Fiduciary Duties in Partnerships and Limited Liability Companies Under California Law

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INTRODUCTION

California business lawyers often face the issue of advising clients regarding a choice of business entity. Typical considerations include tax issues, management and control issues, and the risk of individual liability of the business owners to third parties. The fiduciary duties of owners to the business entity itself and to each other are sometimes not considered. This article addresses fiduciary duties in California partnerships and limited liability companies. A careful practitioner should analyze applicable fiduciary duty issues before recommending that a partnership or limited liability company be formed.

CALIFORNIA PARTNERSHIPS

Under California case law, the principle that partners in a general partnership are fiduciaries of one another has been long established. In 1996, the California legislature enacted comprehensive new partnership legislation—the Uniform Partnership Act of 1994 (Corp C §§16100–16962)—that specifically addressed the fiduciary duties of partners. See Corp C §16404. To understand the impact of the 1996 legislation and the current status of partners' fiduciary duties, it is helpful to review briefly the law in California before 1996.

The Trustee Concept Under Common Law

The common-law principles of fiduciary duties among partners were largely imported from the law of agency. California courts expressed this common-law duty in the broadest terms, describing partners as "trustees" for each other. For example, in *Leff v Gunter* (1983) 33 C3d 508, 514, 189 CR 377, the California Supreme Court stated that:

> Partners are trustees for each other, and in all proceedings connected with the conduct of the partnership every partner is bound to act in the highest good faith to his copartner and may not obtain any advantage over him in the partnership affairs by the slightest misrepresentation, concealment, threat or adverse pressure of any kind. . . .
> Each [partner] occupie[s] the position of a trustee to the other with regard to all the partnership transactions, including the transaction contemplated by the firm and constituting the object or purpose for which the partnership was formed.

Taken literally, the language of cases such as *Leff*, describing partners as "trustees," raised the standard for inter-partner fiduciary duties so high that almost any partner conduct that conceivably could be deemed competitive with the partnership business or be motivated by any type of self-interest could give rise to a claim of breach of fiduciary duty.

As recently as 1999, in *BT-I v Equitable Life Assur. Soc'y* (1999) 75 CA4th 1406, 89 CR2d 811, the court applied the trustee principle to a California partnership. In that case, a general partner (Equitable) purchased the partnership's debt from the bank and foreclosed on the office building that was the partnership's sole asset. The limited partner (BT-I) filed suit for breach of fiduciary duty; the general partner asserted that its actions were permitted under the partnership agreement. The court found that Equitable breached its fiduciary duty, holding that a "general partner that acquires a partnership obligation cannot foreclose on partnership assets." 75 CA4th at 1411. Moreover, the court held that Equitable's fiduciary duties could not be contracted away in the partnership agreement.

The breadth and ambiguity of the "partner as trustee" decisions left practitioners with little meaningful guidance.

In its ruling, the court reiterated that "partners are held to the standards and duties of a trustee in their dealings with each other," and that a partner's fiduciary duties "extend[] to all aspects of the relationship and all transactions between the partners." 75 CA4th at 1410. The court distinguished *AB Group v Werthur* (1997) 59 CA5th 1022, 69 CR2d 652, stating that the disputed transaction in that case was "fundamentally unrelated to the partnership business." Sanctioning Equitable's conduct in this instance, the court explained, would "strip away [Equitable's] fiduciary obligation in what *was* the partnership business." *BT-I v Equitable Life Assur. Soc'y* (1999) 75 CA4th 1406, 1412, 89 CR2d 811.

NOTE: *BT-I* was decided under common law applicable before adoption of the Uniform Partnership Act of 1994 (Corp C §§16100–16962), because the partnership had been formed before adoption of the new legislation. See Corp C §16111.

The breadth and ambiguity of the 'partner as trustee" decisions left practitioners with little meaningful guidance. Commentators argued that the broad language of these cases allowed disgruntled partners to attempt to persuade juries to apply their own idiosyncratic views of fairness, overriding the intent of the contracting parties. See, *e.g.*, Larson, *Florida's New Partnership Law: The Revised Uniform Partnership Act and Limited Liability Partnerships*, 23 Fla St U L Rev 201, 222 (Fall 1995); Hynes, *Fiduciary Duties and RUPA: An Inquiry Into Freedom of Contract*, 58 Law & Contemp Probs 29 (1995); Ribstein, *The Revised Uniform Partnership Act: Not Ready for Prime Time*, 49 Bus Law 45 (Nov. 1993).

Codification of Partners' Fiduciary Duties

In the early 1990s, the National Conference of Commissioners of Uniform State Laws (NCCUSL) proposed the Revised Uniform Partnership Act (RUPA) for adoption by the states. RUPA was the first major effort to modernize and codify state partnership law as it had developed since the original Uniform Partnership Act was adopted in 1914. RUPA included a codification of partners' fiduciary duties, partly in reaction to the broad and often ambiguous case law. The final version of RUPA, now referred to as the Uniform Partnership Act (1997), is available at the official NCCUSL website maintained in association with the University of Pennsylvania Law School: http://www.law.upenn.edu/bll/ulc/ulc_frame.htm

The California state legislature enacted a version of RUPA in 1996 titled the California Uniform Partnership Act of 1994 (California Partnership Act) (Corp C §§16100–16962). Initially, the new law governed partnerships formed on or after January 1, 1997 (unless the partnership was continuing the business of a dissolved partnership). As of January 1, 1999, the new law governs all California partnerships, including those formed before January 1, 1997, thus replacing the former Uniform Partnership Act in its entirety. See Corp C §16111.

The State Bar committee that drafted the legislation believed that the codification of partner fiduciary duties did not materially depart from prior case law. See Senate Judiciary Committee Analysis of AB 583 (Aug. 23, 1996) (Drafters' Comments). The legislative history of AB 583 includes the following commentary on Corp C §16404, the statutory section that sets forth the fiduciary duties of partners:

> This section, which is perhaps the most controversial, provides significant changes and additions to the statutory formulation. Due to the sparse statutory law governing fiduciary duties in [the California Uniform Partnership Act], the intricacies of fiduciary duty have mainly derived from common law. In comparing and contrasting common law with RUPA, it is difficult to say with certainty if RUPA will have any significant impact on existing law.
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> The members of the RUPA Subcommittee reviewed a number of California cases that have dealt with the fiduciary duty of partners. Their goal was to determine whether any of the California cases dealing with fiduciary duty of partners would have been decided differently if Article 4 of

RUPA had been applied. The subcommittee concluded that none of the California cases would have been decided differently; therefore the new fiduciary duty section makes no substantive change from prior law.

The authors of this article believe that the codification of fiduciary law for partnerships in RUPA has been more significant than the foregoing commentary suggests. Among other things, the California Partnership Act permits a careful drafter to define and restrict, although not to eliminate, the fiduciary duties of partners. See Corp C §16103. It also limits the broad implications of prior case law that classified partners as "trustees." For example, unlike a true trustee, a partner under the California Partnership Act does not violate his or her fiduciary duty "merely because the partner's conduct furthers the partner's own interest." Corp C §16404(e). As discussed further below, the California Partnership Act also added some certainty to developing case law by:

- Specifying certain duties as fiduciary duties (see Corp C §16404(b));
- Identifying specifically the obligation of good faith (see Corp C §16404(d)); and
- Allowing limited waivers of fiduciary duties (see Corp C §16103).

The fiduciary duties of partners are codified in Corp C §16404 as follows:

(a) The fiduciary duties a partner owes to the partnership and the other partners are the duty of loyalty and the duty of care set forth in subdivisions (b) and (c).

(b) A partner's duty of loyalty to the partnership and the other partners includes all of the following:

(1) To account to the partnership and hold as trustee for it any property, profit, or benefit derived by the partner in the conduct and winding up of the partnership business or derived from a use by the partner of partnership property or information, including the appropriation of a partnership opportunity.

(2) To refrain from dealing with the partnership in the conduct or winding up of the partnership business as or on behalf of a party having an interest adverse to the partnership.

(3) To refrain from competing with the partnership in the conduct of the partnership business before the dissolution of the partnership.

(c) A partner's duty of care to the partnership and the other partners in the conduct and winding up of the partnership business is limited to refraining from engaging in grossly negligent or reckless conduct, intentional misconduct, or a knowing violation of law.

(d) A partner shall discharge the duties to the partnership and the other partners under this chapter or under the partnership agreement and exercise any rights consistently with the obligation of good faith and fair dealing.

(e) A partner does not violate a duty or obligation under this chapter or under the partnership agreement merely because the partner's conduct furthers the partner's own interest.

(f) A partner may lend money to and transact other business with the partnership, and as to each loan or transaction, the rights and obligations of the partner regarding performance or enforcement are the same as those of a person who is not a partner, subject to other applicable law.

(g) This section applies to a person winding up the partnership business as the personal or legal representative of the last surviving partner as if the person were a partner.

Specific Fiduciary Duties

The California Partnership Act, like RUPA, specifies only two fiduciary duties: a duty of loyalty and a duty of care to the partnership and to the other partners.

Duty of Loyalty

The duty of loyalty has three components: (1) the duty to account; (2) the duty to refrain from self-dealing; and (3) the duty not to compete.

Duty to Account. A partner owes a duty to account to the partnership and hold as trustee for it any property, profit, or benefit derived by the partner in the conduct and winding up of partnership business or derived from the partner's use of partnership property or information, including the appropriation of a partnership opportunity. Corp C §16404(b)(1). In other words, the partnership may recover from a partner any money or property that can be traced back to the partnership. In California, this represents a codification of existing law that a partner may not appropriate benefits from the partnership without the other partners' consent and may not usurp a partnership opportunity. See *Fraser v Boguki* (1988) 203 CA3d 604, 250 CR 41 (overruled on separate grounds); *Ferry v McNeil* (1963) 214 CA2d 411, 29 CR 577.

The NCCUSL drafters intended that the duty to account would continue the general rule that partnership property usurped by a partner, including the misappropriation of a partnership opportunity, is held in trust for the partnership. The drafters explained that (NCCUSL Comment to RUPA §404):

Under a constructive trust theory, the partnership can recover any money or property in the partner's hands that can be traced to the partnership. *See, e.g., Yoder v. Hooper,* 695 P.2d 1182 (Colo. App. 1984), *aff'd.* 737 P.2d 852 (Colo. 1987); *Fortugno v. Hudson Manure Co,.* 51 N.J. Super 482, 144 A.2d 207 (1958); *Harestad v. Weitzel,* 242 Or. 199, 536

P.2d 522 (1975). As a result, the partnership's claim is greater than that of an ordinary creditor.

The duty to account is time-limited. A partner need only account for property, profit, or benefit with respect to the time that the partner engaged in the conduct of partnership business or winding up the partnership. When a partner disassociates from the partnership, he or she need only account for the personal profits derived from matters arising, or events occurring, *before* the disassociation, unless the partner participates in winding up of the partnership. Corp C §16404(b). Once the partner has fully withdrawn, he or she is thereafter free to appropriate any business opportunity regardless of whether the partnership continues in existence. Further, the duty to account does not include the time period before formation. As the NCCUSL drafters explained, the duty of loyalty does not extend to the "pre-formation period when the parties are really negotiating at arm's length." NCCUSL Comment to RUPA §404.

By contrast, case law in California before the adoption of the California Partnership Act held that a partner's fiduciary duties extended to pre-formation negotiations. See *Solomont v Polk Dev. Co.* (1966) 245 CA2d 488, 54 CR 22, citing *Prince v Harting* (1960) 177 CA2d 720, 2 CR 545.

Duty to Refrain From Self-Dealing. The second element of the duty of loyalty states that a partner owes a duty to the partnership and other partners to refrain from self-dealing. Corp C §16404(b)(2). This rule is derived from the law of agency. Insofar as the partner is an agent acting for the benefit of the partnership (*i.e.,* the principal), the partner has a duty to avoid having a conflict of interest with the partnership. See NCCUSL Comments to RUPA §404, citing Restatement (Second) of Agency §§389, 391 (1957).

The prohibition against self-dealing appears to be a codification of existing California law. See *Cagnolatti v Guinn* (1983) 140 CA3d 42, 189 CR 151; *Prince v Harting* (1960) 177 CA2d 720, 2 CR 545. The California drafters indicated that this was the legislative intent. See Drafters' Comments ("common law has long held that a partner may not usurp a partnership opportunity"). When considered together with Corp C §16404(e), which states that "[a] partner does not violate a duty or obligation under this chapter or under the partnership agreement merely because the partner's conduct furthers the partner's own interest," an argument can be made, however, that the law after codification may be different. See Vestal, *Fundamental Contractarian Error in the Revised Uniform Partnership Act of 1992*, 73 Boston Univ L Rev 523, 554 (1993).

A partner's hands are not completely tied by the ban on self-dealing. For example, a partner may lend money and transact other business with the partnership, and to the extent that the partner does so, he or she is to be treated like any other creditor who is not a partner. Corp C §16404(f). And, like the duty to account, the duty not to self-deal is not perpetual and is limited in the same manner as the duty to account. See Corp C §16404(b)(1), (2). Thus, after withdrawal, a partner is free to deal in a manner adverse to the partnership with respect to new matters and events. See Corp C §16603.

Duty Not to Compete. Third, under the duty of loyalty, a partner owes a duty not to compete with the partnership in the conduct of its business. Corp C §16404(b)(3). This rule also derives from the agency principle that an agent (here, the partner) has a general duty to act solely on his principal's (the partnership's) behalf.

[T]he duty not to compete ends immediately on the partner's disassociation from the partnership—even if the partnership continues to exist.

Unlike the other loyalty duties, the duty not to compete applies only to the "conduct" of partnership business, and does not extend to "winding up" the business. See Corp C §16404(b)(3). Therefore, unless the partnership agreement provides otherwise, a partner is free to compete immediately on the partnership's dissolution.

Similarly, the duty not to compete ends immediately on the partner's disassociation from the partnership—even if the partnership continues to exist. Corp C §16603(2). Nonetheless, the disassociated partner cannot use confidential information after his or her disassociation and may also be restricted by laws governing trade secrets or an express confidentiality agreement. See Restatement (Second) of Agency §393 (1957). Prior case law in California recognized a partner's duty not to compete. See, *e.g., Olivet v Frischling* (1980) 104 CA3d 831, 164 CR 87. The new statute, however, appears to have changed the time when that duty ends. Before adoption of the California Partnership Act, it had been held that a partner's duty not to compete survives his or her withdrawal from the partnership unless the parties agree otherwise. *Leff v Gunter* (1983) 33 C3d 508, 189 CR 377.

In *Leff,* the California Supreme Court held that a partner's duty not to compete with the partnership with respect to a partnership opportunity that the partnership is actively pursuing survives the partner's withdrawal from the partnership. In that case, plaintiff and defendants had formed a joint venture to bid on a government project. After submitting their final bid, defendants advised plaintiff that they were withdrawing from the joint venture because they had become overextended on another project. Unbeknownst to plaintiff, however, defendants had already formed a different joint venture, under which they submitted a separate bid for the same government project less than a month after their withdrawal from the joint venture. The project was awarded to defendants because their bid was significantly lower than the bid proposed by the joint venture.

Plaintiff sued defendants for unfair competition and breach of fiduciary duty. Ruling for plaintiff, the California Supreme Court held that defendants breached their duty not to compete when they submitted the separate bid by the new joint venture. In so holding, the court found "an obvious and essential unfairness in one partner's attempted exploitation of a partnership opportunity for his own personal benefit and to the resulting detriment of his copartners." 33 C3d at 514. The court also found that defendants could not relieve themselves of this duty simply by withdrawing from the joint venture. Noting that California law had long recognized a continuing fiduciary duty between former partners, the court cited the rule that "[a former partner] cannot make any profit to himself from a secret transaction *initiated* while the relation of trustee . . . exists, no matter when it springs into actual operation." 33 C3d at 515, quoting *Donleavey v Johnston* (1914) 24 CA 319, 328, 141 P 229.

Duty of Care

The second fiduciary duty codified by the California Partnership Act is the duty of care. Under this duty, a partner must refrain from engaging in grossly negligent or reckless conduct, intentional misconduct, or a knowing violation of the law. Corp C §16404(c). Although other states had recognized this duty before RUPA, California courts had not. See Drafters' Comments ("California courts do not recognize a duty of care, but the duty has been established by other state courts"). The standard appears to be the equivalent of a business judgment rule for partners (see Corp C §309(a)), as distinct from one of ordinary care.

Potential for Additional Fiduciary Duties

The California Partnership Act differs from RUPA in that the California legislation does *not* state that the duties discussed above are the *only* fiduciary duties owed by partners to each other and to the partnership. It leaves the courthouse door open for disaffected partners to assert that additional fiduciary duties exist.

Practitioners should note that this difference is contrary to a central principle of RUPA. In adopting RUPA, the NCCUSL drafters sought to limit fiduciary duties among partners to those specified in RUPA §404 (on which Corp C §16404 was based). The NCCUSL Comments to RUPA §404 explained (emphasis added):

> Section 404 is new. The title, "General Standards of Partner's Conduct," . . . is both comprehensive and exclusive. In that regard, it is structurally different from [the 1914 uniform act] which touches only sparingly on a partner's duty of loyalty and leaves any further development of the fiduciary duties of partners to the common law of agency. . . .
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> Section 404 begins by stating that *the only* fiduciary duties a partner owes to the partnership and the other partners are the duties of loyalty and care set forth in subsections (b) and (c) of the Act.

In contrast, the Drafters' Comments to the California Partnership Act note that a partner's fiduciary duties are *not* limited to only those listed in the statute. In this respect, California law differs from other jurisdictions such as Delaware that adopted RUPA without this change. For this reason, attorneys seeking to limit fiduciary duties among partners may choose to form Delaware partnerships instead. This feature of the California statute is significant, because it contravenes the efforts of the RUPA drafters to restrict the perceived tendency of judges to expand the limits of fiduciary duty. See Weidner & Larson, *The Revised Uniform Partnership Act: The Reporters' Overview*, 49 Bus Law 1 (Nov. 1993).

Obligation of Good Faith and Fair Dealing

In addition to fiduciary duties, the California Partnership Act provides that a partner has an obligation of good faith and fair dealing in the discharge of his or her duties—as well as in the exercise of any rights—under the statute and under the partnership agreement. Corp C §16404(d).

The California Partnership Act . . . leaves the courthouse door open for disaffected partners to assert that additional fiduciary duties exist.

The obligation of good faith and fair dealing is derived from general contract law and is based on the partners' mutual agreement to form the partnership. As such, the concept is not new to California law. Prior cases held that the relationship among partners is of a fiduciary nature that imposes on them a duty of good faith and fair dealing and requires that no partner may take unfair advantage of another partner. See, *e.g., Wyler v Feuer* (1978) 85 CA3d 392, 8149 CR 626; *Page v Page* (1961) 55 C2d 192, 10 CR 643; *Prince v Harting* (1960) 177 CA2d 720, 2 CR 545.

The drafters of both RUPA and the California Partnership Act did not define the obligation of good faith and fair dealing in the statute. It is likely broader than the Uniform Commercial Code definition ("in the case of a merchant . . . honesty in fact and the observance of reasonable commercial standards of fair dealing in the trade" Com C §2103(b)), and one must look to existing case law to comprehend its full scope. Because "good faith and fair dealing" is not defined, the concept remains sufficiently flexible to allow a plaintiff to argue that it includes many perceived unfair practices. The lack of a definition in RUPA has been subject to criticism. See Phillips, *Good Faith and Fair Dealing Under the Revised Uniform Partnership Act*, 64 U Colo L Rev 1179 (Fall 1993).

There are no California cases providing guidance on the meaning of "good faith and fair dealing" as specifically used in the California Partnership Act. Accordingly, the best guidance is prior case law. The leading case in California is *Page v Page* (1961) 55 C2d 192, 10 CR 643. In that case, one of two partners in a linen supply business sued for a declaration that the partnership was a partnership at will. The evidence showed that the partners had entered into an oral agreement without discussing a fixed term. Each partner had contributed $43,000 over the years. The partnership went from incurring losses to becoming profitable when an air force base was established in its vicinity. The plaintiff operated the partnership's business and was its major creditor. As such, he was in a unique position to take over profitable business opportunities on the partnership's dissolution. The Supreme Court held that there was insufficient evidence that the partnership was for a limited term and that there was no showing of bad faith. Despite this, the court held that plaintiff owed defendant fiduciary duties and that plaintiff could be liable in a further action if plaintiff excluded defendant from a future partnership business opportunity.

California courts have relied on *Page* for the proposition that partners must deal with each other in good faith. See, *e.g., Leff v Gunter* (1983) 33 C3d 508, 189 CR 377; *Crouse v Brobeck, Phleger & Harrison* (1998) 67 CA4th 1509, 80 CR2d 94; *Blumberg v Guarantee Ins. Co.* (1987) 192 CA3d 1286, 238 CR 36; *Rosenfeld, Meyer & Susman v Cohen* (1983) 146 CA3d 200, 194 CR 180. The continued viability of *Page* may be subject to challenge, however, because the California Supreme Court in that case specifically relied on the concept of partners as "trustees" (*Page v Page* (1961) 55 C2d 192, 10 CR 643):

> We have often stated that partners are trustees for each other, and in all proceedings connected with the conduct of the partnership every partner is bound to act in the highest good faith to his copartner, and may not obtain any advantage over him in the partnership affairs by the slightest misrepresentation, concealment, threat or adverse pressure of any kind.

Partners Acting in Their Own Self-interest

What is *not* included in the obligation of good faith and fair dealing may be clearer than what *is* included. A partner does not violate his or her obligation under the statute merely because his or her conduct furthers his or her own interests. Corp C §16404(e). Likewise, a partner may lend money and transact other business with the partnership, and should be treated like any other creditor. See Corp C §16404(f).

Limiting Fiduciary Duties and the Obligation of Good Faith

While partners in a California partnership cannot waive or eliminate entirely the duties of loyalty or care or the obligation of good faith, the partnership agreement may set forth the scope and standards by which fiduciary duties are to be measured. Thus, Corp C §16103(b) provides in part:

> (b) The partnership agreement may not do any of the following:
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> . . .
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> (3) Eliminate the duty of loyalty under subdivision (b) of Section 16404 or paragraph (3) of subdivision (b) of Section 16603, but, if not manifestly unreasonable, may do either of the following:

(A) The partnership agreement may identify specific types or categories of activities that do not violate the duty of loyalty.

(B) All of the partners or a number or percentage specified in the partnership agreement may authorize or ratify, after full disclosure of all material facts, a specific act or transaction that otherwise would violate the duty of loyalty.

(4) Unreasonably reduce the duty of care under subdivision (c) of Section 16404 or paragraph (3) of subdivision (b) of Section 16603.

(5) Eliminate the obligation of good faith and fair dealing under subdivision (d) of Section 16404, but the partnership agreement may prescribe the standards by which the performance of the obligation is to be measured, if the standards are not manifestly unreasonable.

The language of Corp C §16103 parallels the language of RUPA §103 to the extent that it allows the partners to limit contractually the fiduciary duties and the obligation of good faith, unless the limitation is "manifestly unreasonable" (as to the duty of loyalty and the obligation of good faith) or "unreasonable" (as to the duty of care). These limitations are intended to restrict potential overreaching by a partner in a superior bargaining position. See NCCUSL Comments to RUPA §404. The meaning of "manifestly unreasonable" and "unreasonable" is left to the courts for determination on a case-by-case basis.

Like the duties of loyalty and care, the obligation of good faith and fair dealing is not waivable.

The RUPA drafters, whose guidance the California drafters followed on the waiver limitations, recognized that broad waivers of all fiduciary duties among partners would be contrary to much of the pre-RUPA case law. The NCCUSL Comments to RUPA §103 explained:

> There has always been a tension regarding the extent to which a partner's fiduciary duty of loyalty can be varied by agreement, as contrasted with the other partners' consent to a particular and known breach of duty. On the one hand, courts have been loathe to enforce agreements broadly "waiving" in advance a partner's fiduciary duty of loyalty, especially where there is unequal bargaining power, information, or sophistication. For this reason, a very broad provision in a partnership agreement in effect negating any duty of loyalty, such as a provision giving a managing partner complete discretion to manage the business with no liability except for acts and omissions that constitute willful misconduct, will not likely be enforced.

While RUPA §103 would allow a specified number of partners after full disclosure to ratify an act that otherwise violates the duty of loyalty, this may only be done under Corp C §16103 if it is not "manifestly unreasonable." Moreover, consent must be unanimous unless the agreement provides otherwise. Corp C §16103(b)(3); Selecting and Forming Business Entities §6.10 (Cal CEB 1996).

Notably, Corp C §16103 does not prohibit waiver of any other potential fiduciary duties. Accordingly, if a practitioner is concerned about the possible expansion of fiduciary duties under California law, Corp C §16103 would not prevent the partners from agreeing to waive any such additional duties.

Like the duties of loyalty and care, the obligation of good faith and fair dealing is not waivable. Corporations Code §16103(b)(5) provides that a partnership agreement may not:

> Eliminate the obligation of good faith and fair dealing under subdivision (d) of Section 16404, but the partnership agreement may prescribe the standards by which the performance of the obligation is to be measured, if the standards are not manifestly unreasonable.

Section 16103(b)(5) is derived from RUPA §103(b); accordingly, the RUPA drafters' comments provide guidance on the interpretation that courts may give to the statute. The RUPA drafters noted that (NCCUSL Comments to RUPA §103):

> Subsection (b)(5) authorizes the partners to determine the standard by which the performance of the obligation of good faith and fair dealing is to be measured. The language of subsection (b)(5) is based on UCC Section 1–102(3). The partners can negotiate and draft specific contract provisions tailored to their particular needs (*e.g.*, five days notice of partners' meeting is adequate notice), but blanket waivers of the obligation are unenforceable.

By permitting a partial waiver of fiduciary duties and the obligation of good faith, the California Partnership Act follows the guiding principle of RUPA that allows partners to modify most of their obligations to each other by agreement. Both the California Partnership Act and RUPA appear to reflect a fundamentally "contractarian" approach to fiduciary duties. The contractarian view of partnership relations basically holds that partnership relations are in the nature of a contract, under which partners are free to serve their respective self-interests, unless they specifically agree otherwise. Contractarians believe that the function of statutes such as RUPA in defining obligations of the parties should be to provide suitable default rules for parties who have not prepared highly customized agreements. The alternative view, sometime referred

to as the "fiduciarian" view, focuses on the parties' status rather than their contract. It regards partnerships as essentially collective in nature, and takes the position that as a fiduciary, a partner can subordinate the collective interest of the partnership entity to his or her own interest only with contemporaneous notice and informed consent of the other partners.

The contractarian view of partnership relations basically holds that partnership relations are in the nature of a contract, under which partners are free to serve their respective self-interests, unless they specifically agree otherwise.

Recent California case law supports a broad contractarian view of partnership agreements. *AB Group v Wertin Co.* (1997) 59 CA4th 1022, 69 CR2d 652, involved a partnership established before adoption of the California Partnership Act. In that case, an issue concerning the parameters of fiduciary duties among partners was raised in a cross-complaint alleging that certain partners breached their fiduciary duty by repaying undisputed, lawful partnership debt instead of attempting to leverage a discount by withholding payment. The court held that withholding payment on loans was not a legitimate partnership opportunity. The cross-complaint further asserted that one of the partners may have co-opted a partnership opportunity when he purchased the partnership's unsecured debt, by shifting a potential discount to himself that might have been obtained by the partnership. The court held that it was not necessary to reach the question of whether that constituted a breach of fiduciary duty, because, by agreement, the partners had given themselves the right to keep any benefits that might accrue to them from their purchase of partnership debt. The court found that the partnership agreement did not approach any limits under California law on the right of partners to structure their own relationships.

Post-California Partnership Act Case Law

There has been only one reported decision based on the California Partnership Act. *Jones v Wagner* (2001) 90 CA4th 466, 108 CR2d 669. In *Jones*, relying on Corp C §16404, the court held that there was no breach of a fiduciary duty by a former partner who bought property formerly owned by the partnership at a foreclosure sale. The case involved a partnership of two couples to buy a beach house. One couple (the Wagners) provided most of the down payment, while the other (the Joneses) provided some cash and agreed to make the mortgage payments. When the Joneses failed to make the payments, the Wagners declined the Joneses' demand to use joint funds to do so. The Wagners then acquired the property at a foreclosure sale, and the Joneses sued for constructive fraud. The trial court dissolved the partnership, and awarded $187,885 and prejudgment interest to the Wagners.

The court of appeal affirmed, holding that: (1) the Wagners had no legal or equitable duty to use partnership funds to make mortgage payments on the townhouse after the partners who were individually liable on the mortgage stopped making payments; and (2) the Wagners could bid and purchase the townhouse property at the foreclosure sale. The court of appeal cited Corp C §16404 for the proposition that "[t]here were unquestionably fiduciary duties among the partners here, as in all partnerships." *Jones v Wagner* (2001) 90 CA4th 466, 471, 108 CR2d 669. However, the court would not create an obligation to make capital contributions beyond the 50/50 formula to which the partners had agreed. With respect to the bid at the foreclosure, the court again relied on Corp C §16404 in holding that a partner does not breach his or her fiduciary duty "merely because the partner's conduct furthers the partner's own interest." 90 CA4th at 473.

LIMITED PARTNERSHIPS

In California, limited partnerships formed on or after July 1, 1984, as well as preexisting limited partnerships that so elect, are governed by the California Revised Limited Partnership Act (CRLPA) (Corp C §§15611–15723). The general partners of a limited partnership have exclusive authority to manage and control the affairs of the limited partnership, while the limited partners restrict their individual liability to the amount of their respective investments in exchange for surrendering management and control rights. See generally Corp C §§15632, 15643.

As discussed below, the CRLPA appears to make a distinction between the fiduciary duties of general and limited partners. Some uncertainty exists, however, because the CRLPA does not separately address fiduciary duties. Instead, it makes reference to the California Partnership Act.

General Partners of Limited Partnerships

The CRLPA provides that a general partner has the same rights and powers and is subject to same restrictions and liabilities as a partner in a general

partnership. Corp C §15643. Moreover, the CRLPA provides at Corp C §15722 that:

> In any case not provided for in this chapter, limited partnerships shall be governed in the same manner as general partnerships would be governed pursuant to Section 16111, by the Uniform Partnership Act (Chapter 1 commencing with Section 15001) or the [California Partnership Act] (commencing with Section 16100)).

Given Corp C §§15643 and 15722, the fiduciary duties of general partners of limited partnerships are the same as those discussed above for partners of general partnerships under the California Partnership Act.

Limited Partners

The CRLPA does not specify whether a limited partner has fiduciary duties. It contains no provision for limited partners comparable to Corp C §15643, discussed above. Nevertheless, a limited partner may have personal liability *to the partnership* for a breach of fiduciary duty or the duty of care and loyalty. For example, a limited partner may be liable to the partnership for misappropriating a partnership economic opportunity, assets, or interest. See *Milazo v Gulf Ins. Co.* (1990) 224 CA3d 1528, 274 CR 632. Moreover, a limited partner who participates in the management of the partnership may by such action assume obligations and fiduciary duties of a general partner. Corp C §15632. See, *e.g.*, *Tri-Growth Centre City, Ltd. v Silldorf, Burdman, Duignan & Eisenberg* (1989) 216 CA3d 1139, 265 CR 330; *Holzman v de Escamilla* (1948) 86 CA2d 858, 195 P2d 833.

To what extent a limited partner has general fiduciary duties and an obligation of good faith and fair dealing to other partners under California law is not certain.

To what extent a limited partner has general fiduciary duties and an obligation of good faith and fair dealing to other partners under California law is not certain. Corporations Code §§15643 and 15722 suggest by omission that limited partners do not have comparable obligations to fellow partners. As noted above, however, Corp C §15722 provides that in any case not provided for by the CRLPA, limited partnerships are governed in the same manner as general partnerships under the California Partnership Act. Read literally, Corp C §15722 appears to incorporate Corp C §16404, which sets forth the fiduciary duties and other obligations of "partners."

Future Developments

The existing uncertainty concerning the potential fiduciary duties of limited partners may be alleviated should California adopt legislation based on the work of the NCCUSL relating to limited partnerships. In August 2001, the NCCUSL approved and recommended for enactment by all states the Uniform Limited Partnership Act (2001), commonly known as Re-RULPA. A copy of Re-RULPA is available at: http://www.law.upenn.edu/bll/ulc/ulc_frame.htm. Re-RULPA was approved by the American Bar Association in February 2002. Re-RULPA is designed to be a "stand alone" act "de-linked" from RUPA and the original 1914 partnership act. Re-RULPA has been the subject of review in 2003 by the State Bar of California. As part of the de-linking, Re-RULPA sets forth explicitly the duties and obligations of general and limited partners of a limited partnership.

Re-RULPA identifies general standards of conduct for general partners. See Re-RULPA §408. Not surprisingly, these standards track the duties of a partner under RUPA. For limited partners, Re-RULPA §305 of provides that:

> (a) A limited partner does not have any fiduciary duty to the limited partnership or to any other partner solely by reason of being a limited partner.
>
> (b) A limited partner shall discharge the duties to the partnership and the other partners under this [Act] or under the partnership agreement and exercise any rights consistently with the obligation of good faith and fair dealing.
>
> (c) A limited partner does not violate a duty or obligation under this [Act] or under the partnership agreement merely because the limited partner's conduct furthers the limited partner's own interest.

This proposed language makes a logical distinction between the limited partners and general partners of a limited partnership, by tying a limited partner's duties to the partner's limited powers. See NCCUSL Comments to Re-RULPA §305(a). The proposed language also explicitly includes the obligation of good faith and fair dealing. This is consistent with the principles reflected in RUPA and the fact that the obligation of good faith and fair dealing is generally read into California contracts. In the view of the NCCUSL drafters (NCCUSL Comments to Re-RULPA §305(b)):

> The obligation of good faith and fair dealing is *not* a fiduciary duty, does not command altruism or self-abnegation, and does not prevent a partner from acting in

the partner's own self-interest. Courts should not use the obligation to change *ex post facto* the parties' or this Act's allocation of risk and power. To the contrary, in light of the nature of a limited partnership, the obligation should be used only to protect agreed-upon arrangements from conduct that is manifestly beyond what a reasonable person could have contemplated when the arrangements were made.

LIMITED LIABILITY PARTNERSHIPS

The limited liability partnership (LLP) is essentially a general partnership with a corporate-style limited liability shield for its partners. All states have some form of LLP legislation. California recognizes foreign limited liability partnerships and "registered limited liability partnerships." Corp C §16951. Some states have adopted a limited liability limited partnership (LLLP) form of limited partnership, affording liability protection to general partners. The California registered limited liability partnership is available only to partnerships that engage in the practice of law, public accountancy, or architecture, and those providing services or facilities related or complementary to those provided by such firms. See Corp C §16101(5), (6), (12), and (17).

The provisions of the California Corporations Code specifically addressing limited liability partnerships appear as part of the California Partnership Act at Corp C §§16306 and 16951–16962. Nothing in those sections expressly covers fiduciary duties; thus, it may be assumed that the general provisions of the California Partnership Act concerning fiduciary duties of partners apply to California LLPs as well.

[T]he fiduciary duties of managers and members of limited liability companies appear largely to be governed by the standards set forth for partners in the California Partnership Act.

The partners of an LLP may agree by majority vote (or a different vote if required in the partnership agreement) to be liable as partners for specified obligations. Corp C §16306(d). Accordingly, partners of an LLP may craft special provisions to enhance their fiduciary obligations.

LIMITED LIABILITY COMPANIES

Limited liability companies (LLCs) combine corporate and non-corporate elements. Most notably, LLCs allow participants, referred to as "members," limited liability and participation in management while avoiding the double tax treatment of C corporations. Alternatively, the members can select one or more managers. The first LLC act in the United States was adopted in Wyoming in 1977. By now, all states and the District of Columbia have adopted LLC statutes, and LLC statutes in many states have been amended several times.

To many practitioners, the LLC has become the business vehicle of choice for non-public enterprises. State statutes vary in describing the duties owed by LLC members. See Keatinge, *The Implications of Fiduciary Relationships in Representing Limited Liability Companies and Other Unincorporated Associations and Their Partners or Members*, 25 Stetson L Rev 389, 407 (1995).

In 1994, the NCCUSL approved a Uniform Limited Liability Company Act (ULLCA), a copy of which is available on the NCCUSL website at: http://www.law.upenn.edu/bll/ulc/ulc_frame.htm. The ULLCA was revised in 1996, and the NCCUSL is considering further revisions. A preliminary draft of a revision of the ULLCA was circulated at the NCCUSL's August 2003 conference. The Partnerships and Unincorporated Business Organizations Committee of the American Bar Association has also drafted its own model LLC act, known as the Prototype Limited Liability Company Act. For further information on this effort, see http://www.abanet.org/buslaw/partners/subcommittees/pllc_act.html

California LLCs are governed by the Beverly-Killea Limited Liability Company Act (LLC Act) (Corp C §§17000–17655). The LLC Act was enacted in 1994, two years before the California Partnership Act took effect. Nonetheless, the fiduciary duties of managers and members of limited liability companies appear largely to be governed by the standards set forth for partners in the California Partnership Act. There is little case or statutory law in California regarding the fiduciary duties of LLC members to each other or to the LLC. A leading treatise has noted that (Marsh's California Corporation Law §3.05[E] (4th ed 2000)):

> The scope of fiduciary duties owed by LLC members and managers to the LLC and its members is an area of significant uncertainty, particularly in cases where the LLC Agreement purports to reduce fiduciary duties below the level established by the default rules.

The LLC Act differentiates between member-managed limited liability companies and manager-managed limited liability companies. Corp C §§17150, 17151.

Member-Managed LLCs

The LLC Act provides that (Corp C §17150):

> Unless the articles of organization include the statement referred to in subdivision (b) of Section 17151 vesting management of the limited liability company in a manager or managers, the business and affairs of a limited liability company shall be managed by the members subject to any provisions of the articles of organization or operating agreement restricting or enlarging the management rights and duties of any member or class of members. If management is vested in the members, each of the members shall have the same rights and be subject to all duties and obligations of managers as set forth in this title.

The fiduciary duties of loyalty and care should be incorporated in the LLC Act by the provision that the members shall be subject to all "duties" set forth in the LLC Act. Corporations Code §17153 provides that:

> [t]he fiduciary duties a manager owes to the limited liability company and to its members are those of a partner to a partnership and to the partners of the partnership.

Because the duty of loyalty and the duty of care are each specific fiduciary duties of partners under the California Partnership Act (Corp C §16404), those duties apply to all members of a California member-managed LLC.

The question then arises whether the obligation of good faith should also be read into the LLC Act. While the issue has not been decided, it is reasonable to conclude that good faith is included, either as an "obligation" incorporated by Corp C §17153 or as a concomitant of general contract law governing the LLC operating agreement.

Manager-Managed LLCs

In a manager-managed LLC, managers owe the same fiduciary duties of care and loyalty to the LLC and its members as a partner owes to a partnership and its partners. Corp C §17153. These duties may be modified only in a written operating agreement with the members' informed consent. Corp C §17005(d). Uncertainty remains concerning the extent to which the duties may be modified.

[I]t is uncertain whether or not LLC members are limited in their ability to waive the fiduciary duties of a manager to the same extent as are partners in a California partnership.

The LLC Act does not address the fiduciary duties of a non-managing member of a manager-managed LLC. See Corp C §§17150-17153. It does, however, specifically provide that a member may lend money to and transact other business with the LLC and, "subject to other applicable law, has the same rights and obligations with respect thereto as a person who is not a member." Corp C §17004(a).

Waiver

It is uncertain to what extent LLC members can agree to waive their fiduciary duties. Corporations Code §17005, which is part of the LLC Act, appears to permit members to agree to modify the fiduciary duties of a manager, provided that the modification is part of a written operating agreement and it is done with the informed consent of the members. The statute does not contain any limitations on the ability to modify fiduciary duties. Read alone, this would appear to permit LLC members to waive any or all of the fiduciary duties of a manager of an LLC. However, Corp C §17153, which is also part of the LLC Act, provides that the fiduciary duties a manager owes to the LLC and its members are those of a partner to the partnership and to the other partners of the partnership. This would suggest that an LLC member's ability to waive the fiduciary duties of a manger is limited in the same way that a partner's ability to waive the fiduciary duties of another partner are limited by Corp C §16103.

The interplay between Corp C §17005(d), §17153, and §16103(b) (which limits the partners' ability to waive certain statutory duties) remains unresolved at this time. Accordingly, it is uncertain whether or not LLC members are limited in their ability to waive the fiduciary duties of a manager to the same extent as are partners in a California partnership. See generally Marsh's California Corporation Law §3.05[E] (4th ed 2000).

CONCLUSION

The status of fiduciary duties among partners in California partnerships or among members of California LLCs remains uncertain. Clearly, those involved in management of partnerships and LLCs owe the entities and their partners or members fiduciary duties. These duties, at a minimum, include some duty of loyalty and some duty of care. Moreover, their activities are subject to a general obligation of good faith and fair dealing. The status of fiduciary duties of limited partners and non-manager LLC members is more problematic, however. Reasonable arguments can be made that limited partners and non-managing LLC members do not have fiduciary duties per se, but rather are subject only to the general duty of good faith and fair dealing. Some courts, however, may look to the provisions of the California Partnership Act that make fiduciary duties applicable to all partners.

The scope of fiduciary duties and the related obligation of good faith and fair dealing may be limited, but not waived, by careful drafting. In the absence of contractual limitations, the default provisions of the applicable statutes impose the duties discussed above.

If a California practitioner elects to use a California partnership or LLC for a client, the client should be advised of fiduciary duties under current law and of potential future developments in light of the common-law tradition that partners were "trustees" for one other.