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How to Remove a General Partner from a Real Estate Partnership

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Default is an unfortunate reality in any partnership. Though no one enters a partnership expecting the other party to default on its obligations, it poses a risk that must be properly addressed to mitigate the limited partner's risk before the partnership is ever established. This article will address the rights and remedies available to the limited partner when the general partner has failed to live up to its commitments, and the procedures that should be followed in obtaining relief. While it is obviously preferable to avoid the need for removal through proper due diligence and risk mitigation, sometimes default cannot be avoided. There are consequences to seeking removal. It is the limited partner who must find a replacement partner once the general partner has been removed. This may be easier said than done, as the partnership agreement, as well as the project documents may require the limited partner to meet certain consent obligations before a new general partner can be admitted. In addition, once the general partner is removed, the general partner will generally request both a release from liability and demand payment for the value of its interest plus any fees that have accrued.

A general partner can only be removed for cause. The grounds for removal are generally governed by the terms of the partnership agreement, and often include fraud, breach of fiduciary duty, intentional misconduct, negligence, a violation of the law, the general partner's bankruptcy or insolvency, an action that would jeopardize the partnership's tax status or that would cause the limited partner to lose its limited liability protection, breach of the project documents or a failure to fund operating deficits. Certain events causing default should be addressed specifically in the partnership agreement.

Once an event causing default has occurred, there are certain procedures that a limited partner must adhere to before a general partner can be removed. Oftentimes, the partnership agreement will provide for notice and cure rights. Industry practice generally provides for a 10 day notice/cure period for monetary defaults, and a 30 day period for non-monetary defaults. It is generally recommended that all notices required pursuant to the partnership agreement be sent to the defaulting party by overnight or certified mail.

An exiting general partner will normally request a release from liability and will demand payment of both the value of its interest plus an accrued, but unpaid fees. These issues should be anticipated and should be properly dealt with under the terms of the partnership agreement. The issue of compensation should not simply be assumed. If the general partner has defaulted on its obligations, what is it being compensated for? There are a number of ways that a partnership agreement can address this issue. For example, the agreement may provide a set-off provision, which would provide that any fees owed to the general partner will be offset against the partnership's damages which have occurred as a result of the general partner's default as well as the limited partner's costs incurred in locating a new general partner that will assume the exiting partner's obligations. While it is industry practice to release the exiting partner from liability for actions occurring after the date of removal, the general partner should remain liable for its actions prior to the date of removal.

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Depending upon the circumstances, there may be tax issues that will need to be addressed once a general partner has been removed. To the extent that the partnership has cancelled any developer fees, the partnership may be required to realize “cancellation of indebtedness income” under IRC § 108. While a cancellation of the developer fees should not affect eligible basis for purposes of determining the amount of tax credits to which the partnership is entitled, the IRS may nevertheless argue that the development fee should have been excluded from eligible basis because, in hindsight, the fee was never paid, and therefore, did not constitute a “true debt.” There are several ways that the partnership agreement can be drafted to avoid this argument. The key is to draft the partnership agreement to avoid any argument that the development fee is contingent while also providing recourse for any damages incurred.

With respect to other fees which are accrued but unpaid, there should generally be no tax consequences to the partnership if the fees are not paid. For example, IRC § 707(a) payments are not deductible until the payee has included the fee as income. To the extent that the payee is a cash method taxpayer, the partnership would not have to include the amount of the fee as income since it was not previously allowed a deduction. However, if the partnership has previously taken a deduction, it may be required to include as income the amount it was previously allowed as a deduction if the fee is ultimately not paid.

While default is a reality that often cannot be avoided, its consequences can be hedged if the partnership agreement is drafted to address all potential issues that may arise.

This post was drafted by Nick Irmen, an attorney in the Springfield, MO office of Spencer Fane. For more information, visit spencerfane.com.