directors of a corporation owe fiduciary duties to the corporation. *International Bankers Life Ins. Co. v. Holloway*, 368 S.W. 2d 567 (Tex. 1963). The officers and directors owe a fiduciary duty to the shareholders as a group. *Faour v. Faour,* 789 S.W. 2d 620 (Tex. App. - Texarkana 1990, writ denied). A majority shareholder owes a fiduciary duty to deal fairly with minority shareholders when the majority shareholder deals with corporate assets. *Thywissen v. Coron*, 781 S.W. 2d 682 (Tex. App. - Houston [1st Dist.] 1989, writ denied).

7. Account - Client Relationship

An accountant owes a fiduciary duty to his or her client particularly when the accountant has a financial interest in the transaction. *Dominguez v. Brackey Enter., Inc.*, 756 S.W. 2d 788 (Tex. App. - El Paso 1988, writ denied).

8. Attorney-Client Relationship

An attorney owes a fiduciary duty to his or her client. *Archer v. Griffith*, 390 S.W. 2d 735 (Tex. 1964). A business interest with a client acquired during the course of the attorney-client relationship is presumed to be fraudulent. *Johnson v. Stickney,* 152 S.W. 2d 921 (Tex. App. - San Antonio 1941, no writ).

9. Spouse

In some instances, when dealing with community property, a person may be found to be a fiduciary for his or her spouse. *See Miller v. Miller*, 700 S.W. 2d 941 (Tex. App. - Dallas 1985, writ ref'd n.r.e.). Generally, a person can make investment decisions with community property under his or her control without liability to the spouse. However, fraud issues could arise if a partnership is used to harm the rights of a spouse in a divorce action.

10. Relationship of Parties

Fiduciary relationships can arise from a close, confidential relationship. *Thigpen v. Locke*, 363 S.W. 2d 247 (Tex. 1962). Fiduciary duties may be owed to persons involved in a family limited partnership even when no formal fiduciary relationship exists.

B. Fiduciary Issues

When all of the interested parties in a transaction either cannot or will not agree to the creation of a family limited partnership and a court order approving the transaction is not a viable option, the following issues may arise:

1. Fiduciary Duties

The fiduciary duties which may come into the consideration of an investment in a family limited partnership include fiduciary duties relating to investments by a fiduciary, the duty of loyalty, the duty of disclosure to persons with a justiciable interest, the duty not to delegate discretionary decisions, the duty to avoid self-dealing and conflicts of interest, the duty to diversify investments and the duty to treat the income beneficiaries and remaindermen impartially.

2. Loss of Value/Prudent Investment

An investment in a family limited partnership almost always results in at least a temporary loss of value. In an estate planning context, the reduction in value is usually documented through appraisals. The loss of value occurs based on restrictions in the partnership agreement and state law on the limited partners rights to distributions and liquidation. The fiduciary may be criticized for making an imprudent investment. A trustee has a duty to put trust funds to a productive use and failure to do so can result in personal liability. *Langford v. Shamburger*, 417 S.W. 2d 438 (Tex. App - Fr. Worth 1967, writ ref'd n.r.e.). On the other hand, if a long term view is taken, an argument can be made that the investment increases the value of the property, reduces taxes and provides the financial advantages set forth at the beginning of this outline.

3. Loss of Control/Delegation of Duties

One of the attributes of a family limited partnership is a loss of control over the assets invested by the limited partners. A fiduciary may be criticized for giving up control of the assets and delegating duties. This can be minimized if the fiduciary also serves as general partner. An argument can be made that virtually any investment in a business enterprise involves a loss of control by the investor. However, many investments are more liquid than an interest in a family limited partnership. Self-dealing issues may arise if the power or control of the fiduciary increase through the transaction.

4. Income Beneficiary vs. Remainderman

A family limited partnership is usually a long-term investment. Depending on the rights of the beneficiaries under the applicable document, issues may arise as to whether the fiduciary who invests in a limited partnership is treating the beneficiaries impartially. For instance, many family limited partnership agreements leave distributions entirely to the discretion of the general partner. This will mean that the fiduciary who is a limited partner cannot be assured that income will be received to distribute to an income beneficiary. This can also be a problem in a guardianship if the guardian invests substantial funds in a family limited partnership because many of the benefits of the planning may not accrue to the ward directly.

5. No Exit Strategy

Most family limited partnerships offer no favorable way to exit without the cooperation of the other partners. Creative exit strategies are available, but a fiduciary may be criticized for making an investment which cannot be easily liquidated. These disadvantages would need to be weighed against the advantages of the investment.

6. Self Dealing

When an investment in a family limited partnership is being considered, the most likely people to be serving in fiduciary capacities are other family members. Consequently, issues may arise as to whether the fiduciary receives a personal benefit from the investment or the fiduciary is a participant in another capacity. *InterFirst Bank Dallas, N.A. V. Risser*, 739 S.W. 2d 882 (Tex. App. - Texarkana 1987, no writ). Many wills and trust instruments authorize self-dealing, but the issues should be carefully examined by the fiduciary before an investment is made in a family limited partnership.

7. Diversification

To obtain the maximum benefit of a family limited partnership for transfer tax purposes, most or all of a client's assets must be invested in the family limited partnership. Often, diversification of investments occurs within the partnership, but issues of proper diversification may arise if a fiduciary invests all of the trust funds in one investment.

8. Duty of Disclosure

A fiduciary must fully disclose all facts and circumstances regarding his dealing's with the trust. Failure to disclose such information can result in a breach of fiduciary duty. *InterFirst Bank Dallas, N.A. v. Risser*, 739 S.W. 2d 882 (Tex. App. - Texarkana 1987, no writ). An investment in a family limited partnership is usually a significant transaction and would need to be disclosed by the fiduciary.

C. <u>Example</u>

Mr. Jones is elderly and has two adult children, his daughter, Plaintiff Jones, and his son, Defendant Jones. Mr. Jones owns 80% of Jones.com Inc. a corporation managed by Defendant. Defendant and Plaintiff each own 10% of Jones.com Inc. The company is worth $100 million. Defendant hears about the advantages of a family limited partnership and has the partnership documents prepared. Without consulting with his nosy sister, Defendant invests all of the assets of Jones.com Inc. in Jones.com, Ltd., a family limited partnership designed to last for 50 years and to be valued for estate tax purposes at $60 million. Mr. Jones consents to the transfer, but it is questionable whether he has capacity to make the decision. Defendant is not worried though because he has a valid power of attorney for Mr. Jones and also signs the documents in this capacity. Defendant is named as a general partner of the new partnership and continues to run the business and make money. Limited partnership interests are distributed to the three family members in proportion to their ownership of the corporation. Mr. Jones dies shortly after the creation of Jones.com, Ltd. with a will leaving his property equally to his two children. Plaintiff wants out of the partnership, but Defendant tells her to read the partnership agreement and take a hike.

If Plaintiff brings a lawsuit, what can the parties argue?

1. Plaintiff can argue:

   a. Creation of the partnership was a breach of duty by Defendant as president of Jones.com, Inc.
   b. Creation of the partnership was a breach of duty by Defendant as the majority shareholder (through his power of attorney).
   c. Creation of the partnership was a self-dealing transaction because of the additional control given to Defendant in the partnership.
   d. Creation of the partnership was a breach of Defendant's duties to Mr. Jones under the power of attorney.
   e. Plaintiff can claim she was damaged by the reduction in value of her investment and by the loss of control of her assets.
   f. Plaintiff can claim the Defendant basically rewrote Mr. Jones' will when Mr. Jones was no longer capable of writing a new will.
   g. Plaintiff could assert a derivative claim on behalf of the corporation concerning the investment.

2. Defendant can argue:

   a. He saved the estate $20 million in transfer taxes. Plaintiff should be thanking him instead of suing him.
   b. The investment was prudent because of the tax savings and long term potential of the investment.
   c. Assuming that the partnership agreement has an arbitration clause, the dispute would have to be decided by arbitration.
   d. Defendant can assert that Plaintiff is only an assignee of a partnership interest and has very limited rights in the partnership and limited standing to sue.
   e. If Plaintiff has accepted any benefits from the partnership, Defendant could assert estoppel as a defense.
   f. Defendant could challenge Plaintiff's right to sue on behalf of their deceased father.
   g. Defendant could also contest whether he owed a fiduciary duty to Plaintiff as a majority shareholder because Defendant only had a majority of the stock if you took into account Mr. Jones' shares.
   h. Defendant can contend that he was in charge of the company before the partnership was created and that Plaintiff has not been harmed by the transaction.

D. Who Should Win?

It is difficult to say who should win. If Plaintiff can establish a fiduciary relationship with regard to the creation of the partnership and standing, the burden will be on Defendant to prove that the transaction was fair. In this example, Plaintiff will be able to show a huge reduction in value ($40 million), but an issue exists as to whether she has really suffered a loss because the business has continued to make money, the underlying assets are still there and she still has her pro rata share of the business. Defendant's lack of disclosure gives a slight edge to Plaintiff.

IX Psychological and Practical Problems which could lead to Litigation

A. The "Big Cheese" Syndrome

Many times a family limited partnership is initially created and managed by the person who made the money or started the business. We will call this person, "The Big Cheese". In some families, the Big Cheese is female. Often, the partnership is formed for estate planning purposes after the Big Cheese has been running his business in another form for many years. The Big Cheese is used to doing what he wants whenever he wants. He often mixes business and personal pursuits. He often views anything he wants as an appropriate use of business funds. The creation of a family limited partnership will create duties and obligations that the Big Cheese has never had to consider before. Several problems can arise from this situation. The Big Cheese may just ignore his duties to his partners and continue to run things as if the partnership did not exist. This can lead to claims of mismanagement by the partners. This type of conduct could also encourage the IRS or other creditors to make a claim that the partnership is not a viable entity and should be disregarded. The worst cases of the Big Cheese syndrome can lead to claims of breach of fiduciary duty or fraud.

The best options for a lawyer when he spots the Big Cheese syndrome is to discourage the use of a family limited partnership or to carefully inform the clients about the duties and obligations of a general partner. In the worst cases, neither of these options will work and the family will be headed for trouble.

B. Sibling Jealousy and Rivalry

In many family limited partnerships, the general partners are given extensive powers. Many times, as long as the matriarch or patriarch holds the powers, the children will not complain. However, problems arise when less than all of the next generation are given the extensive powers. Nothing brings out smouldering childhood problems quicker than having a person's brother or sister completely control his or her inheritance in a entity which could last for a lifetime (or longer). The solutions are either shared control or a dissolution of the partnership. Neither of these solutions are easily obtained in litigation. Consequently, the litigation will often take another form such as claims of mismanagement or breach of fiduciary duty or attacks on the creation of the partnership.

C. Too Complicated to Administer Properly

Family limited partnership agreements are complex. Great wealth does not always coincide with great brains and management skills. In some cases, the general partner may be trying to do things properly, but just cannot make good decisions about how to run the partnership or just cannot understand the partnership agreement. This can lead to claims against the general partner for mismanagement or breach of fiduciary duty. About the only solution is the replacement of the general partner or getting the confused general partner competent advice when he or she needs it. The worst of these situations could lead to a claim that the partnership is not a viable entity.