Rocks - *Partnership Representatives* - Hard Places

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The Partnership Representative ("PR")
The One Voice of the Partnership

- PR has "the sole authority to act on behalf of the partnership" once a BBA audit has commenced. 6223(a).
- The partnership and all direct and indirect partners are bound by the actions taken by the PR on behalf of the partnership. 6223(b).
- "No other person may participate in an administrative proceeding without the permission of the IRS. The failure of the partnership representative to follow any state law, partnership agreement, or other document or agreement has no effect on the authority of the partnership representative." Reg. 301.6223-2(d)(1).
- "By virtue of being designated [as PR, the PR] has the authority to bind the partnership for all purposes". Reg. 301.6223-2(d)(2).

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The Tale of the Unhappy LP: Act I

- In 2018, Pship is formed with two partners:
  - GP has 90% of capital/profits/losses, and
  - LP has 10%.
- Pship Agreement provides that:
  - "GP will be responsible for all tax matters, including preparing and filing returns and handling tax audits."
- Pship's 2018 return is timely filed and designates GP as PR.
- Everyone is still happy at this point.

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The Tale of the Unhappy LP: Act II, Scene I

- In 2020, IRS begins BBA audit of 2018 return.
- GP/PR hires Lawyer to handle audit.
- GP/PR does not tell LP about the audit.

- IRS proposes to increase Pship's 2018 taxable income by $1M.
  - IRS computes initial proposed Imputed Underpayment ("IU") of $370K.

- Lawyer advises GP/PR of all the options including
  - work with IRS Exam to make 6225 "modifications" to IU computation, including via amended partner-level returns and via "Pull-In";
  - after that, IRS Appeals vs. pay IU vs. 6266 "Push-Out".

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The Tale of the Unhappy LP: Act II, Scene II

- GP/PR instructs Lawyer: "Get this audit over with, ASAP; no 6225 modifications, no Appeals, no Push-Out; tell IRS we will pay IU."
- Lawyer: "You sure?"
- GP/PR: "Yes; I am sure this is also what LP would want. And, just between us, I have some other stuff in my 2018 and 2019 returns that I don't want the IRS looking into if I can avoid it."
- Lawyer: "Ok, I will get this closed out before the end of 2020 because I hear another shut-down may be in the offing."
- GP/PR: "BTW, you were so good on this audit, that if the IRS ever were to audit that 'other stuff', I would definitely have you represent me."

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Intermission

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The Tale of the Unhappy LP: Act III

- Audit ends and Pship pays the $370K IU in 2020.
  - Unrelated to the audit, LP's interest in Pship has increased
    - from 10% in 2018
    - to 50% in 2020 (GP has other 50%).
- August 2021: LP receives 2020 K-1 and learns *for the first time* about the audit and the $370K payment.
- LP also learns that Lawyer's fee, which Pship paid in 2020, was $230K.
- LP is not just unhappy, **LP is furious**.

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LP Sets Aside His Emotions and Tallies Up His Actual *Financial* Damages

- LP had net losses in 2018 and could have used them to offset the additional 2018 income either via 6225 Pull-In or via 6226 Push-Out.
- LP's interest in Pship in 2018 was only 10%; but LP bore 50% of the IU (because Pship paid the IU in 2020 when LP had a 50% interest in Pship).
- LP believes that Lawyer was a poor choice and that GP/PR chose Lawyer because Lawyer had represented GP and GP's affiliates in the past.
  - LP believes that a better lawyer would have resulted in zero deficiency.
- LP believes Lawyer's fee was way too high, that GP/PR should have negotiated a fixed fee and that LP should have paid only 10% of the fee.
- All in, LP sees $600K of Pship expense (LP bore 50%) which could have been avoided entirely.

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What Can Unhappy LP Do?

- Can Unhappy LP get any redress through the IRS?
  - Request that IRS set aside the resolution and re-open the audit?
  - Sue the IRS for a refund of the $370K on everyone's favorite theory?
    - IRS action during audit was "arbitrary and capricious" in violation of the Administrative Procedure Act because IRS should not have let Lawyer and GP resolve the audit.

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Some Better Options for Unhappy LP?

- Sue one of the private actors for monetary damages?
  - Who and on what theory?
- Possible persons to sue:
  - GP as the PR.
  - GP as the general partner.
  - Lawyer.
- Possible theories:
  - Breach of contract (Pship Agrt, Lawyer's engagement letter).
  - Breach of implied contractual "covenant of good faith and fair dealing".
  - Breach of fiduciary duty (owed by "agent" to "principal").
  - Malpractice (Lawyer as a lawyer; what if GP is also a lawyer or CPA?).

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Sidebar: Does **BBA** create or support any private right of action against PR?

- Under TEFRA, the TMP was obligated by the IRC to provide the other partners with certain notifications and certain rights of participation.
- Courts reached varying conclusions on whether these created private rights of action.
- BBA was *intentionally design*ed to place no statutory obligations on PR with respect to other partners.
  - Intention was to let partners and PR establish their rights and obligations entirely through private contracts.

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Suing the GP as PR for breach of Pship Agrt

- Suppose Pship Agrt provided only: "GP will be responsible for all tax matters, including preparing and filing returns and handling tax audits."
  - No breach.
- Suppose Pship Agrt also (i) designated GP as the PR and (ii) obligated PR to "keep LP informed" about any IRS audit?
  - Clearly breached, but was breach proximate cause of the taxes? Lawyer's fees?
- Suppose Pship Agrt also obligated PR to "consult with LP" before settling an audit?
  - Same proximate cause problem.

- Note: proximate cause is especially difficult where taxes are involved because courts tend to find that the taxes were due because of the tax law and not because of the contract breach.
  - But, here, we do have an IU that is clearly higher than the actual taxes that would be due if Pull-In or Push-Out were used.

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Suing the GP as PR for breach of Pship Agrt

- Suppose Pship Agrt also obligated PR to get consent of majority of Pship interests for *audited year* prior to settling an audit?
  - PR says "I got the GP's consent for everything I did."
- Suppose Pship Agrt also had a provision under the "Management of the Pship" article requiring consent of majority of LPs prior to taking any "significant action affecting the Pship".
  - PR's defense: "the tax audit/PR specific sections supersede this in the case of tax-audit-related decisions".

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Suing the GP as PR for breach of Implied Covenant of Good Faith & Fair Dealing

- Is there an implied covenant of good faith and fair dealing that common law will *read into* Pship Agrt and which the PR breached?
- The covenant is used by courts to fill gaps in an agreement
  - Court will fill this gap with what the court believes the parties *would have agreed to* had they considered an issue *they did not anticipate arising*.
- But it does not apply to *all gaps:*
- "The implied covenant only applies to developments that could not be anticipated, not developments that the parties simply failed to consider—particularly where the contract authorizes [a party] to act exactly as it did." Nemec v. Shrader, 991 A.2d 1120 (Del. 2010).
- **If** court were to find such a covenant, the court would determine the terms that it believed the parties would have agreed to if they had anticipated the issue.
  - In 2018, what would GP and LP have agreed to put in Pship Agrt for IRS audits?

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Suing the GP as PR for breach of "fiduciary duties"?

- "Agency is the fiduciary relationship that arises when one person (a "principal") manifests assent to another person (an "agent") that the agent shall *act on the principal's behalf* and subject to the principal's control". Restatement (Third) of Agency § 1.01.
- An "agent" owes two duties to its "principal"
  - **Duty of Care** – Agent must act in the best interests of the principal to the exclusion of all other interests, including those of the agent.
  - **Duty of Loyalty** – Agent must avoid conflicts of interest that might give rise to divided loyalties.
- Who is the "principal" to whom a partnership representative owes these duties:
  - Is it the "partnership" or the "partners"?
  - Can "the best interests" of a partnership be determined without regard to the interests of its partners?
  - Can a PR that is a partner ever avoid having "divided loyalties"?

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If the PR is also a general partner, then it owes fiduciaries duties *as a general partner*

- Delaware Partnership Law: a general partner and managing LLC member owe to other partners/members the duties of care and loyalty.
- What statute requires in the case of these duties is very limited:
  - Loyalty: generally, not appropriating partnership property and not conducting partnership affairs on behalf of a third person with interests adverse to the partnership/LLC.
  - Care: "refrain from engaging in grossly negligent or reckless conduct, intentional misconduct, or a knowing violation of law."
  - "**A partner does not violate a duty or obligation under this chapter or under the partnership agreement solely because the partner's conduct furthers the partner's own interest."** DRPA 15-404(d).
- These statutory minimums (and liabilities for breaches) can be expanded or eliminated by contract, *except*
  - may not eliminate the implied contractual covenant of good faith and fair dealing and
  - may not eliminate liability for any act or omission that constitutes a bad faith violation of the implied contractual covenant of good faith and fair dealing.

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With that background: LP suing the GP/PR for breach of care & loyalty

- Did GP *as PR* breach duty of care (must act in the best interests of the principal) owed *by PR*
  - to Pship?
  - to LP?
- Did GP *as PR* breach duty of loyalty (must avoid conflicts of interest) owed *by PR*
  - to Pship?
  - to LP?
- Did GP *as a general partner* breach duties owed to LP?

- How can LP obtain the necessary facts as to what really happened? Can LP force Lawyer to testify to what GP/PR said to Lawyer? Was it a privileged communication between Lawyer and the client (Pship? GP/PR?)

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If principal is Pship, what are the "best interests of the Pship"

- The "best interests of the Pship" can be difficult to determine
  - Baseline: GP/PR can't take a position that harms Pship just to enrich GP
  - Argument: Settling a matter is in the best interests of the Pship (with coincidental benefit to GP)
- Financial Perspective – what maximizes profits for the Pship as a whole
  - Default consideration is financial
  - Fact/circumstances dependent, and may also include timing components and other non-economic factors
- High bar to challenge GP/PR's decisions – Business Judgment Rule?

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With that background: LP suing the GP/PR for breach of care & loyalty

- Suppose there is some breach here, what are the damages?
- Does it matter that LP agreed to the Pship Agreement provisions?

- **Suppose the PR is found liable for some damages, what if the Pship Agrt indemnifies the PR for any liabilities resulting from actions taken as PR?**
  - If Pship bears the cost, then LP bears 50% of the cost?
  - Suppose Pship Agrt has some exceptions to indemnification: can LP prove they apply?
    - Willful breach of Pship Agrt? What if Pship Agrt not breached? How prove willfullness if cannot get Lawyer to testify?
- Should partnerships be trying to obtain insurance for lawsuits against the PR?

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What if the GP/PR is also a lawyer or CPA?

- Can LP sue the GP/PR for malpractice?
- What if Pship Agrt states that PR is not providing legal services?

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What Have We Learned?

- PR can act like a scoundrel without an Unhappy LP having adequate redress
  - *Unless the Pship Agrt provides the right obligations and remedies.*

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Will Unhappy LP Have Better Chances Suing Lawyer?

- To evaluate malpractice, we need to know
  - who is the client; and
  - what services Lawyer agreed to provide.
- Lawyer was hired by GP/PR to handle the audit.
  - Does that mean that the Lawyer *must of course* be representing the Pship (and not the PR, and not the partners)?
- If engagement letter says Lawyer is representing Pship but

  PR thinks Lawyer is also representing PR

  is Lawyer required to clarify this? Or suggest PR obtain its own counsel?

- Professional Responsibility rules governing lawyers are useful guides to whether malpractice has occurred.

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Some relevant MRPC Rules

Rule 1.1: Competence

"A lawyer shall provide competent representation to a client. Competent representation requires the legal knowledge, skill, thoroughness and preparation reasonably necessary for the representation."

Rule 1.2: Scope of Representation & Allocation of Authority Between Client & Lawyer

"A lawyer shall abide by a client's decisions concerning the objectives of representation and, as required by Rule 1.4, shall consult with the client as to the means by which they are to be pursued…. A lawyer shall abide by a client's decision whether to settle a matter."

Rule 1.4: Communications

"(a) A lawyer shall: …. (2) reasonably consult with the client about the means by which the client's objectives are to be accomplished; and (3) keep the client reasonably informed about the status of the matter;….

"(b) A lawyer shall explain a matter to the extent reasonably necessary to permit the client to make informed decisions regarding the representation."

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Some relevant MRPC Rules

Rule 1.7 Conflicts of Interest

(a) Except as provided in paragraph (b), a lawyer shall not represent a client if the representation involves a concurrent conflict of interest. A concurrent conflict of interest exists if:

(1) the representation of one client will be directly adverse to another client; or

(2) there is a significant risk that the representation of one or more clients will be materially limited by the lawyer's responsibilities to another client, a former client or a third person or by a personal interest of the lawyer.

(b) Notwithstanding the existence of a concurrent conflict of interest under paragraph (a), a lawyer may represent a client if:

(1) the lawyer reasonably believes that the lawyer will be able to provide competent and diligent representation to each affected client;

(2) the representation is not prohibited by law;

(3) the representation does not involve the assertion of a claim by one client against another client represented by the lawyer in the same litigation or other proceeding before a tribunal; and

(4) each affected client gives informed consent, confirmed in writing.

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Some relevant MRPC Rules

Rule 1.13: Organization as Client

"(a) A lawyer employed or retained by an organization represents the organization acting through its duly authorized constituents.

"(b) If a lawyer for an organization knows that an officer, employee or other person associated with the organization is engaged in action, intends to act or refuses to act in a matter related to the representation that is a violation of a legal obligation to the organization… and that is likely to result in substantial injury to the organization, then the lawyer shall proceed as is reasonably necessary in the best interest of the organization. Unless the lawyer reasonably believes that it is not necessary in the best interest of the organization to do so, the lawyer shall refer the matter to higher authority in the organization, including, if warranted by the circumstances to the highest authority that can act on behalf of the organization as determined by applicable law.

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Some relevant MRPC Rules

Rule 1.13: Organization as Client

"(f) In dealing with an organization's directors, officers, employees, members, shareholders or other constituents, a lawyer shall explain the identity of the client when the lawyer knows or reasonably should know that the organization's interests are adverse to those of the constituents with whom the lawyer is dealing.

"(g) A lawyer representing an organization may also represent any of its directors, officers, employees, members, shareholders or other constituents, subject to the provisions of Rule 1.7 [relating to consent]."

How do these rules apply if "the organization" is a partnership? Does the partnership have interests that are distinct from those of it owners? What if the interests of the constituents are adverse to the partners but not to the partnership as an organization?

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Some relevant MRPC Rules

Rule 2.1: Advisor

"In representing a client, a lawyer shall exercise independent professional judgment and render candid advice. In rendering advice, a lawyer may refer not only to law but to other considerations such as moral, economic, social and political factors, that may be relevant to the client's situation."

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Some relevant Circular 230 Rules

- **10.22 Diligence.** (a) *In general.* A practitioner must exercise due diligence — … (3) In determining the correctness of oral or written representations made by the practitioner to clients with reference to any matter administered by the Internal Revenue Service.
- **10.35 Competence.** (a) A practitioner must possess the necessary competence to engage in practice before the Internal Revenue Service. Competent practice requires the appropriate level of knowledge, skill, thoroughness, and preparation necessary for the matter for which the practitioner is engaged.

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Some relevant Circular 230 Rules

10.29 Conflicting interests.

(a) Except as provided by paragraph (b) of this section, a practitioner shall not represent a client before the Internal Revenue Service if the representation involves a conflict of interest. A conflict of interest exists if —

(1) The representation of one client will be directly adverse to another client; or

(2) There is a significant risk that the representation of one or more clients will be materially limited by the practitioner's responsibilities to another client, a former client or a third person, or by a personal interest of the practitioner.

(b) Notwithstanding the existence of a conflict of interest under paragraph (a) of this section, the practitioner may represent a client if —

(1) The practitioner reasonably believes that the practitioner will be able to provide competent and diligent representation to each affected client;

(2) The representation is not prohibited by law; and

(3) Each affected client waives the conflict of interest and gives informed consent, confirmed in writing by each affected client, at the time the existence of the conflict of interest is known by the practitioner. The confirmation may be made within a reasonable period of time after the informed consent, but in no event later than 30 days.

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Should Lawyer be worried?

- Who is Lawyer's client?
- Did Lawyer commit malpractice *by failing to clarify that* at the outset and setting the ground rules?
- Was Lawyer obligated to insist on conferring with LP?
- Was Lawyer obligated to consider if the resolution of the audit was more favorable to GP than to LP?
- Was Lawyer obligated to inquire into whether the partners' interests in Pship had changed?
- When red flags were waiving, was Lawyer obligated to react?
- Is being the lawyer to the PR more trepidatious than being the PR?

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Eyes Wide Open

- Partnership Agrt: best source of protection for partners (and the partnership).
- PR should want the PR's obligations and protections clearly delineated.
- Lawyer should want his/her role and obligations clearly delineated.
- Partners coming into partnership or increasing interest in partnership need to *proceed with caution and skepticism.*

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