



THOUGHT PAPER

A House Divided: Deadlock in a 50-50 Partnership

by Sarah P. Barton, JD



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Business planning and estate planning often go hand in hand. Businesses started by parents are frequently passed down to their children, and in the absence of adequate forethought, the new relationships that are formed can quickly disintegrate, causing damage to both the siblings' personal bond and to the business.

This is precisely the situation addressed in *Jarvis v. Jarvis*, H0443930 (Cal. Ct. App., March 2019). At the time relevant to this litigation, two brothers, James and Todd Jarvis, were general partners in Jarvis Properties (the Partnership), a limited partnership formed prior to their father's death. Each brother had a 50 percent interest in the Partnership. James and Todd disagreed about how to dispose of a parcel of land owned by the Partnership, and the partnership agreement (the Agreement) did not include any provisions for resolving a decision-making deadlock. Further, once this litigation arose, the brothers were also deadlocked over the decision about who had the authority to select and direct an attorney on behalf of the Partnership, as the Agreement was also silent on this point.

When the Partnership was originally formed in December 1986, James and Todd's father was the only general partner, and their father, mother, and James were limited partners. The purpose of the limited partnership was to engage in investments in real property, and its primary asset was the parcel that led to the dispute in this litigation.

Since their father's death in 1996, James and Todd's relationship had been characterized by a series of disagreements. By 2015, following years of conflict and litigation involving a family trust, James and Todd were general partners in the Partnership, each having a 50 percent interest. When the Partnership was originally formed, James and Todd's father had the sole authority to make decisions for the Partnership. Deadlock was clearly not contemplated when the Agreement was originally drafted. Unfortunately, the Agreement was never amended to include any provisions for resolving an impasse in decision-making after James and Todd each acquired a 50 percent interest as general partners in the Partnership.

This contested matter arose because the brothers disagreed about how to care for or dispose of the parcels of real property owned by the Partnership, and the Agreement lacked a provision specifying a course of action for resolving the deadlock.

James filed partition actions regarding the two parcels in 2016, one of which was the subject of this appeal. On one of the parcels (the Improved Property), there were several structures, including three older houses, a garage, and a water tower. The parcel had an irregular shape, which James asserted hindered opportunities for further development unless it could be coupled with the second, vacant parcel, which was adjacent to it (the Adjacent Property).

In his complaint, James alleged that the brothers had not been able to agree about how to care for or dispose of the properties. The trial court sustained a demurrer filed by Todd, and James filed a new complaint for partition by sale of the Adjacent Property against Todd and the Partnership, asserting that there was no possibility that James and Todd could cooperate to develop and manage the parcel, that its highest and best use was to be sold, and that its value would be maximized in a partition sale together with the Improved Property.

Dispute over Legal Representation of a Deadlocked Partnership

James accepted service of the new complaint on behalf of the Partnership, and Todd hired an attorney, William Roscoe, to represent the Partnership, as well as another attorney to represent himself individually. James filed a motion to disqualify Roscoe from representing the Partnership, asserting that he lacked authority from a majority of the general partners to represent the Partnership, was not acting in the best interests of the Partnership, and would deplete the Partnership's assets by incurring unnecessary litigation costs. In addition, James alleged that Todd had hired Roscoe over his objection and that Roscoe had taken the position that his representation of the Partnership would be directed solely by Todd and in contravention to James's direction. In response, Roscoe argued that he was not representing Todd, but the Partnership alone¹. The trial court granted James's motion to disqualify Roscoe, dismissed a demurrer filed by Roscoe on behalf of the Partnership, and overruled a demurrer filed by Todd. The court noted that James and Todd were deadlocked, stating: "[I]f these two parties never agree, there is never going to be any action taken on this property ... because of the history of this relationship."

The Court of Appeal affirmed the trial court's order disqualifying Roscoe, holding that the trial court did not err as a matter of law in granting James's motion². The Court found that Todd's and the Partnership's reliance on the argument that, because James had never had an attorney-client relationship with Roscoe, James could not seek Roscoe's disqualification on the basis of conflict of interest was misplaced. Roscoe represented only one client (the Partnership), and thus, the motion for disqualification was not based on a conflict of interest between clients. Rather, "[t]he issue here is Roscoe's lack of authority ab initio to act for the Partnership, and how to resolve a conflict of authority within the Partnership that renders the attorney incapable of acting on the matter in dispute."

¹ Roscoe argued that "the goals, strategy, tactics, and [decision making about] costs of this litigation should be left entirely to [Roscoe], with no direction from any general or limited partner, or from any officer of the Partnership."

² The Court of Appeal rejected arguments asserted by Todd and the Partnership that service on the Partnership was defective and that the trial court's order disqualifying Roscoe and dismissing the demurrer forces the Partnership to default. The Court also rejected Todd's argument that James did not have standing to seek Roscoe's disqualification.

In its analysis, the Court acknowledged that the State Bar Rules of Professional Conduct provide that an attorney who represents a partnership must treat the entity as the client and does not need to also represent the partners individually. This Rule flows from Cal. Corp. Code § 15901.04(a), which states that a “limited partnership is an entity distinct from its partners.” The Court of Appeal then referred to formal opinion No. 1994-137 of the State Bar of California Committee on Professional Responsibility and Conduct, which addresses the ethical duties of a lawyer who represents a partnership and who receives conflicting instructions from two partners, when it is unclear which partner’s instruction should be followed. The Committee concluded that the lawyer’s duty of loyalty requires the lawyer to act at the client’s discretion and that the lawyer cannot take over decision-making for the client without the authority to do so. When the lawyer is unable to determine which partner’s instruction to follow, the lawyer cannot take any action for the partnership related to the disputed matter until the disagreement is resolved.

The Court of Appeal agreed with the Committee that, in determining who has the authority to select an attorney and direct the defense of the Partnership, the courts should first look to the Agreement, which governs relations among the partners and between the partners and the Partnership. If the Agreement is silent, then the relationship will be governed by the Uniform Limited Partnership Act [ULPA].

The Agreement at issue was silent on the point of who has the authority to select counsel for the Partnership, as it did not delegate the selection of counsel or decision-making authority regarding litigation to either James or Todd, nor did it contain any other provision for resolving a deadlock.

The Court thus turned to Cal. Corp. Code § 15904.06(a), the relevant section of California’s version of the ULPA, which states “[e]xcept as expressly provided in this chapter, any matter relating to the activities of the limited partnership may be exclusively decided by the general partner or, if there is more than one general partner, by a majority of the general partners.” Noting that a “majority” means more than 50 percent, the Court, recognizing that neither James nor Todd alone constituted a majority, held that neither the Agreement nor the ULPA provided a resolution to the dispute over Roscoe’s authority to represent the Partnership.

Returning to the ethical considerations, the Court examined the values and interests involved in a disqualification motion, identifying the paramount concern as preserving “public trust in the scrupulous administration of justice and the integrity of the bar.” The Court stated that James had raised legitimate concerns regarding the duty of loyalty owed by Roscoe to the Partnership. The fact that Todd was paying Roscoe’s legal fees and was directing the litigation gave rise to at least the appearance that Roscoe could advance Todd’s interests over those of James, which may not be in the best interests of the Partnership. Moreover, the Court noted that Roscoe could potentially incur unnecessary litigation expenses, which would not only not be in the Partnership’s best interests, but could also deplete the Partnership’s assets, adversely affecting James’s ownership interest in the Partnership. The Court also found Roscoe’s position that he could represent the Partnership without direction from Todd or James to be troubling in light of the relevant provisions of the ULPA and guidance from the State Bar that it “is not within the lawyer’s province to make decisions on behalf of the organization concerning policies and operations.”

The Court of Appeal rejected Todd’s assertions that the disqualification motion would deny the parties substantial justice by impeding a client’s right to chosen counsel or an attorney’s interest in representing a client, by financially burdening a client in requiring the client to replace the disqualified counsel, or by

allowing a disqualification that could be based on tactical abuse. Rather, the Court concluded that the trial court's order was appropriately sensitive to the ethical problems raised by Roscoe's representation of the Partnership and was well within the Court's discretion.

The Court of Appeal noted that Cal. Corp. Code § 15901.7(a) provides that "unless displaced by particular provisions of the [ULPA], the principles of law and equity supplement [the ULPA]." Accordingly, it found that the trial court, in the exercise of its inherent and equitable powers, could decide whether James and Todd could sufficiently articulate their opposing positions without separate counsel for the Partnership, or if the appointment of a receiver, neutral counsel, or other neutral party was necessary to resolve the deadlock at the entity level.

Takeaways

Jarvis v. Jarvis highlights the destructive consequences that can emerge if a partnership is structured in a way that could lead to deadlock and the partnership agreement lacks provisions for resolving such an impasse. If the disagreement concerns a major decision that impedes the ability of a business to move forward, the future of the business itself is placed in jeopardy. Even if the deadlock concerns a less important decision, the resulting frustration can be damaging to the relationship of the partners and thus harmful to the business. As in Jarvis v. Jarvis, the deadlock could lead to expensive and lengthy litigation. In some cases, it could even lead to the dissolution of the partnership.

Attorneys should help their business clients avoid this situation by encouraging them to enter into a well-drafted partnership agreement containing provisions designed to prevent a deadlock from ever arising. There are a variety of potential solutions. In some situations (typically more appropriate for partners already having a solid relationship), the partnership agreement could provide for a 50-50 split in profits, but a 51-49 split in control over decision-making. Alternatively, in situations in which there have been a history of disagreements and litigation similar to the circumstances that plagued the Jarvis family, the agreement could name a trusted and impartial individual familiar with the business having a two percent ownership interest who could act as the tiebreaker in case a deadlock arises, but still allow the two general partners to retain equal ownership and control with a 49-49 split. A buy-sell provision or put or call mechanism could also be included, both to encourage the deadlocked partners to find a solution to avoid triggering these provisions and to provide a predetermined way for one of the partners to exit the business in the event the partners are unable to iron out their differences.

Each of these potential solutions has advantages and disadvantages: For example, when partners have enjoyed a positive long-term relationship, having a 51-49 split in decision-making authority may seem like the perfect solution. However, there is no guarantee that the relationship will continue to be problem-free. Likewise, a buy-sell provision is meaningless unless each of the partners has the financial ability to exercise it. You and your clients should carefully consider which solution or combination of solutions is best suited for their particular circumstances.

According to the biblical adage, "a house divided against itself will not stand." A deadlock regarding a major decision that prevents a partnership from moving forward can be its death knell. This situation is easily preventable by ensuring that a business partnership has an up-to-date and well-drafted partnership

Domestic Asset Protection Trusts after Toni 1 Trust

agreement providing steps for resolving a deadlock. As discussed in *Jarvis v. Jarvis*, the courts may be able to step in to resolve the deadlock by, for example, appointing a receiver to act as a tiebreaker. However, this step involves unnecessary litigation expenses and almost inevitable and possibly irreparable damage to the relationship of the partners and to the business itself.

Business Docx[®] is WealthCounsel's premier document drafting solution that streamlines the process of preparing high quality documents for your small business clients. *Business Docx*'s Operating Agreement can help address potential deadlocks with the addition of its deadlock provision. This provision can easily be added during the interview process. See the sample deadlock provision below:

OPERATING AGREEMENT & ANCILLARIES

PROGRESS: 97%

- Operating Agreement
- Determination of Purchase Price
- Adjustments to Value
- Payment Terms
- Installment Note Payments and Interest
- Resolving Deadlock / Forced Sale** 2
- Dissolution and Liquidation
- Miscellaneous Provisions 1
- Signing Information and Layout Options
- Ancillary Document Assembly Options
- LLC Playbook - Document Preferences
- End of Interview

Resolving Deadlock / Forced Sale

How will the Members resolve management deadlocks? | ⚙

- By submitting the deadlock to an advisory board
- By submitting the deadlock to arbitration
- By forcing a buy-out of the Company
- No deadlock resolution provision

Select one of the following forced sale options: | ⚙

- A Member (the "Offeror") can make an offer to the other Members (the "Offeree") to purchase all of the Offeror's equity at a stated price and the Offeree may either accept the offer or buy the Offeror's equity at the same price.
- A Member (the "Offeror") can make an offer to the other Members (the "Offeree") to purchase all of the Offeror's equity at a stated price and the Offeree may either accept the offer, buy the Offeror's equity at the same price or force a dissolution of the Company.
- Any Member owning more than a stated percentage of the equity may make a joint offer to the remaining Members to buy all of the remaining Shareholder's equity. The remaining Members may either accept the offer or buy the offering Member's equity at the same price.
- Any Member owning more than a stated percentage of the equity may make a joint offer to the remaining Members to buy all of the remaining Member's equity. The remaining Members may either accept the offer, buy the offering Member's equity at the same price, or dissolve the Company.

The Offeree will have how many days after receipt of the offer to decide what course of action to take?

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Include a provision that the Forced Sale provision cannot be used against a disabled Member.

- Yes
- No | ⚙

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