The Partnership Agreement and Third Parties: ReRULPA § 110(b)(13) v. RUPA § 103(b)(10)

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I. INTRODUCTION

Over the past few years, the number of limited liability companies (LLCs) has grown prodigiously.[1] As a result of the favorable tax treatment of organizations treated as partnerships, unincorporated business organizations in general—and LLCs in particular—are being used in many types of business formally served by corporations. While the tax benefits have been the factor drawing people toward the use of unincorporated business organizations,[2] the ability of the owners to order their relationship by agreement has been an attractive characteristic of unincorporated businesses.

The essence of an unincorporated business organization such as a general partnership, limited partnership, or LLC (collectively in this article, an "organization") is that its internal structure can be established by the partners or members (collectively, "owners") as reflected in the partnership agreement or operating agreement (collectively, "organic agreements").

Unincorporated business organizations organized under uniform acts—the Uniform Partnership Act (1914) (UPA), the Uniform Limited Partnership Act (1916) (ULPA), the Revised Uniform Limited Partnership Act (1976 with 1985 Amendments) (RULPA), the Uniform Partnership Act (1997) (RUPA), the Uniform Limited Partnership Act (2001) (ReRULPA), and the Uniform Limited Liability Company Act (1995) (ULLCA)[3]—have several common

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1. Staff of Joint Committee on Taxation, *Background and Proposals Relating to S Corporations, Scheduled for a Public Hearing Before the Subcommittee on Select Revenue Measures of the House Committee on June 19, 2003*, JCX 62-03 June 18, 2003, *available at* http://www.house.gov/jct/x-62-03.pdf. "Since 1996, LLCs have grown at a rate of 34 percent per year." *Id*. at *14.

2. That the benefits of pass through taxation (i.e., the imposition of a single level of taxation at the owner level) are not limited to unincorporated business organizations is proven by the fact that there were 2,860,478 S corporations compared to 719,000 LLCs taxed as partnerships, and that over the past two decades S corporations have grown from approximately three percent of all business entities to over ten percent. *Id*. at *14-19.

3. Although the National Conference on Commissioners on Uniform State Laws (NCCUSL) has recognized the transitory nature of business legislation by replacing the term "revised" from the names of updated acts with a reference to the year of revisions, both the Uniform Partnership Act (1997) and the Uniform Limited Partnership Act (2001) have acquired acronyms referring to revisions.

characteristics. With a few exceptions, they are created by an association or contract among one or more owners.[4] The statutory provisions of each of the acts provide for a person—a general partner in a partnership or limited partnership, a manager in a manager-managed LLC or a member in a member-managed LLC (collectively, "statutory agents")—with authority to bind the organization through acts that appear to carry on the affairs of the organization in the usual manner.[5] The current uniform acts—RUPA, ReRULPA, and ULLCA[6]—each take a different approach to expanding or limiting the apparent authority of the statutory agents.[7] The statutes vary on the degree to which

4. LLCs need have only one member. UNIF. LTD. LIAB. CO. ACT § 202(a) (1995) [hereinafter ULLCA]. "One or more persons may organize a limited liability company, consisting of one or more members." *Id.*; *see* UNIF. P'SHIP ACT § 101(6) (1997) [hereinafter RUPA] ("'Partnership' means an association of two or more persons to carry on as co-owners a business for profit formed under Section 202, predecessor law, or comparable law of another jurisdiction"). Under the Uniform Limited Partnership Act of 2001 (ReRULPA), a limited partnership is described as "an entity, having one or more general partners and one or more limited partners, *which is formed under this [Act] by two or more persons* or becomes subject to this [Act] under [Article] 11 or Section 1206(a) or (b)." UNIF. LTD. P'SHIP ACT § 101(11) (2001) [hereinafter ReRULPA]. The term includes a limited liability limited partnership. *Id*. § 1206(a)-(b). This definition is based on the definition in the 1976 Uniform Limited Partnership Act (RULPA), section 101(7), which defines a limited partnership as a "partnership" formed by two or more persons. UNIF. LTD. P'SHIP ACT § 101(7) (1976) [hereinafter RULPA] (emphasis added). Because the Uniform Partnership Act (UPA) definitions supplement those of RULPA section 1105, a limited partnership organized under RULPA must have at least two partners because a partnership must have at least two partners. UPA § 6. A partnership is "the association of two or more persons to carry on as co-owners a business for profit." *Id.* Because ReRULPA does not link to the organic law governing general partnerships—either UPA or RUPA—the absence of a definition under which a limited partnership is defined as having two partners raises the theoretical question of whether a limited partnership could be formed by two persons and continue after the dissociation of one of the two partners.

5. UNIF. P'SHIP. ACT § 9 (1914) [hereinafter UPA] (giving general partner ability to bind partnership by actions that appear to carry on business of partnership in usual way); UNIF. LTD. P'SHIP ACT § 9 (1916) [hereinafter ULPA] (giving general partner of limited partnership all powers of partner in general partnership); RULPA § 403 (similar); RUPA § 301 (giving each general partner apparent authority to bind organization for transactions "for apparently carrying on in the ordinary course the partnership business or business of the kind carried on by the partnership"); ReRULPA § 402(a). A General Partner is an agent of the limited partnership for purposes of the partnership's business; the actions of a general partner bind the organization if they apparently carry on the activities of the partnership in the ordinary course of business. ReRULPA § 402(a); ULLCA § 301 (giving members in member-managed, or manager in manager-managed, LLC ability to bind organization). Some state statutes provide different rules for statutory authority. *See* DEL. CODE ANN. tit. 6, § 18-402. "Unless otherwise provided in a limited liability company agreement, each member and manager has the authority to bind the limited liability company." *Id*. Because the Delaware LLC act conditions the agency authority on the LLC agreement, third parties need to familiarize themselves with the LLC agreement—a non-public document. *Id.* Thus, in the absence of examination of the agreement, a third party gets no benefit from the statute. *Id*. In other words, no member or manager has apparent authority if that authority is negated in the LLC agreement. *Id*.

6. In this article, references to "current uniform acts," unless the context indicates otherwise, are to RUPA, ReRULPA, and ULLCA, although neither ReRULPA nor ULLCA have yet attained wide acceptance.

7. RUPA § 303 (permitting grant of apparent authority in document filed in records of Secretary of State or grant or restriction of authority with respect to real property in document filed in real estate records); ULLCA § 301(c). Section 301(c) of the ULLCA permits the organization to file a statement of authority with the Secretary of State giving person authority beyond that given in the statute and permitting the recording of a statement of authority in the real estate records either expanding or limiting the apparent authority of the persons having apparent authority of the agent. ULLCA § 301(c). ReRULPA provides neither for a statement

owners may be liable to third parties for failure to make agreed contributions or for the receipt of incorrect distributions.[8]

In providing this flexibility, the current generation of uniform acts set forth the effect of the organic agreement on third parties. None of the last generation of uniform acts—UPA, ULPA, and RULPA—explicitly dealt with the ability of the owners to vary the provisions of the organic act or with the question of the effect of the organic agreement on third parties. In contrast, each of the current uniform unincorporated acts—RUPA, ULLCA, and ReRULPA—have a provision that states that the organic agreement may not restrict the rights of third parties.

This article considers those provisions and the question of the relationship of the organic agreement and third parties. It first describes the provisions of the uniform partnership and LLC statutes (the "organic statutes"), limiting the effectiveness of the organic agreements with respect to third parties. It then considers the questions of what the organic agreements consist of and who "third parties" are within the meaning of those provisions. Having defined third parties, it considers what rights third parties have under the organic statutes. It concludes by considering the efficacy and advisability of the provisions as they currently exist, and whether they mean what they say.

Each of the current uniform acts contain a provision addressing the effect of the operating agreement on "third parties." The provision (referred to in this article as a "third-party limitation") generally provides that the organic agreement may not impose a restriction on the rights of third parties under the organic act. The language was originally developed for RUPA and has changed through the development of other uniform acts.

The RUPA third-party limitation is fairly terse. RUPA section 103(b)(10) provides: "[t]he partnership agreement may not . . . restrict rights of third parties under this [Act]." The commentary to RUPA section 103(b)(10) states that this provision is axiomatic as a contract and can only affect those who are parties to it.[9]

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of authority nor for the ability to modify apparent authority in the certificate of limited partnership.

8. RUPA does not have a provision with respect to contributions—relying on joint and several liability in the case of general partnerships that are not LLPs, and on the concept of fraudulent conveyances to address wrongful distributions. ULPA § 16(1). A limited partner may not receive a return of contribution until all creditors are repaid or there is property sufficient to repay them. *Id*. A limited partner is liable for unmade contributions. *Id*. § 17. A partner is liable for returns of contributions for one year, but only to the extent necessary to repay creditors who extended credit while the contribution was held by the partnership, or for six years if the distribution is made in violation of the agreement or when the partnership does not have sufficient remaining assets to repay the creditors. *Id*. § 608. "Unless otherwise provided in the a limited liability company agreement, each member and manager has the authority to bind the limited liability company." Note that under the Delaware language—unlike the uniform acts—members of an LLC with managers have authority to bind the organization and the statutory authority of members and managers is not limited to matters in the ordinary course of the LLC's business. ULLCA § 402.

9. The commentary to RUPA section 103(b)(10) states:

Although stating the obvious, subsection (b)(10) provides expressly that the rights of a third party

The third-party limitation under ULLCA is more specific. ULLCA section 103(b)(7) provides: "[t]he operating agreement may not . . . restrict rights of a person, other than a manager, member, and transferee of a member's distributional interest, under this [Act]."

ReRULPA section 103(b)(13) provides: "[a] partnership agreement may not . . . restrict rights under this [Act] of a person other than a partner or a transferee."

To understand third-party limitations, it is necessary to consider what the organic agreement is and who the third parties are.

II. WHAT IS THE ORGANIC AGREEMENT?

Organic agreements are agreements among the owners of the organization concerning the relations among the owners, between the owners and the organization and, in the case of LLCs, between the managers, the members, and the company.[10] Thus, at least as to the internal relationships among the owners, and between the owners and the organization, organic statutes largely provide default rules—rules that apply unless modified in the organic agreement.[11] Because it supplements and replaces the organic statute, the organic agreement may establish the fundamental structure of the organization. The organic agreement, which may be thought of as the "operating agreement," is the agreement under RUPA section 103 concerning the relations among the members, managers, and limited liability company. The term includes amendments to the agreement.

The relationship between the organic statutes and the organic agreement is not entirely clear. As noted above, the organic agreement prevails over—and is therefore distinct from—the organic statutes. On the other hand, except in the case of some partnerships, owners may only become members of an organization by agreeing—or in the case of a single member LLC, by determining—to become an owner of a particular form of organization.[12] A

under the Act may not be restricted by an agreement among the partners to which the third party has not agreed. A non-partner who is a party to an agreement among the partners is, of course, bound.

RUPA § 103(b)(10) cmt.

10. ULLCA § 103(a).

11. The commentary to RUPA provides that the act "gives supremacy to the partnership agreement in almost all situations." RUPA is, therefore, largely a series of "default rules" that govern the relations among partners in situations not addressed in a partnership agreement. The primary focus of RUPA is the small, often informal, partnership. Larger partnerships generally have a partnership agreement addressing, and often modifying, many of the provisions of the partnership act.

12. RUPA § 202(a). An association of two or more persons to carry on as co-owners of a business for a profit forms a partnership, whether or not the persons intend to form a partnership. *Id.* ReRULPA provides that a limited partnership is formed when a certificate of limited partnership is filed with the secretary of state (ReRULPA does not indicate who must file the certificate of limited partnership, but it must be signed by all the general partners). ReRULPA § 204(a)(1). But in order to be a limited partnership, the organization must have at least one general partner and at least one limited partner. *Id*. § 102(11). Except in a merger, a person becomes a partner either as provided in the partnership agreement or by the consent of the partners. *See id*. §

partnership may arise even when the participants do not intend to become partners, but it always arises as a result of the conscious decision to take actions that may later be characterized as a partnership relationship.[13]

III. WHO ARE THIRD PARTIES?

Neither RUPA section 103(10) nor its commentary identifies who are "third parties" or what constitute restrictions. Third parties may include persons other than persons who are parties to the agreement. In contrast to the more specific definition of third parties contained in ULLCA and ReRULPA, it is unclear whether such a provision applies to a partner's transferee or a person claimed by or through a partner. There may also be a question of whether the partnership itself is a third party.

Unlike RUPA, ULLCA section 110(b)(7) expressly excludes assignees and statutory agents (managers) from third-party limitations. While there is no position that corresponds to that of manager in partnerships, partnerships—both general and limited—do have the concept of assignees or transferees, persons who acquire economic rights in a partnership but are not admitted to membership in the partnership and are therefore denied rights to information and to participate in management. ULLCA, by eliminating the general term "third party," identifies the persons entitled to the benefits of the third-party limitation by negative reference—all persons other than members, managers and assignees.

The language of the statute, read literally, would appear to indicate that the organic agreement could not restrict the rights of the LLC itself. Cases such as *Elf Atochem N.A. v. Jaffari*,[14] and *Bubbles & Bleach, LLC v. Becker*,[15] make clear that the applicability of the operating agreement to restrict the rights of the LLC itself is significant.[16] The better reasoning would be that because the LLC is created and defined by the operating agreement, it should be subject to any limitations contained therein. The commentary to ULLCA section 110(b)(7) does not discuss the third-party limitation. The inclusion of managers in the persons whose rights under the organic statute could be limited by the agreement is significant. For example, if a manager's duties are raised above the statutory floor (i.e., increasing the duty of care from not engaging in

301 (limited partners); *id*. § 401 (general partners). Thus, in order for the initial partners to become partners, they must be made partners as provided in the partnership agreement, which is defined as the partners' agreement, whether oral, implied, in a record, or in any combination, concerning the limited partnership. *Id*. § 102(13). Taken as a whole, a limited partnership may not be created without a partnership agreement. A similar approach is taken in ULLCA. ULLCA section 202(a) provides that an LLC must have one or more members. ULLCA § 202(a).

13. RUPA § 202(a).

14. Elf Atochem N.A., Inc. v. Jaffari, 727 A.2d 286, 291 (Del. 1999).

15. Bubbles & Bleach, LLC v. Becker, No. 97 C 1320, 1997 WL 285938 (ND Ill. May 23, 1997).

16. *Compare Bubbles & Bleach*, 1997 WL 285938 (holding arbitration agreement not binding on LLC because not party to operating agreement), *with Elf Atochem*, 727 A.2d at 287 (holding the contrary).

grossly negligent conduct to not engaging in simply negligent conduct), presumably that provision would be binding on the manager notwithstanding the fact that a manager is not a party to the operating agreement.

ReRULPA follows the language of ULLCA, and the questions with respect to the definition of third parties carries over to ReRULPA. Unlike ULLCA, ReRULPA does provide some additional commentary on the third-party limitation, which provides that the third-party limitation does not apply to the parties to the contract; although, like the ULLCA third-party limitation, it could be read to provide that the rights of the organization may not be restricted by a third-party limitation.[17]

There are persons who might be considered third parties for purposes of the third-party restriction—the organization itself, persons voluntarily engaged in transactions with the organization, persons in involuntary transactions with the organization such as persons damaged by or damaging the organization as a result of torts, persons having rights and duties as successors to owners, and persons engaged in transactions with owners.

A. The Organization

As noted above, there is a question of whether the organization itself is subject to the third-party limitations. None of the uniform acts provide that the organic agreement does not affect the rights of the organization.

B. Persons Engaged in Non-Equity Transactions With the Organization

These transactions may be agreements such as loans, contracts, or purchases and sales of property or non-contractual transactions, but do not include transactions by which an equity interest in the organization is transferred or encumbered.

1. Persons Who Voluntarily Enter Into Agreements With the Organization

Persons entering into contracts, loans, purchases, and sales with the organization generally have an opportunity to become familiar with the internal structure of an organization. This group includes creditors seeking to ensure the authority of the persons acting on behalf of the organization and persons entering into contracts or sales with the organization. Such persons will have

17. The commentary to ReRULPA section 110(b)(13) states:

> The partnership agreement is a contract, and this provision reflects a basic notion of contract law—namely, that a contract can **directly** restrict rights only of parties to the contract and of persons who derive their rights from the contract. A provision of a partnership agreement can be determined to be unenforceable against third parties under paragraph (b)(13) without therefore and automatically being unenforceable *inter se* the partners and any transferees. How the former determination affects the latter question is a matter of other law.

ReRULPA § 110(b)(13) cmt.

concerns with such matters as the authority of agents acting on behalf of the organization, the manner in which organizations make decisions, and the property and rights owned by the organization. In significant transactions, persons voluntarily entering into transactions with an organization will have the opportunity to determine the content of the organic agreement and otherwise satisfy themselves with respect to the validity of the transaction and the property of the organization. Persons in voluntary transactions also will have concerns with matters taking place after entering into the transaction, including the disposition of the property of the organization. Again, in significant transactions, such persons may be able to control the actions of the organization by agreement made as part of the transaction in question.

2. Persons Involuntarily in Transactions With the Organization—Such as a Person Injured by the Organization or Who Injures the Organization or its Property

Persons who find themselves in involuntary transactions ordinarily will not have an opportunity to learn the identity and nature of the organization before becoming involved with it. Often, their concerns will be limited to changes occurring after the transaction takes place. As a result of the lack of a pre-transaction relationship between such persons and the organization, these people will not have the ability to protect themselves with respect to activities of the organization.

C. Equity Owners and Persons Taking Through Equity Owners

1. Owners

It is clear that partners and members are bound by the organic agreement and are not entitled to the protection of the third-party limitations.[18] This is especially true in that the organic agreement is the document that defines the owners' rights and duties. Thus, unless a provision of the organic agreement is otherwise proscribed by the organic acts[19] or by other law governing contracts or fiduciary relationships, the organic agreement should be effective to restrict any rights that the equity owners would otherwise have under the organic rights.

2. Successors to Owners and Persons Taking Through Owners

Perhaps the most difficult issue is the ability of the organic agreement to

18. Fox v. I-10, Ltd., 957 P.2d 1018 (Colo. 1998). "Where a party enters into a contract absent fraud, duress or incapacity, the courts will not relieve that party of the consequences of the bargain simply because it may have been improvident." *Id.* at 1022.

19. *See* RUPA § 103(b); ULLCA § 103(b); ReRULPA § 110(b).

restrict the rights of persons having claims on the organization by or through owners. This group includes assignees and transferees of ownership interests, persons negotiating to acquire ownership interests, persons holding charging orders to recover judgments against owners, and persons taking pledges of ownership interests or otherwise relying on owners' interests in entering into contracts with owners or assignees. As noted above, by definition, assignees and transferees, at least in LLCs and limited partnerships, are not protected by third-party limitations.

IV. WHAT ARE A THIRD PARTY'S RIGHTS UNDER THE ORGANIC ACTS?

The third-party limitation applies to prevent the organic agreement from restricting rights of third parties under the organic act. Thus, the starting point of the analysis of the restrictions is to catalogue the "rights" of a third party under the organic acts.

A. Rights Against the Organization

The principal interest of third parties in dealing with the organization is in ensuring that the transactions are effective and binding upon the organization. Thus, the concerns of third parties arise in two contexts: authority of individuals involved in the organization to bind the organization, and the steps necessary in order to give the organization notice of a fact (notice).

1. Agency Authority of the General Partner, Manager, or Member

Each of the uniform acts provide that statutory agents have authority for carrying on the business of the organization in the ordinary course. For example, ReRULPA section 402(a) provides that each general partner is an agent of the partnership for the purpose of carrying on, in the ordinary course of business, the activities of the partnership and similar activities, unless the person dealing with the general partner has knowledge of a limitation. RUPA and ULLCA have similar provisions. Thus, a person dealing with a statutory agent carrying on the business of the organization in the usual way would be protected, even if the statutory agent did not have authority. Such an arrangement is intended to place the risk of the statutory agent's misbehavior on the organization and its owners—the "know your partner" rule. A prudent third party would want to determine: (1) Does the person purporting to be a statutory agent acting actually hold the appropriate position with the organization; and (2) Is the action under consideration appropriate for carrying on the business of the organization in the usual manner? The third party will apparently be protected regardless of such investigation, unless the third party learns information to the contrary as part of the investigation. RUPA has a

provision permitting the recording of a statement of authority which gives third parties notice of limitations on the authority with respect to real property.[20] Under all of the other uniform acts, there is no effective way to limit this authority of the partner, general partner, manager, or member—as the case may be—other than giving the person dealing with the partnership information concerning the limitation.[21]

Persons voluntarily dealing with the organization have some opportunity to address potential restrictions on the authority of individuals contained in the organic agreement. Those involuntarily dealing with the organization take the organization as they find it. In either case, an argument could be made that the third-party limitation is inappropriate, particularly in light of the fact that some or all of an organic agreement may not be in writing—either being the result of an oral agreement or an agreement created by course of conduct.

Thus, in the case of voluntary transactions, the third-party limitation has the effect of making restrictions on the authority of a partner, member, or manager in the organic agreement ineffective as to third parties who take without knowledge of the restriction.

2. Notice and Knowledge of the Organization

A person entering into a transaction with an organization will have an interest in confirming whether some action is sufficient to give the organization notice or whether the organization may be charged with the knowledge of one of its owners or agents. For example, a person injured by the organization may wish to charge the organization with the knowledge of a defect held by one of its constituents. Similarly, a person entering into a transaction with an organization may have a need to know how to put the organization on notice of a particular matter. RUPA, RULPA, and ULLCA each have provisions providing for what constitutes knowledge or notice:

> An entity knows, has notice, or receives a notification of a fact for purposes of

20. RUPA § 303(e).

21. RNR Invs. Ltd. P'ship v. Peoples First Cmty. Bank, 812 So. 2d 561 (Fl. Dist. Ct. App. 2002).

> [E]ven if a general partner's actual authority is restricted by the terms of the partnership agreement, the general partner possesses the apparent authority to bind the partnership in the ordinary course of partnership business or in the business of the kind carried on by the partnership, unless the third party knew or had received a notification that the partner lacked authority.

Id. at 565; *see* Donald J. Weidner & John W. Larson, *The Revised Uniform Partnership Act: The Reporters' Overview*, 49 BUS. LAW. 1, 31-32 (1993) (footnotes omitted). "Absent actual knowledge, third parties have no duty to inspect the partnership agreement or inquire otherwise to ascertain the extent of a partner's actual authority in the ordinary course of business, . . . even if they have some reason to question it." *Id*. at 32 n.200. The apparent authority provisions of section 620.8301(1) reflect a policy by the drafters that "the risk of loss from partner misconduct more appropriately belongs on the partnership than on third parties who do not knowingly participate in or take advantage of the misconduct." J. Dennis Haynes, *Notice and Notification Under the Revised Uniform Partnership Act: Some Suggested Changes*, 2 J. SMALL & EMERGING BUS. L. 299, 308 (1998).

> a particular transaction when the individual conducting the transaction for the entity knows, has notice, or receives a notification of the fact, or in any event when the fact would have been brought to the individual's attention had the entity exercised reasonable diligence. An entity exercises reasonable diligence if it maintains reasonable routines for communicating significant information to the individual conducting the transaction for the entity and there is reasonable compliance with the routines. Reasonable diligence does not require an individual acting for the entity to communicate information unless the communication is part of the individual's regular duties or the individual has reason to know of the transaction and that the transaction would be materially affected by the information.[22]

RUPA section 102 sets forth rules for the determination of whether a partnership has knowledge or has received notice of a fact. In particular, RUPA section 102(f) provides that:

> A partner's knowledge, notice, or receipt of a notification of a fact relating to the partnership is effective immediately as knowledge by, notice to, or receipt of a notification by the partnership, except in the case of a fraud on the partnership committed by or with the consent of that partner.

ReRULPA section 103(h) has a similar definition of notice to a limited partnership, but states that only the knowledge, notice, or notification of a general partner will be attributed to the partnership. There is no similar provision in ULLCA, so knowledge of, or notice to, a member or a manager will not automatically be attributed to the entity.

The attribution of knowledge or notice from a partner, member, or manager to the entity may be an important issue for both voluntary and involuntary creditors of the organization and for persons against which the organization has rights. Such matters as duties, waiver, and even limitation of actions may be determined by reference to knowledge and notice. The effect of RUPA section 103(b)(10) would be to make ineffective as to third parties any provision in the partnership agreement stating that no knowledge of a passive general partner would be attributed to the partnership, unless the partner was acting adversely to the partnership. Is this an appropriate rule in a large national professional partnership? It should be noted that in the world of legal ethics, a similar rule has been adopted, the idea that a conflict of any lawyer in the firm is attributed to the entire firm.[23]

22. *See* ULLCA § 102(e); *see also* ReRULPA § 103(g); RUPA § 102(e).

23. MODEL RULES OF PROF'L CONDUCT R. 1.10 (2003) [hereinafter MRPC] (imputation of conflicts of interest). In 2001, the ABA Commission on Evaluation of the Rules of Professional Conduct (Ethics 2000 Commission) had recommended a variation on the rule of absolute imputation, providing for lawyers whose representation of a former client would have been attributed to the new firm. Under the proposal—which is similar to a longstanding rule dealing with attorneys who leave government service to work for a firm—the firm could avoid the disqualification by "screening" the new lawyer from the matter with respect to which the lawyer would have a conflict, and by notifying the former client. The proposals to modify Rule 1.10 of the MRPC were defeated by the ABA House of Delegates in 2001.

B. Rights Against Owners

The organic statutes provide third parties certain rights against owners. Historically, the principal right held by third parties with respect to owners related to the vicarious liability of general partners. In a world of LLPs, LLCs and LLLPs, other rights with respect to owners are becoming more important as partners increasingly reduce their vicarious liability for partnership obligations. Thus, for the most part, those rights apply to the owners' interests in the organization and the ability of third parties to rely on either the owners' duties to the organization or the owners' rights.

1. Vicarious Liability of the Partners

Although the concept of universal vicarious liability of partners has been significantly reduced, partners in a general partnership (other than in an LLP),[24] and general partners in a limited partnership (other than in an LLLP),[25] are vicariously liable for the obligations of the partnership. While partners may agree among themselves to apportion liabilities by contribution or indemnification, any agreement limiting vicarious liability of a partner is ineffective as to creditors of the partnership.[26]

2. Contribution Obligations

The organic statutes, other than RUPA, provide for an obligation on the part of the partners to make contributions as agreed in the partnership agreement.[27] While the obligation to make contributions may be waived, creditors of the partnership are granted rights with respect to the contributions. The organic statutes themselves grant the ability to modify the rights of third parties to pursue owners with respect to unmade contributions.[28] RUPA apparently does not consider the rights of third partners with respect to contribution obligations as all partners are jointly and severally liable for partnership obligations.[29] No provision for creditors was added when the limited liability partnership provisions were added to RUPA. Thus, a creditor of the partnership has no

24. RUPA § 306(a).

25. RULPA § 403(a); ReRULPA § 404(a).

26. First Tenn. Prod. Credit Ass'n v. Davis, NO. 6, 1986 WL 6199 (Tenn. Ct. App. June 3, 1986), *rev'd*, 748 S.W.2d 83 (Tenn. 1988). Limitation in the partnership agreement on the vicarious liability of a partner ineffective as to third parties unless third party expressly agrees to the provisions of the agreement. *Id.*

27. ReRULPA § 502; ULLCA § 402.

28. ReRULPA § 502(c).

> The obligation of a partner to make a contribution or return money or other property paid or distributed in violation of this [Act] may be compromised only by consent of all partners. A creditor of a limited partnership which extends credit or otherwise acts in reliance on an obligation described in subsection (a), without notice of any compromise under this subsection, may enforce the original obligation.

Id.; *see* ULLCA § 402(b) (similar).

29. RUPA § 306(a).

right under RUPA to enforce an obligation to contribute. This distinction among organic acts is difficult to justify and may simply be an historical oversight.

3. Wrongful Distributions

The organic acts, other than RUPA, provide for liability with respect to distributions made when the organization is insolvent or in violation of the organic agreement. The owner or statutory agent is liable for wrongful distributions, and the recipient is liable if the recipient knew the distribution was wrongful.[30] In this regard, the rule differs from the former strict liability that applied to partners under RULPA.[31]

V. EXAMPLES

Several situations exist in which a third-party limitation may operate to negate a restriction. The following are examples of a few of the possible circumstances where there may be an issue. Generally, the determination of the applicability of the third-party limitation will require three steps. First, is the person affected a "third party" entitled to the protection of the third-party limitation? Second, does the person have rights under the organic statute? And third, is there a restriction in the organic agreement that restricts those rights? In many cases, there may be other provisions limiting the efficacy of the provision in the organic agreement limiting the ability of the organization to restrict the rights of a third party. While some of these alternative limitations are noted below, this article is chiefly concerned with restrictions in the organic agreement, and does not attempt to discuss other limitations in any depth. The examples below are intended to be illustrative only, and other situations may arise that would be subject to similar analysis.

A. Restrictions on Transfer

An agreement of an organization to transfer of its interest to a third party, without consent of the other owners, is ineffective. Further, if the owner purports to transfer its interest without consent, the transfer shall be disregarded for "all purposes." Presumably, the effect of such a provision is to permit the organization to continue to treat the transferor as the owner and to ignore the transferee in all respects, including for purposes of distributions. In other words, if a member purports to transfer its membership interest without whatever consent set forth in the operating agreement, the transfer does not

30. *See* ReRULPA § 507; ULLCA § 407.

31. RULPA § 608(a). A partner receiving a rightful distribution is liable for one year after the receipt for the amount sufficient to pay the creditors. *Id.*; ReRULPA § 608(b). A partner receiving a wrongful distribution is liable for six years after the distribution. ReRULPA § 608(b).

affect the member's status as a member in the company. This sort of provision would affect (1) the limited liability company; (2) the member who wishes to transfer its interest; (3) the transferee who wishes to receive the transfer; and (4) creditors and other persons dealing with either the transferor or the transferee.

The starting point is the evaluation to determine whether there are "rights" under the organic statute. Third-party limitations appear as part of a section dealing with the ability of owners to modify the default rules governing the relationship among the owners, between the owners and the organization, and, in at least some cases, between the assignees or transferees and the organization. Thus, presumably among the "rights" that exist under the statute is the expectation that the default rules of the statute will apply to govern those relationships. All of the uniform acts, and many state statutes, contain provisions providing that an interest may be transferred, but limiting the rights of the transferee unless admitted. For example, ULLCA section 501(b) provides that "[a] distributional interest in a limited liability company is personal property and, subject to Sections 502 and 503, may be transferred in whole or in part."[32] ULLCA section 502 provides, "[a] transfer of a distributional interest does not entitle the transferee to become or to exercise any rights of a member. A transfer entitles the transferee to receive, to the extent transferred, only the distributions to which the transferor would be entitled." Similarly, ULLCA section 503(d) provides that "[a] transferee who does not become a member is not entitled to participate in the management or conduct of the limited liability company's business, require access to information concerning the company's transactions, or inspect or copy any of the company's records."[33]

The third-party limitation does not limit the rights of the organization or the owners, but may it limit the rights of the transferee? Both ULLCA and ReRULPA make restrictions in the organic agreement effective to restrict the rights of assignees and transferees, while RUPA is generally silent on the rights of assignees and transferees. By the language of the statute, a person other than an assignee or transferee is probably a third party, but by becoming an assignee or transferee, the person becomes subject to the organic agreement and that person's rights may be restricted thereby. The logical conclusion of such a reading would be that, where the organic agreement provides that an interest is transferable, a provision restricting the transfer would be effective as against one who becomes an assignee, but not as against one who does not. More specifically, a provision prohibiting transfers might be less enforceable (because the person attempting to become an assignee or transferee never

32. Similar are section 503(a) of RUPA and section 702(a) of ReRULPA. Sections 502 and 503 of the ULLCA describe limitations and rights of a transferee. ULLCA §§ 502, 503.

33. Similar are section 503(a)(3) of RUPA and section 702(a)(3) of ReRULPA.

becomes one, thereby remaining a third party), while one eliminating the voting and economic rights of a transferee or assignee might be effective, because it applies to a transferee.

B. Discharge of Obligations to Make Contributions or Return Distributions

The agreement for an organization provides that, notwithstanding any provision of the statute, upon the occurrence of certain circumstances, no owner shall be obligated to restore wrongful distributions or make otherwise unconditional contribution obligations. In this case, some of the organic statutes providing specifically for liability to those authorizing or receiving such distributions, upon which creditors are relying, may not be changed except as permitted in the organic statute. Such a reading would call into question the provisions of the organic agreements providing that contribution agreements are not for the benefit of third parties. This reading creates a particularly troublesome interaction between the organic agreement and the third-party limitation. The third-party limitation would say that no obligation under the organic statute to enforce contribution obligations may be modified. The organic statute sets limitations on the ability of the owners to modify the liability of owners to third parties with respect to contribution obligations, but the obligation to make contributions is a part of the organic agreement. It would appear that a third party should only have rights with respect to a contribution obligation as the obligation is set forth in the organic agreement. In other words, one reading of the third-party limitation would be to read a conditional contribution obligation as making the contribution obligation enforceable by third parties, while making any restrictions on the contribution obligation unenforceable as to third parties. Such a reading of the third-party limitation, permitting a third party to exercise something of a line-item veto with respect to the organic agreement, would clearly be inappropriate.

C. Modification of Agency Authority

A provision in an organic agreement provides that a person having statutory power to bind the organization does not have authority to enter into certain transactions that might otherwise be within the ordinary course of the activities of the organization. As noted above, under each of the organic acts except with respect to a manager-managed LLC, some or all of the owners have the statutory power to bind the organization except to the extent that the person dealing with that owner or manager is aware of the fact that the owner or manager does not have authority. Subject to RUPA's statement of partnership authority, this sort of restriction on the third party's ability to rely on the statutory authority of that owner or manager should be unenforceable under the third-party limitation. Because the rights of third parties are conditioned upon their lack of knowledge of any restrictions on the authority of the owner or

manager, the third-party limitation operates slightly differently in this case than it might in others. For example, a third party's right to purchase or foreclose on an interest in the organization would not be affected by the third party's knowledge of a restriction in the organic agreement, but a third party's ability to rely on the power of an owner or manager to bind the organization would be defeated by knowledge of a restriction on the authority of that owner or manager in the organic agreement before entering into the transaction.

D. Negation of Organizational Liability for Injuries Caused by Statutory Agents

The organic agreement provides that the organization shall not be liable for actions of the statutory agents. It seeks to do this in two fashions: (1) it simply states that the organization shall not be liable to persons injured by the statutory agents; and (2) it provides a very limited definition of what constitutes the conduct of the business of the organization beyond that which would otherwise apply.

The victim of a tort committed by an agent normally will only have a claim against the principal if the agent is a servant and the principal is a master[34] or, in modern argot, an employee[35] under the doctrine of respondeat superior. As noted in the commentary to the *Restatement (Third) of Agency* section 2.04,[36] the principal's liability for the errors in judgment of an agent is limited to agents who are employees or servants—persons with respect to whom there is "a continuing relationship and a continuing set of duties that the employer and employee owe to each other."[37] Respondeat superior does not apply to other agents.

Under the uniform acts, organizations have the same sort of liability with respect to the acts of their statutory agents (i.e., general partners, managers in manager-managed LLCs, and members in member-managed LLCs). While using the term "respondeat superior," the claim against the principal with respect to the tortuous actions of a servant while under the direction of the principal, in terms of the liability of the organization, it will turn on whether the person acting on behalf of the organization was a "servant." The original uniform partnership act statutorily made all general partners "servants" by making the partnership liable for all actions of the general partners.[38] This

34. RESTATEMENT (SECOND) OF AGENCY § 219(a) (1958). "A master is subject to liability for the torts of his servants committed while acting in the scope of their employment." *Id.*

35. RESTATEMENT (THIRD) OF AGENCY § 2.04 (Tentative Draft No. 2, 2001). "An employer is liable for torts committed by employees while acting in the scope of their employment." *Id.*

36. *Id*. § 2.04 cmt.

37. *Id*. § 2.04 cmt. b.

38. RUPA § 305. "A partnership is liable for loss or injury caused to a person, or for a penalty incurred, as a result of a wrongful act or omission, or other actionable conduct, of a partner acting in the ordinary course of business of the partnership or with authority of the partnership." *Id*. "A limited liability company is liable

concept has been carried forward into ULLCA and ReRULPA.

E. Property of the Owner or Property of the Organization

The partnership agreement of a general partnership provides (1) that certain other property titled in the name of one of the partners actually belongs to the partnership; and (2) that certain property titled in the name of the general partner is property of one of the owners.

RUPA section 204 provides that property is partnership property if acquired: (i) in the name of the partnership;[39] (ii) by one or more partners in their capacity as partners in the partnership, if the name of the partnership is indicated in the instrument transferring title to the property;[40] or (iii) by one or more partners with an indication in the instrument transferring title to the property of the person's capacity as a partner or of the existence of a partnership but without an indication of the name of the partnership.[41] If there is no indication of name or existence of the partnership, but the property is acquired with partnership assets, the property is presumed to be partnership property. All other property acquired in the name of a partner—even if used in the partnership business—is presumed not to be partnership property. Neither ReRULPA nor ULLCA contain similar provisions.

RUPA section 204 also addresses rights that go beyond those of the partners themselves, and it could have an effect on the rights of various third parties. With respect to creditors of the partnership and people against whom the partnership may have rights, they will want to be able to assume what property the partnership owns. On the other hand, a person dealing with a partner may want to confirm the separate property owned by that person.

The interaction of RUPA section 103(b)(10) and RUPA section 204 presents some issues that may not have been thoroughly thought through by the drafters. For example, RUPA appears to provide that property is partnership property if acquired in the name of the partnership or in the name of one or more partners in their capacity as such, if the instrument indicates the name of the partnership or the existence of a partnership. This would appear to be an absolute rule, upon which a third person could rely even if the partnership agreement provided otherwise, although it is not clear whether a provision indicating that the partners took title in their capacity as partners might be governed by the

for loss or injury caused to a person, or for a penalty incurred, as a result of a wrongful act or omission, or other actionable conduct, of a member or manager acting in the ordinary course of business of the company or with authority of the company." ULLCA § 302. "A limited partnership is liable for loss or injury caused to a person, or for a penalty incurred, as a result of a wrongful act or omission, or other actionable conduct, of a general partner acting in the ordinary course of activities of the limited partnership or with authority of the limited partnership." ReRULPA § 403(a).

39. RUPA § 204(a)(1), (b)(1).

40. RUPA § 204(a)(1), (b)(2).

41. RUPA § 204(a)(2).

partnership agreement. With respect to property acquired in the name of one or more partners without an indication of the partnership's name or existence, RUPA section 204 merely provides presumptions with respect to the ownership of the property. Presumably, a presumption could be overridden by proof reflected in the partnership agreement.

In the absence of RUPA section 204, ownership of the property would be subject to other law. Such law often turns on the knowledge of the person examining the record. For example in a race-notice system of real estate, a party can rely on the state of the public record in the absence of knowledge or notice to the contrary. Thus, assume the partnership agreement provides that although property had been transferred into the name of partnership, the partners had agreed that it would remain the property of a partner. Under normal circumstances, a third party becoming aware of that provision would not be able to rely on the record title in the name of the partnership. It is not clear whether a similar situation would apply under RUPA section 103(b)(10). If effective, the provision in the partnership agreement would limit the rights of a creditor of the partnership under RUPA section 204 with respect to the property in question. Thus, RUPA section 103(b)(10) would render the provision ineffective as to the third party so that the third party could treat the property as partnership property, even with knowledge of the limitation on the partnership's ownership of the property. It would seem likely that the equities would argue against this result, and a court seeking to remedy this problem might be able to contort the situation in order to avoid the inappropriate result. It might invoke other law to find that although the partnership had legal ownership of the property, it was, in fact, holding the property in trust for the partner. It might find that RUPA section 103(b)(10) does not apply to RUPA section 204.

The lack of a similar provision in either ReRULPA or ULLCA presents a different question. One of the principal purposes of the adoption of ReRULPA was to cure the "linkage" problems that had traditionally existed with limited partnerships under the RULPA.[42] As there was no provision addressing the ownership of property by a limited partnership, presumably the ownership of property by a limited partnership governed by RULPA was drawn from the general partnership act—either RUPA or UPA, depending on state law. By not including special rules for dealing what property is partnership property or limited liability company property, the drafters are relying on other law to determine what property is organizational property.

42. *See* RULPA § 1106. "In any case not provided for in this [Act] the provision of the Uniform Partnership Act shall govern." *Id.*

VI. CONCLUSION

At best, the third-party limitations may be an ineffective statement of a much more complex issue. In one respect, they are overbroad in that the rights of third parties may be restricted by the organic agreement because the organic agreement constitutes not only a contract among the owners and the organization, but also the fundamental structure of the organization. On the other hand, suggesting that a provision in the organic agreement only restricts the rights of third parties may be too narrow because such restrictions may be ineffective as against assignees and others taking through owners and statutory agents such as managers. This being the case, third-party limitations provide a useful way to look at the function and efficacy of the organic agreement. Such an inquiry will become increasingly important as the uses of unincorporated entities and incorporated entities (which do not have the flexibility of structure afforded by unincorporated entities) become more interchangeable. It remains to be seen whether the academic benefits of such a provision outweigh the potential mischief that may result from the bald, and somewhat incorrect, statement that the organic agreement may not restrict the rights of third parties.