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The Unintentional Business Partnership & Liability For New Post-Dissolution Obligations

This week we tackle a complex but extremely important area of law – formation of a partnership. On first glance, you may think that the formation of a partnership is a rather formal process much like the incorporation of a business. Through this week's discussion you will see that not only is the formation of a partnership not dictated by rigorous formalization, but that its resulting existence can lead to personal exposure to a great deal of liability for the actions of a partner. Our discussion will largely revolve around the recent Indiana Court of Appeals case *Curves for Women Angola v. Flying Cat, LLC*.

Before we launch into great depth on the *Flying Cat* decision, there is an interesting dynamic to the law of partnership that draws mention. So important is partnership law that in 1914 The National Conference of Commissioners on Uniform State Laws (the NCCUSL) adopted the Uniform Partnership Act (UPA). According to the NCCUSL, every state, with the lone exception of Louisiana, adopted the UPA into its laws. Louisiana, is the only non-common law state, so it often finds itself as an outlier compared to the other forty-nine states. After more than four decades of evolution in law, the NCCUSL began to adopt revisions to the UPA, which became known as the Revised Uniform Partnership Act. The most recent revisions to the UPA arose in 1997. To date, thirty-seven states along with

the District of Columbia and the U.S. Virgin Islands have adopted the 1997 revisions. That leaves twelve states, Indiana among them, who still cling to the 1914 version.

In *Flying Cat*, defendant Dan Cole appealed the trial court's determination that he was personally liable for a lease extension that was signed by Mr. Cole's ex-wife Lori. The Coles entered into a lease in 2001 to operate a Curves fitness center. "After the Lease was executed, Lori managed the day-to-day operations of Curves of Angola, and Dan handled the accounting responsibilities and maintenance of the equipment. Dan and Lori operated Curves of Angola for profit and treated the profits of the business as marital property that they were both entitled to use." The lease was for a three-year term with an option to extend the lease twice for additional three-year periods each. In 2004, Dan and Lori opted to exercise their option and extend the lease for another three years. By May 2007, Lori filed for dissolution of the couple's marriage.

The couple found themselves in default of the lease to the tune of more than $21,000 by the end of 2007. Despite the breakdown of their marriage and the default, Lori extended the lease again on January 1, 2008. This final three-year period, though signed on behalf of Curves of Angola, was only signed by Lori and not by Dan. In March 2010, after the landlord attempted to work with Lori to cure the default, the landlord – Flying Cat, LLC – filed suit against Lori, Curves of Angola, and Dan. After bench trial, the court found that Dan and Lori were business partners until May 2007 – when Lori filed for Divorce – and that even though the lease extension was signed after the end of the partnership, Dan was liable for the lease.

On appeal, before the court of appeals could decide whether Dan ought to be liable for the lease, the court first had to determine whether the trial court erred in finding that Dan and Lori were in a business partnership. Section 6(1) of the UPA, codified into Indiana law at Indiana Code section 23-4-1-6(1), defines a partnership: "A partnership is an association of two or more persons to carry on as co-owners a business for profit." Under Indiana case law, a partnership exists where "the parties [ ] have joined together to carry on a trade or venture for their common benefit, each contributing property or services, and having a community of interest in the profits." In making this determination, courts applying Indiana law must establish that: (1) there was a voluntary "association for the purpose of sharing profits and losses"; and (2) the parties intended to form a partnership.

Of the two prongs, the intention aspect is the most complicated. The reason for this is that the intention is not drawn by subjective evidence of what the parties actually intended, but rather through the objective actions that the parties take. On

an evidentiary level this makes sense. How would someone ever bring a case requiring proof of a partnership where the defendants could simply assert that they did not intend to be partners? That said, it does pose a serious conundrum in that persons may find themselves in a business partnership without meaning to be so.

In attempting to determine whether a partnership exists, the UPA provides a list of considerations:

> **§ 7. Rules for Determining the Existence of a Partnership**
> In determining whether a partnership exists, these rules shall apply:
> (1) Except as provided by section 16 persons who are not partners as to each other are not partners as to third persons.
> (2) Joint tenancy, tenancy in common, tenancy by the entireties, joint property, common property, or part ownership does not of itself establish a partnership, whether such co-owners do or do not share any profits made by the use of the property.
> (3) The sharing of gross returns does not of itself establish a partnership, whether or not the persons sharing them have a joint or common right or interest in any property from which the returns are derived.
> (4) The receipt by a person of a share of the profits of a business is prima facie evidence that he is a partner in the business, but no such inference shall be drawn if such profits were received in payment:
> (a) As a debt by installments or otherwise,
> (b) As wages of an employee or rent to a landlord,
> (c) As an annuity to a widow or representative of a deceased partner,
> (d) As interest on a loan, though the amount of payment vary with the profits of the business,
> (e) As the consideration for the sale of the good-will of a business or other property by installments or otherwise.

Though the Indiana adoption of the UPA largely tracks it verbatim, Indiana's version of this section has some slight differences. Indiana Code section 23-4-1-7 adds a fifth subsection with further considerations.

> (5) The existence of a partnership is not affected by the following:
> (a) The filing or failure or omission to file an original or renewal registration as a limited liability partnership under section 45 of this chapter.
> (b) The expiration of a partnership's status as a limited liability

partnership.
(c) The filing of a notice of withdrawal under section 45 of this chapter.

Dan sought to overturn the trial court's findings by arguing: (1) that Lori, not he, was involved in the day-to-day operation of the business; (2) he and Lori did not share profits "under any set formula"; and (3) that a partnership cannot be found based upon a "community of interests." The court rejected all three of these arguments. The court noted that, under Indiana law, "the lack of daily involvement by one party is not *per se* indicative of an absence of a partnership." The court also found that the considerations of section 7(4) do not require that the sharing of profits arise from a set formula. The third argument was quickly dispatched with by the court by citing to a prior decision that stated, "for a partnership to exist, the parties must have joined together to carry on a trade for their common benefit, each contributing property or services, and having a *community of interest in the profits*."

The court having found that a partnership did exist, moved to the next issue, whether Dan could be held liable for a lease extension signed after the partnership ended. In answering this second issue by affirming the trial court's decision, the court of appeals looked once more to the UPA, providing, in relevant part:

§ 35. Power of Partner to Bind Partnership to Third Persons after Dissolution

(1) After dissolution a partner can bind the partnership except as provided in Paragraph (3).
  (a) By any act appropriate for winding up partnership affairs or completing transactions unfinished at dissolution;
  (b) By any transaction which would bind the partnership if dissolution had not taken place, provided the other party to the transaction
    (I) Had extended credit to the partnership prior to dissolution and had no knowledge or notice of the dissolution; or
    (II) Though he had not so extended credit, had nevertheless known of the partnership prior to dissolution, and, having no knowledge or notice of dissolution, the fact of dissolution had not been advertised in a newspaper of general circulation in the place (or in each place if more than one) at which the partnership business was regularly carried on.

To summarize, the UPA, and the Indiana Code section that mirrors this provision, provide that there are circumstances in which a partner may be liable to actions of

his partner(s) even after the partnership has been dissolved where the second party knew that a partnership had existed but had no knowledge of the dissolution of the partnership. Here, the landlord knew that Lori and Dan were business partners from when the two together signed the first lease and the subsequent first extension. However, the landlord did not learn of their divorce until after the lease extension had been signed. As such, the court found that Dan was liable for the lease extension even though it was signed after the official end of his business partnership.

Another interesting aspect that is somewhat applicable to the facts of the *Flying Cat* case that was not given much discussion is the concept of "partnership by estoppel." Estoppel is a fancy legal term meaning a mechanism that prevents a party from arguing an issue. In the case of "partnership by estoppel" the mechanism prevents a party to the partnership from being able to argue that there was not actually a partnership. What makes the concept interesting is that for there to be any utility in using "partnership by estoppel" there must have been no actual partnership in existence.

Recall that section 7 of the UPA says, "Except as provided by section 16 . . . ." Section 16, to which it refers, outlines the requirements to find partnership by estoppel.

§ 16. Partner by Estoppel

(1) When a person, by words spoken or written or by conduct, represents himself, or consents to another representing him to any one, as a partner in an existing partnership or with one or more persons not actual partners, he is liable to any such person to whom such representation has been made, who has, on the faith of such representation, given credit to the actual or apparent partnership, and if he has made such representation or consented to its being made in a public manner he is liable to such person, whether the representation has or has not been made or communicated to such person so giving credit by or with the knowledge of the apparent partner making the representation or consenting to its being made.
   (a) When a partnership liability results, he is liable as though he were an actual member of the partnership.
   (b) When no partnership liability results, he is liable jointly with the other persons, if any, so consenting to the contract or representation as to incur liability, otherwise separately.

(2) When a person has been thus represented to be a partner in an existing partnership, or with one or more persons not actual partners, he is an agent of the persons consenting to such

> representation to bind them to the same extent and in the same manner as though he were a partner in fact, with respect to persons who rely upon the representation. Where all the members of the existing partnership consent to the representation, a partnership act or obligation results; but in all other cases it is the joint act or obligation of the person acting and the persons consenting to the representation.

This is a particularly potent mechanism. The first subsection describes the liability for a person who has represented himself to be a member of a partnership. It identifies that such a person is personally liable for his actions. The second subsection speaks to the liability of a partnership for representing a person to be a partner who is not. In such a circumstance, the partnership is liable just as if the person had actually been a partner.

So what should you take away from *Flying Cat*? The most important lessons is to be mindful of your actions in a business setting because you can inadvertently enter into a partnership relationship that exposes you to a great deal of liability. Another very important lesson is to be cognizant that even after the partnership has been dissolved, you may still be subject to liability for new obligations. Thus, it is vitally important to be mindful of informing those who knew of the business partnership that it has been dissolved.

Join us again next time for further discussion of developments in the law.

<u>Sources</u>

- *Curves for Women Angola v. Flying Cat, LLC*, ___ N.E.2d ___, No. 76A04-1206-PL-312 (Ind. Ct. App. Feb. 26, 2013).
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- Indiana Code chapter 23-4-1.
- Uniform Partnership Act (1914).
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- NCCUSL: Legislative Fact Sheet – Partnership Act.

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