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Commentary

An Expulsion Remedy Provision: A Clear And Straightforward Penalty

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Unfortunately, in these harsh economic times, the following scenario plays out repeatedly: a business entity with bright aspirations, such as a dot.com, is unable to operate at a profit and, in turn, must be further capitalized by its financiers in order to survive. However, due to scarce resources, some of the capital partners to the promising venture refuse to offer that business any more money in the wake of its short-term or long-term unprofitability. In this scenario, the individuals who thought that the risk of this enterprise would be shared with these partners may demand that action be taken against them to compel further capital contributions or to insulate the business venture from continued dealings with them.

Because the above scenario occurs so often, it is important that before consummating a partnership agreement (especially during the current economic downturn) the contracting parties need to ask a specific, but essential, question: what remedy will the partners have if one particular partner breaches the material provisions of the agreement? One specific remedy — expulsion — will not be available to general partners unless a provision in the partnership agreement specifies otherwise. Accordingly, if prospective partners want to avail themselves of this remedy — such as in a situation where a partner refuses to contribute to the operating losses of the partnership, a specific provision concerning partnership expulsion under certain circumstances should be included.

In the absence of an expulsion provision, it is generally difficult to rid a partnership of a breaching partner and thus strip him of his managerial powers, *i.e.*, his power to bind the affairs of the business. However, under certain circumstances, it is possible for the partnership or the non-breaching partners of the partnership, after receiving an award from a tribunal, to charge or attach a partner's financial interest in a partnership, which includes a partner's interest in the profits of the partnership income and any gain (surplus) that would befall the partnership in its sale of its assets.

The Charging Order procedure, however, when compared to the operation of an automatic expulsion provision, is convoluted, uncertain and expensive. In order to be awarded a Charging Order, the partnership or non-breaching partners would have to make an application to the Court that provided for the judgment. Generally, the Charging Order

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will specify that the financial interest of the breaching or debtor partner will be transferred to a receiver or other judicial officer who will sell that interest at public auction or by private sale. The breaching partner's management interest will generally, however, not be charged, especially if the partner maintains a significant capital account within the partnership. In this instance, even though a particular partner may have breached the operative agreement and may not have any right to future profits accrued by the entity, the partner may still have the right to make decisions on behalf of the business. Recognizing this absurd result, a few courts have also ordered the attachment and sale of a debtor partner's management interest.

In light of the above, the only sure way that non-breaching partners can protect themselves against an extremely convoluted and unsure enforcement process is to specify remedy provisions in their agreement that will call for the expulsion of a breaching partner in certain circumstances. Moreover, the partnership agreement should clearly define what is meant by "expulsion." In my view, in order to guard against future unwanted involvement from the breaching partner, the partnership agreement should define expulsion as "the termination of the breaching partner's interest in the profits of the firm, any surpluses that the firm may achieve either through the dissolution process or otherwise, and the management of the firm, including any right to inspect any of the books or records of the partnership." The foregoing provision does not call for the transference of the partner's capital account, which is generally regarded as personal property. Of course, partners to a partnership could always legitimately include such an automatic transfer clause within the definition of expulsion, if they all found the clause acceptable.

Clearly identifying the potential remedies to be incurred in light of a breach by a partner, because it will place all partners on notice of the consequences of unlawful conduct, will add certainty to inter-partner dealings. A general partnership that adopts such a remedy provision in its governing agreement will thus operate more efficiently and effectively.

In sum, in order for partners to expel a partner who has breached their agreement:

- An expulsion provision should be clearly identified in the partnership agreement; or

- A judgment will have to be obtained against the breaching partner and an application for a Charging Order will have to be made in order to foreclose upon the breaching partner's interest. ■

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