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THE SPOTLIGHT

BROUGHT TO YOU BY ROBINS KAPLAN LLP'S WEALTH PLANNING, ADMINISTRATION, AND FIDUCIARY DISPUTES GROUP

Binding Ties: The Partnership Law Edition

WELCOME TO THE SPOTLIGHT

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The Spotlight strives to provide a forum to discuss the latest news and compelling issues impacting fiduciaries and those to whom fiduciaries owe duties. Whether you are an officer, director, trustee, beneficiary, trust officer, attorney, financial advisor, or anyone impacted by the law governing fiduciaries, we hope that you will find this newsletter interesting, informative, and perhaps at times even a bit entertaining.

Fiduciary disputes come in many varieties, but they share some consistent themes that involve the erosion of trust, high emotion, and opportunities—sometimes missed—for creative approaches to avoid or resolve litigation. As practitioners and teachers of fiduciary law, our attorneys have built a reputation for excellence in meeting the needs of individuals and organizations facing complex fiduciary issues, starting with the transactional and estate planning work that can mitigate risk from the beginning. We counsel individuals and business owners in a broad range of fiduciary issues, from estate planning and business succession, to dispute resolution and litigation when unavoidable.

Is there a topic affecting your practice that you would like us to discuss in an upcoming issue of The Spotlight? Let us know at all_marketing@robinskaplan.com.

– **Denise S. Rahne and Steven K. Orloff**

A New York Partnership?

BY LAUREN COPPOLA AND ERIC LINDENFELD

In determining whether parties are, in fact, in a partnership depends on the conduct of the parties. Titles, labels, and disclaimers are often meaningless. Consider the following scenario.

In a New York City bar, two successful entrepreneurs clink glasses over an exciting new venture. They shake hands and declare that, while they are not partners, success is inevitable—after all, their AI-powered estate planning app will revolutionize the way people avoid lawyers. Both are wary of entanglements. One — on the heels of unwinding a small family business after the death of one of the first-generation founders—is inspired to create something that assists families to cost-effectively manage family assets without a probate. The other—just finished wrangling a family trust—still flinches at the memory of a fiduciary duty debacle at the hands of his wayward uncle. At the height of their distrust, they agree from the start: No partnership. Staying independent keeps things clean.

After discussing, they determine to put their agreement in writing. A key provision, in bold, makes it crystal clear:

"The parties are not partners."

Fast-forward a year. One of them lands a major investor behind the other's back, cutting the other out entirely. When the aggrieved party complains, the party with the new investor responds: Not my problem. We're not partners. I owe you nothing.

The other—shocked—struggles to process the betrayal. After all, they had built something together—contributing capital equally, splitting profits, sharing costs, making joint decisions, and celebrating wins side by side. They had shared financial risks, had joint control over the business, and had always spoken about the company as "ours" in meetings.

The aggrieved party stares at the contract, his own signature staring smugly back at him, thinking, "I can't believe I agreed to that provision. I should have known better."

But despair isn't necessarily the end of the road for the aggrieved party. Courts may very well still interpret the parties as having an implied partnership based on their course of conduct— disclaimer be damned.

No matter what the parties wish or intend, partnership is not just a label—it is a legal test. In New York, for example, courts have long held that "labels don't matter, reality does." *Martin v. Peyton*, 246 N.Y. 213 (1927). And attempts to create a contract that supersedes legal scrutiny are vulnerable from the start. As Judge Andrews of the New York Court of Appeals further explained in *Martin v. Peyton*: "A contract may be a mere sham intended to hide the real relationship... Mere words will not blind us to realities. Statements that no partnership is intended are not conclusive." Subsequent cases confirm this legal concept. Twenty years after *Martin v. Peyton*, the New York Appellate Division in *Rubenstein v. Small*, 273 A.D. 102 (1st Dep't 1947) noted that: "The court is not bound by a contract's disclaimer of partnership, joint venture, or agency. It is free to look beyond the wording to determine the parties' true relationship."

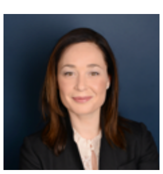
Establishing that a disclaimer is ineffective does not, however, help us understand when and how a court might determine whether a partnership exists as a matter of law. Ultimately, things like sharing profits and losses, joint management, ownership of assets, control over the business—even how the parties talk about the company—matter. In short, it's not about how parties label their arrangement, it's about what they *do*.

Under New York Partnership Law § 10, a partnership is "an association of two or more persons to carry on as co-owners of a business for profit." Courts analyze several factors, including:

- **Intent of the Parties** – The most critical factor is whether the parties intended to form a partnership. This can be expressed or implied from their conduct. *See Martin v. Peyton*, 246 N.Y. 213 (1927) (noting that, aside from self-serving statements, the key inquiry is whether the parties intended to be partners or their arrangement was something else, such as a loan or profit-sharing agreement).
- **Sharing of Profits and Losses** – A significant indication of a partnership is whether parties share in the profits and losses. *See Brodsky v. Stadlen*, 138 A.D.2d 662 (2d Dept. 1988) (noting that profit-sharing created a presumption of a partnership unless rebutted). The sharing of losses is particularly critical to a court's analysis.
- **Joint Control and Management** – The extent to which parties share decision-making and control over business operations is important. *See Kyle v. Ford*, 184 A.D.2d 1036 (4th Dept. 1992) (no partnership was found where there was no evidence of joint control or decision-making authority).
- **Capital Contributions** – While not required, contributions of money, property, or labor toward the business can indicate a partnership.
- **Holding Out as Partners** – If parties present themselves as partners to third parties, courts may find that a partnership exists based on apparent authority. *See Czernicki v. Lawniczak*, 74 A.D.3d 1121 (2d Dept. 2010) (partnership found when the parties held themselves out as partners to clients and third parties).
- **Liability to Third Parties** – Courts also consider whether the alleged partners acted in a way that created joint liability for business debts.

The lesson from this hypothetical scenario? In business, the deal parties intended is not always the deal that they made, and one cannot escape legal obligations just by declaring that a deal does not reflect a partnership. If parties act like partners, the law may see them as partners, no matter what their contract says.

So, for those who see themselves as some version of our hypothetical entrepreneurs, before you clink glasses and shake hands, ask the tough questions and consider legal advice on the front end: What are we really agreeing to? Does the way we structure this deal create legal obligations? Whether or not you are in fact in a partnership, investing in clarity on the front end can help avoid costly and unanticipated legal disputes later in the relationship.



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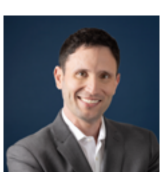

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Navigating General and Limited Partnerships:

Common Pitfalls and How to Avoid Them

BY DAVID MARTINEZ
AND TOMMY DU

Choosing the right business structure is critical for the operation of a business. General and limited partnerships are common business structures for those wanting to enter business together. While both partnerships offer flexibility and a shared approach to business ownership, they differ significantly in terms of control, liability, and financial responsibilities. In this article, we explore the key differences between these types of partnerships, the common pitfalls, and ways to resolve them.

General Partnerships

In a general partnership, two or more individuals come together to operate a business. General partnerships are often used by small businesses where each partner is closely involved in the daily operations and share equal responsibility. These usually include local retail stores, restaurants, and coffee shops.

In a general partnership, all partners share equal responsibility in managing the business, contributing capital, and making decisions. This gives each partner a role in the business's daily operations. Each partner is personally responsible for covering the business's debts, and personal assets can be at risk. This is true even if the act was carried out by another partner so long as the copartner was carrying on partnership business in the ordinary course.

Pitfalls and Solutions

Pitfall #1: Unlimited liability. All partners share in unlimited liability and are personally liable for the business's debts, which can expose partners' assets if the business faces lawsuits or financial troubles.

Solution: Partnerships should obtain comprehensive business insurance that protects personal assets. While partners may agree among themselves to share losses or debts in differing proportions, third parties are usually not bound by such an agreement and can seek equal contribution from each partner.

Pitfall #2: Conflicts in decision-making. Because each general partner has an equal responsibility in the management of the business, decision-making can become contentious, especially if partners disagree on the approach.

Solution: Having clearly defined roles and responsibilities in a written partnership agreement can help prevent disputes. Further, partners should consider a dispute resolution clause in place requiring mediation and arbitration.

Pitfall #3: Unequal distribution of profits. Disputes often arise resulting from the distribution of profits, particularly when there is a sense that one partner contributes more to the business than the other.

Solution: To avoid this, the partnership agreements should explicitly outline how profits (and losses) will be shared and what factors play a role in the distribution, such as each partner's contribution, capital investment, and/or role within the business.

Limited Partnerships

A limited partnership consists of at least one general partner and one or more limited partners. Limited partnerships are often used in industries where passive investors want to contribute capital without getting involved in the management of the business. This includes businesses such as real estate investment groups, venture capital funds, and private equity firms. The general partner is usually a special purpose entity incorporated as an LLC or a corporation to shield the general partner from personal liability.

Limited partners share profits. But, unlike general partners that control business management and are liable for partnership debts, limited partners usually take no part in running the business and incur no liability beyond their capital contributions. If the business fails or faces a lawsuit, unless the limited partner participates in the control of the business, the limited partner's liability is limited to their initial investment.

Pitfalls and Solutions

Pitfall #1: Return on investment. Limited partners focus on the return on investment as they play no role in the day-to-day management of the business. When limited partners do not see a return on their investment, such as during a down year, this can lead to dissatisfaction and disagreement between the limited and general partners.

Solution: Open communication is key. General partners should regularly update limited partners on the business, including key initiatives and financial status.

Pitfall #2: Misunderstanding profit distributions. Profit distributions between general and limited partners are often different and usually dependent upon the proportion of the partner's contributions. Disproportionate distributions may lead to disputes among the partners.

Solution: To avoid misunderstandings, the partnership agreement should clearly define how profits and losses are to be shared and detail any preferred returns or priority distributions for limited partners.

Pitfall #3: Reliance on general partners. General partners have full control and responsibility over the business's operations, and limited partners do not have the ability to manage the day-to-day business. As a result, if general partners make poor decisions or mismanage the business, limited partners may be without recourse.

Solution: To mitigate this risk, limited partners should carefully vet general partners before entering the partnership. In addition, depending on the business structure, limited partners may engage in certain actions that can help drive the direction of the business without it constituting "control of the business." This includes, without limitation, serving on an audit committee, proposing or calling a meeting of the partners, and serving on a committee to approve certain actions of the general partner.

The choice between general and limited partnerships affects every aspect of how a business is run, how profits are distributed and shared, and how liabilities are handled. By understanding the pros and cons of each structure and anticipating the common pitfalls, partners can make informed decisions to minimize conflict and keep the business running smoothly. Careful planning, clear agreements, and open communication are key to ensuring a successful partnership—whether general or limited.

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Show Me the Books!

Navigating Minority Shareholder Access to Corporate Information

BY DENISE RAHNE AND THOMAS BERNDT

A common adage tells us that in the absence of information, people tell themselves a story. In the corporate version, add in frayed business relations, and the plotline quickly thickens with suspicion and distrust. Minority shareholders, because they lack control over a company's operations and financial information, will at times find themselves in this very position—suspicious and distrustful—leading them to ask a very logical question: When and how can I access information about the business?

Those representing minority shareholders, officers, or majority shareholders are familiar with the tensions between an aggrieved minority shareholder's expectation that they should get to see everything, and officers and majority shareholders who may be inclined to be overly protective of the confidential and proprietary interests of the company. The actual entitlement to information generally falls somewhere in the middle of these two positions: While majority shareholders and corporate officers hold considerable power and control, minority shareholders have rights, including the right to access financial information under certain circumstances.

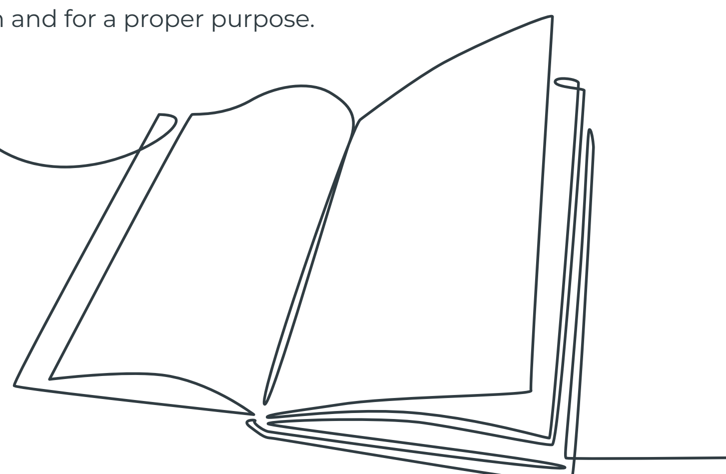
Under Minnesota law, minority shareholders' rights can be found in a combination of statutory provisions and common law principles. The primary legal sources governing these rights include primarily:

1. **Minnesota Business Corporation Act (MBCA)** – The MBCA provides various rights to shareholders, including access to corporate records and financial statements.
2. **Common Law Fiduciary Duties** – Corporate directors and officers owe fiduciary duties to shareholders, including duties of care, loyalty, and good faith.
3. **Judicial Remedies for Minority Shareholders** – Minnesota courts recognize equitable remedies to protect minority shareholders from oppressive conduct by majority shareholders.

Under the MBCA (Minn. Stat. §302A), shareholders have a statutory right to inspect and copy certain corporate records, including financial statements, minutes of board meetings, and shareholder lists. Specifically, the statute provides that:

- A shareholder who has been a holder of record for at least six months or holds at least 5% of the corporation's shares may demand access to financial records.
- The corporation must provide an annual financial statement upon request.
- The shareholder must make the request in good faith and for a proper purpose.

While the MBCA provides a general right to financial information, it does not explicitly grant minority shareholders an automatic right to an accounting. That said, when evidence suggests the existence of mismanagement or misconduct, a minority shareholder may seek an accounting through legal action.



Under Minn. Stat. §302A.751, courts may order an accounting as part of an equitable judicial remedy if:

- The directors or those in control have acted in an illegal, fraudulent, or unfairly prejudicial manner toward shareholders.
- Corporate assets are being mismanaged or diverted for personal gain.

When there is evidence that corporate funds are being misused, minority shareholders may request an accounting to uncover fraudulent activity. Mismanagement may include unauthorized loans, excessive executive compensation, or siphoning corporate assets for personal use. Where directors and/or majority shareholders engage in self-dealing or conflicts of interest, minority shareholders can seek an accounting to assess the extent of the breach and seek legal remedies.

Another circumstance that may warrant an accounting is where there is evidence of shareholder oppression. Oppression occurs when majority shareholders engage in conduct that unfairly prejudices minority shareholders. This can take the form of denying access to financial records, withholding dividends, or diluting minority ownership through stock issuance. In addition, when a minority shareholder seeks to sell their shares or is subject to a buyout, an accounting may be necessary to determine the fair value of the corporation. In such instances, Minnesota courts may order an accounting in the context of an effort to calculate the fair value of the shareholder's interest.

Apart from the MBCA, Minnesota's common law separately recognizes the equitable right to an accounting in cases where a fiduciary duty exists and there are allegations that would justify an accounting as a remedy. Directors and majority shareholders owe fiduciary duties to minority shareholders, including the duty of loyalty and the duty to act in good faith. In some circumstances, denying a minority shareholder access to certain information may represent a breach—a breach for which the remedy is then access to the relevant information. If minority shareholders can demonstrate that the corporate officers or majority shareholders have failed to act in good faith or treat them fairly, the court may compel an accounting to ensure transparency and protect minority shareholders' interests.

At the end of the day, under certain circumstances, minority shareholders in Minnesota have legal avenues to demand financial transparency and accountability from corporate officers and majority shareholders, including an accounting. Corporate officers, majority, and minority shareholders all need to appreciate the balancing act involved in determining what information should be made available and under what circumstances. For officers and majority shareholders, an overly conservative approach often increases suspicion and escalates tensions. For minority shareholders, unrealistic expectations can lead to both disappointment and excessive legal expenses. Courts generally recognize the importance of financial accountability and may order an accounting to protect minority shareholders' interests, but unfettered access should not be expected. Corporate officers, majority shareholders, and minority shareholders should all consider seeking professional guidance in navigating the balancing act that disclosing sensitive corporate information requires.

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