Rocks — Partnership Representatives — Hard Places

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Ethical Obligations of Partnership Representatives
By: Diana Wollman, Diana S. Doyle and Bryan Skarlatos

I. LAWYERS AS PARTNERSHIP REPRESENTATIVE – OBLIGATIONS UNDER THE MODEL RULES OF PROFESSIONAL CONDUCT ("MRPC")

A. Duty of Loyalty.

1. The Comment to Rule 1.7 of the MRPC states that "loyalty and independent judgment are essential elements in the lawyer's relationship to a client." Thus, a lawyer may be required to take, or refuse to take, certain actions in the context of any particular representation as a result of his/her duty of loyalty to others.

B. Duty of Confidentiality.

1. MRPC Rule 1.6 governs a lawyer's duty of confidentiality. In general, a lawyer has a duty to keep information relating to the representation of a client confidential "unless the client gives informed consent" or "the disclosure is impliedly authorized in order to carry out the representation."

2. Notwithstanding the general rule described above, a lawyer may reveal otherwise confidential information to the extent the lawyer reasonably believes necessary: "(1) to prevent reasonably certain death or substantial bodily harm; (2) to prevent the client from committing a crime or fraud that is reasonably certain to result in substantial injury to the financial interests or property of another and in furtherance of which the client has used or is using the lawyer's services; (3) to prevent, mitigate or rectify substantial injury to the financial interests or property of another that is reasonably certain to result or has resulted from the client's commission of a crime or fraud in furtherance of which the client has used the lawyer's services; (4) to secure legal advice about the lawyer's compliance with [the MRPC]; (5) to establish a claim or defense on behalf of the lawyer in a controversy between the lawyer and the client, to establish a defense to a criminal charge or civil claim against the lawyer based upon conduct in which the client was involved, or to respond to allegations in any proceeding concerning the lawyer's representation of the client; (6) to comply with other law or a court order; or (7) to detect and resolve conflicts of interest arising from the lawyer's change of employment or from changes in the composition or ownership of a firm, but only if the revealed information would not compromise the attorney-client privilege or otherwise prejudice the client."

3. Moreover, a lawyer has a duty to take reasonable efforts to prevent the inadvertent or unauthorized disclosure of such confidential information.

C. Conflicts of Interest.

1. In general, under Rule 1.7 of the MRPC, a lawyer may not represent a client if the representation involves a "concurrent conflict of interest." A concurrent conflict of interest exists if: "the representation of one client will be directly adverse to another client; or 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."

2. Even if a concurrent conflict of interest exists, a lawyer may represent the client if: "the lawyer reasonably believes that the lawyer will be able to provide competent and diligent representation to each aff ected client; the representation is not prohibited by law; 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 each aff ected client gives informed consent, confirmed in writing."

D. Organization as Client.

1. When representing an organization, a lawyer generally must consider the best interests of the organization, rather than of the individuals employed by the organization, in connection with the representation.[1]

2. Under Rule 1.13 of the MRPC, "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, or a violation of law that reasonably might be imputed to the organization, and that is likely to result in substantial injury to the organization," then the lawyer should proceed in the best interest of the organization. Further, the lawyer, the lawyer must refer the matter to higher authority in the organization, unless the lawyer reasonably believes that it is not necessary in the best interest of the organization to do so.[2]

3. A lawyer has a duty to clarify its duty to the organization when dealing with the organization's constituents. Specifically, the MRPC provide that "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

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[1] *See* MRPC Rule 1.13(a). Note that a lawyer representing an organization may concurrently represent any of the organization's directors, officers or employees, subject to Rule 1.7 relating to conflicts of interest.

[2] MRPC Rule 1.13(b).

organization's interests are adverse to those of the constituents with whom the lawyer is dealing."[3]

II. CIRCULAR 230

A. A tax practitioner practicing before the IRS will also be required to comply with requirements of Circular 230.

B. Section 10.20 provides that if the IRS makes a lawful request for information, the practitioner is generally obligated to provide the information to the IRS, unless he or she believes (in good faith and on reasonable grounds) that the material is privileged. This section would be particularly relevant to a partnership representative, and his/her lawyers.

C. Section 10.22 imposes due diligence requirements that may be relevant to the partnership representative. In general section 10.22 provides that the tax professional must exercise due diligence in preparing or assisting in the preparation of, approving and filing tax returns, documents, affidavits and other papers relating to matters with the IRS.

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[3] MRPC Rule 1.13(f).

Ethical Obligations of Partnership Representatives
Diana S. Doyle, Latham & Watkins LLP[1]

I. THE PARTNERSHIP REPRESENTATIVE AS AN AGENT AND FIDUCIARY

A. Partnership Representative as Agent

1. Elements of Agency

a. The principal manifests assent to the agent "that the agent shall act on the principal's behalf and subject to the principal's control."[2]

b. The agent "manifests assent or otherwise consents so to act."[3]

2. Scope of Agency Authority

a. Actual authority. The agent has the actual authority to take stated or implied action based on the principal's manifestations to the agent. The agent may also perform acts necessary or incidental to achieving the principal's objectives, as the agent reasonably understands them.[4]

b. Reasonableness. The agent's "interpretation of the principal's manifestations is reasonable if it reflects any meaning known . . . to be ascribed by the principal," or "as a reasonable person in the agent's position would interpret" those manifestations. The agent's "understanding of the principal's objectives is reasonable if it accords with the principal's manifestations and the inferences that a reasonable person . . . would draw from circumstances creating the agency."[5]

3. Partnership Representative Agency Relationship – Proposed Treasury Regulations

a. American Bar Association Comments. The American Bar Association Section of Taxation *Comments on Proposed*

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[1] Diana Doyle is a partner in the Chicago office of Latham & Watkins LLP. The views herein are entirely her own, as are any omissions or errors. Thanks to Joseph Thomas for his invaluable help on sections of this outline.

[2] RESTATEMENT (THIRD) OF AGENCY § 1.01.

[3] *Id.*

[4] *Id.* § 2.02(1).

[5] *Id*. § 2.02(2)-(3).

Regulations Implementing the Partnership Audit Procedures Enacted as Part of the Bipartisan Budget Act of 2015 reflect the ABA's view on the role of the partnership representative ("PR"), and are a response to the initial proposed PR regulations under the Bipartisan Budget Act of 2015 (the "BBA").[6] The Comments view the PR as the agent of the partnership in IRS proceedings, and suggest certain ethical duties of the PR flowing from that agency relationship.

b. Proposed Treasury Regulation § 301.6223-2(c)[7]

(1) Proposed Treasury Regulation § 301.6223-2(c) states that "[n]o state law, partnership agreement, or other document or agreement may limit the authority of the partnership representative or the designated individual as described in section 6223 and this section."[8]

(2) This is arguably inconsistent with the application of the state laws of agency or fiduciary duties if nothing can limit the authority of the PR. However, the ABA took the view that the Code itself and court precedent instructed that the PR was to be an agent of the partnership, and suggested the IRS amend Proposed Treasury Regulation § 301.6223-2(c) to "implement section 6223 in a manner that contemplates that the Partnership Representative will act in a manner consistent with the authority granted to her by the partnership."[9]

c. ABA's Argument

(1) The Comments explain that Section 6223 bestows "sole authority" on the PR, but that authority is cabined to "act on behalf of the partnership under this subtitle [sic]."[10] Because state law allows principals to limit the powers of

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[6] AMERICAN BAR ASSOCIATION, SECTION OF TAXATION, COMMENTS ON PROPOSED REGULATIONS IMPLEMENTING THE PARTNERSHIP AUDIT PROCEDURES ENACTED AS PART OF THE BIPARTISAN BUDGET ACT OF 2015 1 (2017).

[7] Prop. Treas. Reg. § 301.6223-2(c), 82 Fed. Reg. 27334, 27381–82 (June 14, 2017).

[8] *Id.* at 27381.

[9] AMERICAN BAR ASSOCIATION, *supra* note 6, at 53 (Section 6223 uses the word "subchapter").

[10] *Id.* at 46.

their agents, partnerships should be allowed to limit the power of the PR to act as their agent.[11]

(2) Because the PR has sole "authority to act on behalf of the partnership," and the partnership and all partners are bound "by actions taken . . . by the partnership," the Comments argue it is clear that Congress intended the PR to act as an agent on behalf of "and at the direction of the relevant partnership."[12]

(a) Congress's use of the word "representative" also has import, as statutes authorizing the Department of the Treasury to impose regulations on agents and attorneys appearing before the IRS as representatives of claimants have been in force since the 1800s.[13]

(b) The D.C. Circuit has stated that "[t]he term 'representative' is traditionally and commonly defined as an agent with authority to bind others."[14]

(3) Preemption

(a) The ABA noted that courts have "been reluctant to find that state law is preempted in the absence of a direct conflict between a provision of the Code and a state law rule."[15] It further argued that since regulation of a business's internal affairs is generally reserved for state law, it was unlikely that Congress would displace relevant law without explicit mention.[16]

(b) To the ABA, the only justification for the Proposed Treasury Regulation was if there were a direct conflict between federal law and state law on

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[11] *Id.* at 47.

[12] *Id.* at 48.

[13] *Id.* (citing Loving v. IRS, 742 F.3d 1013, 1019 (D.C. Cir. 2014) (quoting Act of July 7, 1884, ch. 334, sec 3, 23 Stat. 258)).

[14] Loving v. IRS, 742 F.3d 1013, 1016 (D.C. Cir. 2014).

[15] *See* AMERICAN BAR ASSOCIATION, *supra* note 6, at 50–51.

[16] *Id*. at 51.

partnerships and agency, and it would be impossible for the PR to comply with both.[17]

(c) The ABA noted that a requirement to confer with partners before taking action "is not incompatible with the language of section 6223 indicating that the decisions of the Partnership Representative will bind the partners and the partnership, because it does not impose inconsistent federal and state obligations on the Partnership Representative."[18]

4. Partnership Representative Agency Relationship – Final Regulations

a. The Final Regulations did not adopt the ABA's view "[b]ecause the authority of the partnership representative under federal law preempts any state law requirements."[19]

b. However, the Final Regulations did revise the Proposed Treasury Regulation language to provide that the PR's scope and limits could be restricted by contract, but failure to follow those contracts would not affect the validity of actions taken by the PR at the IRS.[20] The only remedy for partnerships would be under state law.

c. The Final Regulations create a situation resembling an apparent authority agency relationship.[21] The PR, as agent, has apparent authority from its principal to act before a third party (IRS). Because the IRS relies on the apparent authority, the agent's actions are binding. However, the agent could still be liable to the principal for exceeding its actual authority.

B. Partnership Representative as Fiduciary

1. Fiduciary Duties of Agents. As an agent, the PR would have the fiduciary duties owed to principals by their agents. These duties include the duties of care and loyalty.

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[17] *Id.*

[18] *Id.*

[19] T.D. 9839, 2018-35 I.R.B. 12.

[20] *Id.*

[21] RESTATEMENT (THIRD) OF AGENCY § 2.03 ("Apparent authority is the power held by an agent or other actor to affect a principal's legal relations with third parties when a third party reasonably believes the actor has authority to act on behalf of the principal and that belief is traceable to the principal's manifestations.").

a. Duty of Care. The duty of care requires a PR to act in the best interests of the principal to the exclusion of all other interests, including those of the PR.[22]

b. Duty of Loyalty. The duty of loyalty requires a PR to avoid conflicts of interest that might give rise to divided loyalties, particularly if the PR is a partner, and not an independent entity.[23]

C. Comparison with Tax Matters Partner ("TMP")[24]

a. TMP Was Fiduciary to Partners and Partnership. The predecessor to the PR was the TMP, which was implemented as part of the Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA").[25] TMP was held by the courts to be an agent and fiduciary to all the partners, not just the partnership itself.[26] Unlike under TEFRA—where partners could seek to intervene into IRS decision-making to protect their interests—partners cannot intervene into an audit under the BBA.[27]

b. PR Is Potentially a Fiduciary Only to the Partnership. Although it is by no means clear, there is an argument that the PR is now a fiduciary only to the partnership itself.[28]

(1) Under the Delaware Revised Uniform Partnership Act (DRUPA), "[a] partnership is a separate legal entity which is an entity distinct from its partners unless otherwise provided in a statement of partnership existence or a statement of qualification and in a partnership agreement."[29] Delaware law provides for default fiduciary duties of care and loyalty owed by general partners to each

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[22] *See* Terence Floyd Cuff & Jerald David August, *The Partnership Representative*, 75 N.Y.U. ANN. INST. ON FED. TAX'N § 14.13 at 13 (2017).

[23] *Id.*

[24] Pub. L. No. 97-248, 96 Stat. 664 (codified at 26 U.S.C. § 6231(a)(7)) (repealed 2015).

[25] Pub. L. No. 97-248, 96 Stat. 324.

[26] *See* Transpac Drilling Venture 1982-12 v. Commissioner, 147 F.3d 221, 225 (2d Cir. 1998) (citing Computer Programs Lambda, Ltd. v. Commissioner, 89 T.C. 198, 205 (1987)).

[27] Fred F. Murray, *The New Partnership Examination Rules Enacted in the Bipartisan Budget Act of 2015*, *in* THE PARTNERSHIP TAX SERIES: PLANNING FOR DOMESTIC AND FOREIGN PARTNERSHIPS, LLCS, JOINT VENTURES & OTHER STRATEGIC ALLIANCES 319A, 319A-15 (Louis S. Freeman & Clifford M. Warren eds., 2018).

[28] *See* Cuff & August, *supra* note 22, at 13.

[29] DEL. CODE ANN. tit. 6, § 15-201(a).

other.[30] These duties can also be expanded or completely eliminated, and liability for breaches can also be expanded or completely eliminated.[31]

(2) Under the Delaware Revised Uniform Limited Partnership Act (DRULPA), a "limited partnership . . . shall be a separate legal entity."[32] Delaware law provides for default fiduciary duties owed by general partners to the limited partners.[33] These duties can also be expanded or completely eliminated, and liability for breaches can also be expanded or completely eliminated.[34]

(3) Under the Delaware Limited Liability Company Act, a "limited liability company . . . shall be a separate legal entity."[35] Delaware law provides for default fiduciary duties owed by managing members to each other, passive members, the manager and the LLC.[36] These duties can be expanded or completely eliminated, and liability for breaches can also be expanded or completely eliminated.[37]

(a) "[Non-member] [m]anagers and managing members owe default fiduciary duties" under Delaware law.[38]

c. Presuming the PR is an agent for the partnership under state law, query whether it has any duty to the individual partners. A partner/member PR would theoretically still owe default fiduciary

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[30] DEL. CODE ANN. tit. 6, § 15-404(a)-(c).

[31] DEL. CODE ANN. tit. 6, § 15-103(f); *see also* Ann E. Conaway, *Lessons to Be Learned: How the Policy of Freedom to Contract in Delaware's Alternative Entity Law Might Inform Delaware's General Corporation Law*, 33 DEL. J. CORP. L 789, 790–91 n.8 (2008).

[32] DEL. CODE ANN. tit. 6, § 17-201(b).

[33] *See* Boxer v. Husky Oil Co., 429 A.2d 995, 997 (Del. Ch. 1981).

[34] DEL. CODE ANN. tit. 6, § 17-1101(d), (f).

[35] DEL. CODE ANN. tit. 6, § 18-201(b).

[36] DEL. CODE ANN. tit. 6, § 18-1104.

[37] DEL. CODE ANN. tit. 6, § 18-1101(c), (e); *see* VGS, Inc. v. Castiel, No. 17995, 2000 WL 1277372, at *4–5 (Del. Ch. Aug. 31, 2000), aff'd, 781 A.2d 696 (Del. 2001); Feeley v. NHAOCG, LLC 62 A.3d 649, 662 (Del. Ch. 2012).

[38] *Feeley*, 62 A.3d at 662.

duties to the individual partners/members from its own status as a partner/member.[39]

II. THE COVENANT OF GOOD FAITH AND FAIR DEALING

A. Elements of the Covenant. The covenant's function is to fill gaps in an agreement by allowing courts to consider what parties to a contract would have agreed to had they considered an issue they did not anticipate arising.[40]

1. Whether the contract contains a gap that needs filling;

2. Whether an implied contractual term fills a gap; and

3. What would the parties themselves have agreed to had they considered the issue in their original bargaining positions.[41]

B. Features of the Covenant

1. Covenant of good faith and fair dealing cannot be waived in either the Delaware partnership or LLC contexts, unlike general fiduciary duties, which can be waived completely or not at all. The covenant applies to every contract.[42]

2. Breaches of the covenant can only arise out of conduct not explicitly forbidden by the terms of the contract. Successful invocation of the covenant under Delaware law is rare.[43]

3. When parties eliminate fiduciary duties as part of a detailed contract, courts are reluctant to read terms into the agreement on the basis of the covenant. "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 . . . ."[44]

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[39] DEL. CODE ANN. tit. 6, § 15-404(a) ("The only fiduciary duties a partner owes to the partnership and the other partners are the duty of loyalty and the duty of care . . . ").

[40] Practical Law Corporate & Securities, *Fiduciary Duties in LLCs and LPs,* Practice Note w-017-3039, at 5 (West 2018).

[41] *Id.*

[42] DEL. CODE ANN. tit. 6, § 18-1101(c); DEL. CODE ANN. tit. 6, § 17-1101(d).

[43] *See* Fisk Ventures, LLC v. Segal, No. 3017-CC, 2008 WL 1961156, at *10 (Del. Ch. May 7, 2008); Kuroda v. SPJS Holdings, LLC, 971 A.2d 872, 888 (Del. Ch. 2009).

[44] Nemec v. Shrader, 991 A.2d 1120, 1126 (Del. 2010) (Corporate board redeemed its put rights on stock of retired executives during the time period and at a price contemplated by the stock

4. Breaches of the covenant can be sidestepped depending on the standard of care the agreement contains. If the misconduct required for breach is higher than the traditional "gross negligence," such as "fraudulent or illegal," then courts will not find breaches of the covenant unless the misconduct rises to that level.[45]

5. The Delaware Supreme Court has been slightly more open to finding breaches of the covenant recently. The Court found a breach of the implied covenant when a master limited partnership disclosed more information than was strictly required by its partnership agreement, and that disclosure contained materially misleading information.[46] Reasoning that a gap existed between the language of the agreement and what the parties would have negotiated had they considered excess disclosure, the Court found that they would have negotiated a provision forbidding the partnership from presenting misleading information.[47]

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purchase plan, without informing the executives of a pending sale. The court found no breach of the covenant.).

[45] *See* Practical Law Corporate & Securities, *supra* note 40, at 9 (citing Wood v. Baum, 953 A.2d 136, 141–43 (Del. 2008)).

[46] *See* Dieckman v. Regency GP LP, 155 A.3d 358, 367–68 (Del. 2017).

[47] *Id.* at 369.