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Comment

DRAFTING PROBLEMS OF PARTNERSHIP AGREEMENTS

The attorney for the promoters of a prospective small business will probably find that choice of the form of business is dictated by tax factors. Such traditional advantages of incorporation as perpetual existence, limited liability and easy transferability of interest may largely be discounted. Continuation of the business after the death or withdrawal of an associate can be assured by provision for it in the partnership agreement. Limited liability may be sacrificed, as credit generally will be extended to the business only if it is backed up personally by the co-owners; tort liability may be shifted by insurance. The only willing purchasers of a co-owner's interest are likely to be his associates. On the other hand, a corporation may be given many of the characteristics of a partnership through use of stockholders' agreements and other devices.[1] But the distinction which the income tax and the excess profits tax make between the corporate and partnership forms cannot be ignored.[2]

[1] See ISRAELS AND GORMAN, CORPORATE PRACTICE 17-23 (Practising Law Institute, 1951); Hornstein, *Stockholders' Agreements in the Closely Held Corporation*, 59 YALE L. J. 1040 (1950).

[2] See on the choice of organization, particularly with reference to tax considerations: KNAPP AND WARREN, FORMS OF BUSINESS ORGANIZATION AND THE FEDERAL TAX LAWS (Practising Law Institute, 1951); 6 MERTENS, LAW OF FEDERAL INCOME TAXATION § 35.01 (1942); RESEARCH INSTITUTE OF AMERICA, PARTNERSHIP OR CORPORATION (Dec. 1951); ROHRLICH, ORGANIZING CORPORATE AND OTHER BUSINESS ENTERPRISES § 5.05 (1949); Ray and Hammonds,

This comment assumes that such tax considerations have been weighed and that the partnership form has been recommended. It is the intention here to explore the different arrangements which can be made to tailor this form of business organization to the needs of particular clients.[3] Although the success of a small business must rest on sound personal relationships among its co-owners, a well constructed legal framework may often forestall friction, or at least prevent it from stopping the business altogether.[4]

Throughout the discussion it will be necessary to distinguish two broad types of businesses because their differing characteristics often make identical treatment inappropriate. These types are the service partnership, illustrated by professional firms, and the capital partnership, represented by the manufacturing concern in which physical assets are important.[5]

INITIAL CONTRIBUTIONS TO CAPITAL

Valuation of initial contributions to capital in the agreement is important primarily because the partners are entitled to a return of the value of their contributions upon liquidation.[6] Cash presents no difficulty; other assets should be valued cautiously, for the figure reached may not only be the basis for valuation in a purchase and sale agreement but may also produce tax consequences under the main agreement.[7] Amendment of the schedule of valuations should be provided for whenever additional property is contributed or an original contribution is withdrawn.

All property which will be used by the partnership need not belong to it. However, all property contributed becomes partnership property in which individual rights are destroyed.[8] If a partner wishes to insure that a specific item, such as a patent, will be returned to him in the event of dissolution, he should not contribute it as capital but rather should lease or lend it to the firm.

Some assets, such as special licenses personal to one of the partners, may be essential to the conduct of the business. Restriction on withdrawal

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Corporation or Partnership: Federal Income Tax Aspects, 27 TEX. L. REV. 469 (1949); Seidman, *Tax Advantages of a Corporation v. Partnership or Sole Proprietorship*, 90 J. ACCOUNTANCY 104 (1950).

[3] Particular reliance has been placed on four sources which may be consulted to great advantage by the lawyer about to draft a partnership agreement: LITTLE, FEDERAL INCOME TAXATION OF PARTNERSHIPS (1952); MULDER AND VOLZ, THE DRAFTING OF PARTNERSHIP AGREEMENTS, (American Law Institute, 1950); 1 RABKIN AND JOHNSON, CURRENT LEGAL FORMS WITH TAX ANALYSIS, c. 1 (1948); and Worcester, *The Drafting of Partnership Agreements*, 63 HARV. L. REV. 985 (1950). The second and third authorities cited contain extensive and carefully considered forms.

Several items which should be included in every agreement, such as the name and place of business, and limitations on the powers of a partner (see UPA § 9), will not be discussed.

[4] The Uniform Partnership Act, now adopted in 32 jurisdictions, is the primary source of the legal rules which will be considered. In most cases, the rules can be varied by agreement. The Act, cited herein as the UPA, has been in effect in California since 1929. It is presently located in CAL. CORP. CODE §§ 15001-15043. The section numbers of the UPA and of the Corporations Code correspond, *e.g.*, UPA § 1 is the same as CAL. CORP. CODE § 15001.

[5] The distinction is suggested by Worcester, *supra* note 3.

[6] Edwards v. Arvin, 272 Ky. 528, 114 S.W. 2d 778 (1938) (partner furnishing only services not entitled to share in capital contributed by other partner); UPA § 40(b)(III).

[7] See text at note 15 *infra*.

[8] UPA § 25(2)(a).

of the asset during the life of the partnership is thus desirable.[9] If continuation of the partnership is contemplated in spite of retirement by the partner bringing the asset into the business, consideration should be given to restricting his disposition of the asset even after retirement.[10]

Some risks involved in contributing property to the firm may be reduced by taking precaution in the agreement. For example, title to real property need not be deeded to the partnership in order for the rights of the firm to attach.[11] Yet if title must be conveyed by all the partners a subsequent purchaser will be put on notice of the existence of the partnership and may therefore be led to inquire into the scope of the authority of a partner who may attempt to convey the land wrongfully.[12] With regard to cash, a special provision is advisable requiring that no money shall be deposited for the partnership in a joint account. If a joint account were set up the right of survivorship would attach and might cause a partner's estate to lose the right to share in the value of the account.[13]

If only part of the agreed capital is to be contributed at the outset, the period in which the partners must meet their obligations to contribute should be defined.[14]

Apportionment of possible tax burdens may justify detailed provisions treating basis and depreciation, when assets of substantial value, such as an existing plant, are being turned over to the partnership.[15] The problem arises from the fact that property contributed to the partnership retains the basis it had in the hands of the contributing partner,[16] while his capital balance will be credited with the fair market value of the property upon contribution. Market value and basis may differ substantially, so that even an immediate sale would produce a taxable gain to the partnership. None of this gain should be allocated to non-contributing partners; they will have received no benefit from the sale and it would be unfair to require them to pay a tax.

Fluctuations in the value of the property after its acquisition by the partnership will further complicate the situation. For example, a subsequent disposition will produce economic loss if the sale was made below the value at which the asset is carried on the partnership books. This economic loss would normally be allocated among the partners in the loss sharing ratio, since all assets were deliberately subjected to this sort of risk. However, an economic loss will result in taxable gain if the amount realized on the sale was nevertheless greater than the asset's basis.

Similar problems are raised concerning the depreciation allowable on

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[9] See MULDER AND VOLZ, *op. cit. supra* note 3, at 60.

[10] See the agreement in Gill v. Mallory, 274 App. Div. 84, 80 N.Y.S. 2d 155 (1948) (expelled partner of brokerage firm owned seat on stock exchange).

[11] Swarthout v. Gentry, 62 Cal. App. 2d 68, 144 P. 2d 38 (1943); UPA § 10(3).

[12] See UPA § 10(1); Dodson v. Webb, 50 N.W. 2d 92 (N.D. 1951) (partners bound by conveyance of partner holding title).

[13] See CAL. FIN. CODE § 852; Stroh v. Dumas, 84 A. 2d 408 (Vt. 1951).

[14] MULDER AND VOLZ, *op. cit. supra* note 3, at 58.

[15] See generally in regard to the discussion which follows: LITTLE, *op. cit. supra* note 3, c. 6; Dibble, *Allocations of Partnership Profits and Losses*, 2 U.S.C. TAX INST. 43, 52 *et seq.* (1950).

[16] INT. REV. CODE § 113(a)(13).

a contributed asset. For example, if *A* contributes a building valued on the partnership books at $50,000 but which has a basis of $25,000, the partnership will only be able to deduct depreciation expenses on half the value of the asset.[17] *B*'s distributive share of income will be less as a result unless all the deductible expense is allocated to him.

The tax rules regarding allocation of taxable gains and of deductible losses and expenses between the partners are obscure.[18] Therefore detailed provisions for allocation in the partnership agreement may be necessary in order to insure a fair solution of the problem.[19] If the tax authorities refuse to accept these allocations it may nevertheless be provided that reimbursement shall be made to any partner required to pay a larger tax than he would have if the agreement controlled.

MANAGEMENT

Management by a majority is the rule of the UPA.[19a] It is commonly varied by leaving ordinary business decisions to a "majority in interest," that is, to the partners who together are entitled to more than half of the profits.[20] If profit sharing is not determined by the ratio of capital balances, it may be provided that the partners who have contributed more than half of the capital shall control.[21] In either case it is highly important that this part of the agreement be correlated with the provisions regarding changes in the capital balances.[22]

A majority contributor may insist upon complete control,[23] perhaps until a specified amount has been repaid him from the earnings of his partners.[23a] A similar way of achieving the same result is to give the majority partner an option to buy out the others at any time.[24]

On the other hand, a minority partner may require protection. If a guarantee of employment induced him to join the firm, the powers of the majority should be limited by providing that the partnership shall exist

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[17] U.S. Treas. Reg. 111, § 29.113(a)(13)-1.

[18] LITTLE, *op. cit. supra* note 3, at 104-105, 113.

[19] Suggestive forms are available in LITTLE, *op. cit. supra* note 3, at 413, and in 1 RABKIN AND JOHNSON, *op. cit. supra* note 3, Forms 1.07-1.11.

[19a] § 18(h).

[20] Worcester, *supra* note 3, at 992.

[21] Morrison v. Ultican, 35 Wash. 2d 504, 213 P. 2d 617 (1950).

[22] See text at note 54 *infra*.

[23] But a managing partner may not over-reach for his own benefit since he is a fiduciary; Waldor v. Bruey, 24 N.J. Misc. 354, 49 A. 2d 151 (1946), *aff'd*, 139 N.J. Eq. 238, 50 A. 2d 646 (1947) (managing partner bought goods for partnership at unreasonable price from his own business).

[23a] See Cominos v. Kalkanes, 226 P. 2d 863 (Wash. 1951). *Cf.* Kirkpatrick v. Christensen, 68 Ariz. 364, 206 P. 2d 577 (1949) (provision that certain partners entitled to 75% of profits until capital contributions repaid held to entitle them to preference on liquidation).

[24] This arrangement has been made, for example, in a speculative venture where one partner wished eventually to have full ownership but was forced to take in another to obtain more capital. Vance v. Ingram, 16 Wash. 2d 399, 133 P. 2d 938 (1943). See also Hagan v. Dundore, 185 Md. 86, 43 A. 2d 181, 160 A.L.R. 517 (1945); Crane v. Dalton, 102 W. Va. 550, 136 S.E. 33 (1926). In the *Vance* and *Crane* cases, the issue was whether the option had been exercised, *i.e.*, whether the optionor's withdrawals were from profits or were instead payments to him to be credited on the purchase price of his interest.

for a specified term unless the minority partner assents to earlier dissolution. During this term the salary of the particular partner should be subject to change only with his consent.[24a] Partners causing a dissolution before that period will then be liable in damages.[25]

Potential disagreement is the greatest risk facing the partnership.[26] This risk may be diminished by providing for arbitration where questions arise as to the meaning of the articles or the accuracy of accounts.[27] But an arbitration clause is not a cure-all for defects in the instrument, nor should it be looked on as providing the solution to all disputes between the partners. Courts with some frequency have refused to order arbitration of disputes even under broadly worded clauses, and have instead decided disputes themselves where the intent of the agreement seemed clear.[28]

INCOME

Sharing of Profits and Losses

From an economic point of view, the rules of law governing profits, salaries and interest may be considered sound where the partners contribute equally to the venture. It is fundamental that without contrary agreement the partners share equally in profits and losses,[29] but are not entitled either to interest on capital contributions[30] or to salaries for their services except when rendered in winding up firm affairs.[31]

Thus, in a service partnership, if the abilities and experience of the partners are substantially the same, equal apportionment of the firm's earnings is equitable. The same is true in a capital partnership if the partners contribute similar amounts of capital and expect to devote their full time to the business.

But to the extent that contributions are disparate, different rules may be needed. The senior partner in a professional firm, because his work is experienced and his reputation established, will demand more of the earnings than his associates. Contributions to a manufacturing enterprise may vary widely in terms of plant, good will and time.

By fixing the percentages in which each partner is to share in the profits, some of these differences may easily be taken into account. For example,

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24a It should be realized that such a provision may operate to require payment of salary even though no profits are earned, thus impairing capital which the majority partner may have contributed.

25 *Cf.* Kurtzon v. Kurtzon, 339 Ill. App. 431, 90 N.E. 2d 245 (1950); UPA § 31; Note, 21 A.L.R. 21, 73 (1922).

26 Worcester, *supra* note 3, at 985.

27 *Id.* at 992; see Kagel, *Labor and Commercial Arbitration Under the California Arbitration Statute,* 38 CALIF. L. REV. 799 (1950).

28 Bercu v. Levinson, 270 App. Div. 537, 61 N.Y.S. 2d 116 (1946), *aff'd mem.,* 296 N.Y. 866, 72 N.E. 2d 607 (1947) (claimed right to bring in new partner); *In re* Rosenshine's Estate, 199 Misc. 984, 102 N.Y.S. 2d 3 (1950) (claimed right to purchase decedent partner's interest); Margolies v. Zimmerman, 341 Pa. 493, 19 A. 2d 737 (1941); Young v. Cooper, 30 Tenn. App. 55, 203 S.W. 2d 376 (1947) (claimed right to buy out other partner at fair price).

29 UPA § 18(a).

30 UPA § 18(d); see text at note 48 *infra.*

31 Levy v. Leavitt, 257 N.Y. 461, 178 N.E. 758 (1931) (even where extraordinary services); Duncan v. Bartle, 188 Ore. 451, 216 P. 2d 1005 (1950) (even where other partners abandoned partnership); UPA § 18(f).

if the chief variation in contribution is to be in amounts of capital, the proportion of capital contributed may serve as the proportion in which profits are to be shared.[32]

However, in many situations it may be felt wise to reflect economic contributions by providing for salaries and interest in addition to profit sharing,[33] as for example when one partner is to contribute managerial talent and the other capital.[34]

Loss apportionment will be governed by the arrangement adopted for profit sharing unless there is some other agreement.[35] Only in unusual cases should losses be apportioned differently from profits. Doing so invites claims that losses in one year were the result of mismanagement the preceding year. Such claims would be less likely had previous profits been shared in the same way as current losses. Nevertheless, in a capital partnership where substantial losses can occur in a short period of time, there may be good reason to vary loss sharing from profit sharing. One commentator suggests that losses be borne to a large extent by the capital invested, so that those partners who contribute managerial skill alone will not be threatened with the heavy personal liability more easily borne by other partners.[36]

Determination of net income will ordinarily be based on the fiscal year. Provision should be made in the agreement for adjustment in case profit sharing provisions are changed during the year or a new partner is admitted.[37] The accounting formula to be used may also be set out,[38] but ordinarily it would seem sufficient to leave this up to the firm's accountants under a provision that generally accepted accounting principles are to be followed.

Drawing Accounts and Compensation

Other arrangements may be better adapted to the firm's needs than salary provisions. Since no tax is imposed on the partnership itself, tax factors need not be considered in determining whether firm income should be distributed as salaries.[39]

[32] Where large earnings would make the shares of the senior partners subject to very heavy income taxes, interest at an agreed percent may be set, with the remainder of profits to be allocated equally. MULDER AND VOLZ, *op. cit. supra* note 3, at 68.

Consideration should be given to the possibility that later changes in capital contributions may upset a profit-sharing ratio based on capital balances. See text at note 54 *infra*.

[33] Interest is particularly appropriate in capital partnerships where the contributions of assets are large and subject to great risk. Worcester, *supra* note 3, at 987.

[34] Another possibility is to provide for sharing of profits up to a certain amount in stated percentages, with all other profits to be shared equally. MULDER AND VOLZ, *op. cit. supra* note 3, at 67-68.

[35] UPA § 18(a).

[36] Worcester, *supra* note 3, at 988. In the event that a partner's capital contribution is completely exhausted by losses without full satisfaction of the loss, the agreement should specify how the remainder is to be apportioned among the partners. *Ibid.* Without specific provision, contributions can be required in the profit ratio. UPA § 18(a). But *cf.* Meadows v. Mocquot, 110 Ky. 220, 61 S.W. 28 (1901).

[37] Worcester, *supra* note 3, at 988.

[38] MULDER AND VOLZ, *op. cit. supra* note 3, at 70, where expenses to be deducted from gross receipts are listed.

[39] INT. REV. CODE §§ 181, 187; U.S. Treas. Reg. 111, § 29.183-1(2).

Drawing accounts may be utilized to produce periodic income for the partners' subsistence. An upper limit, set below anticipated profits, should be established. Unanimous consent should be required before the limit may be exceeded, and excessive withdrawal should be charged with interest.[40] Establishment of a drawing account presupposes a net profit. Therefore provision may be made for refunds by the partners, in the profit sharing ratio, where losses are incurred or where annual profits do not equal even the permitted withdrawals, provided the partners in control decide the capital is needed by the business.[41]

A commission arrangement might serve the firm's purpose better than a salary provision if one of the partners is to be in charge of selling.[42] A guarantee may be stipulated if a partner must be assured of a certain level of income. In the latter case, if the partner's share in the profits of one period were less than the amount guaranteed he would receive the latter, but would not be entitled to share in the profits remaining. A salary, on the other hand, would be deducted as an expense so that the partner entitled to it would also share in the net income remaining.[43]

It is apparent that payments intended as salary should be labeled as such to distinguish them from receipts under a guarantee and from sums paid under a drawing account arrangement, both of which are credited against the partner's share in the annual profits.[44]

The salary provision must be correlated with the provision governing the time that must be devoted to the business.[45] If sickness is to excuse performance of this promise, it may also be desirable to reduce or abrogate payment of salary.[46]

CHANGES IN CAPITAL

Changes in capitalization should be anticipated in the agreement. No business can consistently function on a static financial basis; partners may be faced either with the need for additional capital for expansion or with a capital impairment after losses have been sustained.[47] The most obvious

[40] 1 RABKIN AND JOHNSON, *op. cit. supra* note 3, Form 1.25.

[41] Compare the agreement in Blut v. Katz, 14 N.J. Super. 121, 81 A. 2d 406 (1951) (determination of withdrawals based on monthly reports of accountant). Payment of salaries raises the same problem of impairment of capital. Provision should be made for reduction of salaries by the majority in interest if their payment will reduce the capital of the firm below a working level. *Cf.* note 24a *supra.*

[42] 1 RABKIN AND JOHNSON, *op. cit. supra* note 3, Form 1.02.

[43] Worcester, *supra* note 3, at 987.

[44] Boyer v. Bowles, 310 Mass. 134, 37 N.E. 2d 489 (1941) (drawing account). But *cf.* Dugan v. Forster, 104 Cal. App. 117, 285 P. 384 (1930) (provision for drawing account construed to provide for salary).

[45] See text at note 66 *et seq. infra.*

[46] A disabled partner is still entitled to his salary, Quillen v. Titus, 172 Va. 523, 2 S.E. 2d 284 (1939), and the partner who stays on the job will not be entitled to compensation for performing the sick partner's duties unless so agreed. *Ibid.*; Treat v. Ogden, 56 Cal. App. 2d 70, 76, 132 P. 2d 493, 496 (1942). If the disabled partner's salary is abrogated, this will increase the working partner's share of profits.

[47] A partner cannot be required, without so contracting, to furnish money or credit in order to rehabilitate the business following a substantial impairment of the original capital, even though losses may be much greater if capital is not put in than if the business could be kept in operation. Thomson v. Langton, 51 Cal. App. 142, 196 Pac. 103 (1921).

and perhaps the best sources for obtaining increased capital or for restoring capital will be the partners themselves.

Three methods may be considered in solving the problem of obtaining new capital from the partners. First, it may be left to the discretion of each partner himself to determine whether additional contributions will be made by him. This method will be examined at some length. Second, needed capital may be obtained through regulation of the drawing accounts. Third, the controlling partners may be given the power to compel additional contributions.

If the individual partners are to be left to decide whether to make additional contributions, the incentives will probably be determinative. One incentive may be payment of interest, and another may be an additional share in the profits.

Interest, under the UPA, need not be paid on the "capital contributed" by a partner, and it is probably not payable on any additional amounts contributed to the business permanently.[48] Interest is payable on loans and advances which are subject to withdrawal by the lender.[49] This distinction causes no problem if the agreement provides that interest is to be paid on all contributious of capital.[50] However, if interest is not to be paid on such contributions the agreement should provide that loans or interest bearing advances be accounted for separately and that contribution of such amounts be permitted only with the consent of the controlling partners.[51]

The distinction between additional contributions and loans or advances is also important as applied to a partner's share of unwithdrawn profits. As long as this share is left in the business the partner is apparently entitled to receive interest on it.[52] Hence, again, it should be provided that no interest is to be paid on amounts subject to withdrawal except with the consent of the partners having control.[53]

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[48] Section 18(d) provides that interest is payable on capital contributions "only from the date when repayment should be made." *See* Rodgers v. Clement, 162 N.Y. 422, 425, 56 N.E. 901 (1900) (loans distinguished from additional contributions to capital).

[49] Neilsen v. Holmes, 82 Cal. App. 2d 315, 186 P. 2d 197 (1947); Levy v. Leavitt, *supra* note 31; Rodgers v. Clement, *supra* note 48; Kaufman v. Catzen, 108 W. Va. 1, 150 S.E. 371 (1929) (interest allowed on amount one partner had to borrow to compensate for other's failure to contribute agreed amount).

[50] See text at note 33 *supra*.

[51] Without such a provision, a partner may have an unqualified right to advance money for carrying on the business and hence to receive interest thereon. Morrison v. Ultican, *supra* note 21 at 509, 213 P. 2d at 620. A prohibition against borrowing, without more, does not preclude advancement by a partner since it applies only to third parties. *Ibid.*

[52] *Cf.* Boreing v. Wilson, 128 Ky. 570, 108 S.W. 914 (1908); M. & C. Creditors Corp. v. Pratt, 172 Misc. 695, 17 N.Y.S. 2d 240, *aff'd mem.*, 255 App. Div. 838, 7 N.Y.S. 2d 662 (1938), *aff'd mem.*, 281 N.Y. 804, 24 N.E. 2d 482 (1939) (amount of profits left in firm constitutes advance and not contribution to capital, hence is not reduced by losses suffered by firm but is rather a fixed obligation); Paggi v. Quinn, 179 S.W. 2d 789 (Tex. Civ. App. 1944). *But cf.* Houston Bank and Trust Co. v. Landsdowne, 201 S.W. 2d 834, 838 (Tex. Civ. App. 1947) (contract held to contemplate plowing back profits so that no interest due).

[53] Each partner's interest should be subdivided into a capital account and a drawing account, with capital contributions credited to the former and profits and losses to the latter. Loans or additional capital contributions should be listed separately under a notes payable or similar account. MULDER AND VOLZ, *op. cit. supra* note 3, at 105. Payment of interest, profit sharing and control may hinge on clear separation of loans from capital contributions.

Profit sharing, as well as payment of interest, may be made an incentive to capital contributions by gearing it to the amounts of the partners' capital balances as augmented by subsequent contributions.[54] As in the case of interest, the status of accumulated profits should be defined.

The amounts of the capital balances may vary from time to time as a result of additional contributions. Therefore some method must be fixed for measuring the amounts of these contributions within a fiscal period in order to provide a base from which interest can be computed, or from which the ratio of capital balances can be determined for purposes of profit sharing.

Several methods for setting such a base may be employed. A weighted-average base measures the contribution according to the time it has been left in the business; to prevent varying interpretations it may be well to insert illustrative examples in the provision. An easier base to compute is that of the credit balances in the capital accounts at the beginning of the year. It should be specified whether the date referred to is the beginning of the fiscal year or the calendar year, or is the anniversary date of the partnership, if these dates vary. In the case of interest, the time at which the amount earned the preceding year is payable should be indicated.

A second method of control over the firm's capitalization is regulation of the drawing accounts. For a young or expanding business, a low ceiling may be placed on withdrawals of anticipated profits, actual profits being plowed back into the business in an amount which the partners in control periodically decide to be necessary.[55] In an established business, the drawing account may serve the purpose of preventing impairment of capital by limiting the profits subject to withdrawal to a percentage of the earnings of the previous year. This is especially desirable where the business is a speculative one.[56]

A third and more drastic way of obtaining needed capital is to give partners with a controlling interest both the power to issue calls for capital and the power to impose sanctions on those partners failing to respond. This device furnishes a means for discrimination against a partner who is caught financially unprepared. It should only be used where each partner subject to call is of substantial means and even then should be safeguarded from abuse by carefully drawn notice conditions and by absolute limits on the amount which can be demanded by the controlling partners during a given period.[57] Where appropriate, greater safety may be obtained by limiting the

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[54] Consider also that control may be hinged on the relative proportions of the capital balances. Text at note 21 *supra*.

[55] Such decision will control even in the absence of agreement. Wolcheck v. Wecher, 66 N.Y.S. 2d 384 (Sup. Ct. 1946), *aff'd mem.*, 272 App. Div. 912, 72 N.Y.S. 2d 273 (1947).

[56] MULDER AND VOLZ, *op. cit. supra* note 3, at 69 (form); *cf.* the agreement in Walsh v. Atlantic Research Associates, Inc., 321 Mass. 57, 71 N.E. 2d 580 (1947) (dollar limit on weekly withdrawals, further withdrawals permitted at end of quarter up to stated percentage).

[57] In Neustadter v. United Exposition Service Co., 14 N.J. Super. 484, 82 A. 2d 476, 477 (1951), the managing partners unsuccessfully attempted to utilize a short notice period in order to deprive a partner of his interest. The call provision is of interest because of its elaborate detailing of the sanction for failure to meet a call. At the option of the majority the interest of the partner not responding was to be reduced proportionately, or he could be bought out and his share offered to the others; furthermore, refusal to take a call eliminated any opportunity to buy the interest of others who might themselves later so refuse.

amount of contribution required to sums necessary for payment of the firm's expenses when receipts are inadequate for that purpose.[58]

Capitalization should also be protected against excessive withdrawals by the partners, either by conditioning such withdrawals on the consent of the controlling partners or by requiring the payment of interest on the amount withdrawn. In the absence of agreement, interest must be paid on excessive withdrawals.[59] The interest rate applied will be the same as that specified for loans or advances.[60]

DUTY TO WORK FOR THE FIRM

Because he is a fiduciary, a partner will be held accountable for profits made in competition with the business.[61] Yet, when litigation develops it is not always easy to determine what the partners intended as the scope of the business.[62] Partners in a real estate business may have intended to retain some freedom to deal on their own account.[63] Wildcatters interested in oil lands may have had only the development of specific leases in mind.[64] Failure to delineate the scope of the partnership in the purposes clause invites later quarrels.[65]

A closely allied problem is that of the amount of time to be spent by each partner on firm business. If outside interests of one or more of the partners are to be permitted, the agreement should so provide; if not, the promise to devote full time to the business should be phrased so that engaging in any other business is prohibited.[66]

In order for the firm to recover for breach of a covenant to devote time to the business, damages must be shown.[67] Consequently, where the part-

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58 See 1 RABKIN AND JOHNSON, *op. cit. supra* note 3, Form 1.27.

59 Shulkin v. Shulkin, 301 Mass. 184, 16 N.E. 2d 644, 118 A.L.R. 629 (1938); Kaufman v. Catzen, *supra* note 49. The contrary California cases seem in the minority: Forsyth v. Butler, 152 Cal. 396, 93 Pac. 90 (1907); Costa v. Maggio, 65 Cal. App. 2d 456, 150 P. 2d 905 (1944) *semble.*

60 Boreing v. Wilson, *supra* note 52.

61 Holmes v. Darling, 213 Mass. 303, 100 N.E. 611 (1913); UPA § 21. The wrongdoer is required to account to the firm for his profits, but as a member of the firm is still entitled to his share of such profits. *Cf.* Sbulkin v. Shulkin, *supra* note 59. Only where the firm is unable to undertake the business itself, and after full disclosure, is competition permitted. Shrader v. Downing, 79 Wash. 476, 140 Pac. 558 (1914) (partner developed land, paid partnership commission for selling it, was allowed to keep profits from sale).

62 See Neilsen v. Holmes, *supra* note 49 (firm engaged in buying up reservoir lands to sell to government; partner held entitled to buy similar lands on own account).

63 See Martin v. Stout, 151 Iowa 716, 130 N.W. 718 (1911) (agreement permitted each partner to deal in "own" lands); Shrader v. Downing, *supra* note 61.

64 Meyer v. Sharp, 341 Ill. App. 431, 94 N.E. 2d 510 (1950) (partner struck oil bonanza on non-contiguous lands which were held to be individual property in view of agreement limiting firm's undertakings to those mutually approved); More v. Burroughs, 111 Kans. 28, 205 Pac. 1029 (1922) *semble.*

65 See Holmes v. Keets, 153 F. 2d 132 (D.C. Cir. 1946), where a statement in the agreement that the purpose of the partnership was to operate a specific hotel was held to permit one partner to continue to run a competing hotel. But what decision would have been reached had the competition begun after the partnership was formed? The extent of permissible competition should also be described if an implied approval of all other competition is to be prevented.

66 See the agreement in Lynch v. Bailey, *infra* note 98.

67 Metcalfe v. Bradshaw, 145 Ill. 124, 33 N.E. 1116 (1893) (no damages shown); Riley v. Riley, 150 Neb. 176, 33 N.W. 2d 525 (1948) (same). Breach of a promise to devote full time

ners expect to perform definite duties, the intended division of labor should be outlined. When absence is prolonged, damages can generally be proved and the breach will render the wrongdoer liable to the firm for the reasonable value of his services,[68] the cost of hiring another to perform his work,[69] or, if there is provision for salaries, for the amount of the salary.[70] In effect, this means that the wrongdoer is charged only half of this amount in a two-man venture, since half of the firm's recovery is his.[71]

Consideration should also be given to circumstances which will relieve the obligation to attend to firm affairs. Is sickness to excuse performance?[72] If the partner's services must be performed by someone, it may be fair to provide that he be charged for the cost of employing a substitute.

One type of case deserves specific mention with respect to the duty to work for the firm. Where patents are developed by a partner as a result of his experience in the business, some courts have held that such patents were not partnership property, even though they pertained directly to the business being carried on and were developed on firm time with the use of firm labor by a partner who had covenanted to give his whole time to firm business.[73] The lesson is clear for the attorney drafting articles for a capital partnership in which inventions may possibly result.

RETIREMENT OR DEATH OF A PARTNER

Continuation of the business after the death or retirement of a partner is usually desirable, if for no other reason than to maintain the value of the investment in assets or good will. "Dissolution" of the partnership is caused when a partner ceases to be associated with the firm because of death or retirement.[74] But dissolution does not require liquidation of a going concern if the partners agree that the business is to continue.[75]

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and efforts to the partnership does not entitle the firm to the income earned by the wrongdoer in following pursuits outside the scope of the business. Metcalfe v. Bradshaw, *supra*. Compare cases cited note 61 *supra*.

[68] Olivier v. Uleberg, 74 N.D. 453, 23 N.W.2d 39, 165 A.L.R. 974 (1946) (one partner ran whole business; no salary agreement); Degen v. Brooks, 43 N.W.2d 755 (N.D. 1950) (partner required to reimburse partnership for loss during absence of four weeks; no salary agreement; earnings divided by total weeks worked by both partners to produce value per week per partner).

[69] Fithel v. Saltes, 11 S.W.2d 815 (Tex. Civ. App. 1928); Valentin v. Sarrett, 25 Idaho 517, 138 Pac. 834 (1914) *semble*.

[70] Lay v. Emery, 8 N.D. 515, 79 N.W. 1053 (1899) (partner charged one-half of the amount of his salary).

[71] Olivier v. Uleberg, *supra* note 68.

[72] See text at note 45 *supra*; McDowell v. North, 24 Ind. App. 435, 55 N.E. 789 (1899) (sickness excuses performance).

[73] Belcher v. Whittemore, 134 Mass. 330 (1883) (invention of type of implement which firm manufactured); Burr v. De La Vergne, 102 N.Y. 415, 419, 7 N.E. 366, 367 (1886). *But cf.* Zanetti v. Zanetti, 77 Cal. App. 2d 553, 175 P.2d 603 (1947) (evidence that other partner contributed to development); Blood v. Ludlow Carbon Black Co., 150 Pa. 1, 24 Atl. 348 (1892) (same).

[74] UPA §§ 29, 31.

[75] UPA §§ 41, 42; Wood v. Gunther, 89 Cal. App. 2d 718, 201 P.2d 874 (1949). In the absence of such agreement the retiring partner or the decedent partner's representative may demand immediate liquidation, although there is no duty to liquidate if neither insists upon it. M. & C. Creditors Corp. v. Pratt, *supra* note 52. As to rights of a retired partner or a deceased partner's representatives when partnership is continued without consent, see Ruppe v. Utter,

Continuation requires satisfactory disposition of the ex-partner's interest, and this is the outstanding problem in drafting the partnership agreement.[76] Almost always it will be provided that the withdrawn partner's interest be disposed of to the remaining partners.

Disposition of a decedent partner's interest, particularly in the case of a capital partnership, will require substantial and relatively prompt payment to a decedent partner's representatives for the purchase of his interest in the concern. It is widely recognized that life insurance provides the only way this payment can be made without critical impairment of business capital.[77] Insurance funding raises so many complex questions, principally of the tax variety, that it cannot be treated here, but there are excellent discussions of the subject.[78] Extensive information is also available from life insurance companies.

Voluntary Retirement

The right of voluntary retirement should be reserved for each partner, since the partnership relationship is such a close one that it is inadvisable to continue it in the face of dissatisfaction.[79] Sufficient protection can be given all parties if adequate notice of the withdrawal is required and the valuation of the interest of each is settled in advance.[80]

A notice period of several months may be necessary to give remaining partners time in which to accumulate enough to purchase the interest of the retiring partner.[81] On the other hand, relations may be so strained as to make it desirable to terminate immediately the withdrawing partner's power, as an agent of the firm, to bind its other members and to participate in the management.[82] Both these objectives can be achieved by providing that the retirement shall become effective at the end of several months

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76 Cal. App. 19, 243 Pac. 715 (1925); Painter's Ex'rs. v. Painter, 133 Cal. xix, 65 Pac. 135 (1901); Gray v. Andrews, 141 Fla. 47, 192 So. 634 (1939); Note, 2 A.L.R. 2d 1084 (1948). *Cf.* Sechrest v. Sechrest, 248 Wisc. 516, 22 N.W. 2d 594 (1946).

[76] See generally, Currie, *Buy and Sell Agreements with Respect to Corporate and Partnership Interests* (1950) WISC. L. REV. 12, 21-26 (sample agreement); Darling, *Buy and Sell Provisions of Partnership Agreements,* 29 ORE. L. REV. 286 (1950); Fuller, *Partnership Agreements for Continuation of an Enterprise After the Death of a Partner,* 50 YALE L. J. 202 (1940); Note, 63 HARV. L. REV. 1074 (1950); Note, 46 MICH. L. REV. 970 (1948).

[77] Even though the partners are persons of means at the time the partnership is formed, there is no assurance that each of them will enjoy the same status at death.

[78] Fahr, *The Business Purchase Agreement and Life Insurance,* 15 LAW & CONTEMP. PROB. 319 (1950); Forster, *Legal, Tax and Practical Problems Under Partnership Purchase and Sale Agreements Coupled with Life Insurance,* 19 So. CALIF. L. REV. 1 (1945); Matthews, *Estate Tax Consequences of Agreements for the Sale of a Partnership Interest Effective at the Partner's Death—An Appraisal of the Status of the Law,* 26 TEX. L. REV. 729 (1948); 1 RABKIN AND JOHNSON, *op. cit. supra* note 3, Forms 1.49-1.53.

[79] Worcester, *supra* note 3, at 986. A partner can never be compelled to retain that status, but where the partnership is for a fixed term he has no right to a prior dissolution, Meherin v. Meherin, 93 Cal. App. 2d 459, 209 P. 2d 36 (1949), and a premature withdrawal subjects him to damages for breach of contract. Kurtzon v. Kurtzon, *supra* note 25; *see* Lunt v. Van Gorden, 224 Iowa 1323, 1328, 278 N.W. 631, 634-5 (1938).

[80] As to protection of a minority partner, see text at note 24a *supra.*

[81] MULDER AND VOLZ, *op. cit. supra* note 3, at 82. A partner may be permitted to sell his interest in part as well as in whole. See agreement in Hagan v. Dundore, *supra* note 24.

[82] Worcester, *supra* note 3, at 989.

unless, after receipt of the notice, the partners with majority control designate an earlier effective date.

Purchase of the retiring partner's interest should not be obligatory. It may be infeasible to carry on the business at the time of the withdrawal, or there may simply be no funds available.[83] It is always well to preserve for the remaining partners the alternative of winding up the enterprise. In addition, the existence of this right may act as a deterrent to any withdrawal.

Where there are only two partners, it is often provided that one may offer at any time to sell out (at a valuation set either by himself or in the agreement)[84] and that if his offer is not accepted within a period of one or three months he may then buy out the other partner at a similar figure.[85] If he does not choose to do so, and if sale of either's interest to a third party is not feasible,[86] the partnership may be dissolved. The partner not giving first notice may be designated as the liquidator.

Involuntary Withdrawal

The fact that a troublemaker can quickly ruin the relations between the rest of the partners should be anticipated in the agreement by expulsion provisions.[87] The UPA permits bona fide expulsion when that power is conferred by agreement.[88]

The provisions covering disposition on voluntary retirement should be made applicable to cases of expulsion. Not only is it more certain that expulsions made under such circumstances will be upheld,[89] but differentiation between voluntary and involuntary withdrawal will only increase the

[83] Obviously the advantages of life insurance arrangements are not available when a partner is retiring.

[84] On valuation, see text at note 146 *infra.* If either partner is permitted to make the valuation, a partner of greater means might be able to make an offer which is too low but which he knows the other cannot accept. He would thus be able to take advantage of the other's financial situation to obtain the business at a premium. See also text at note 150 *infra.*

[85] See Barnes v. Moore, 80 Cal. App. 2d 39, 180 P. 2d 740 (1947); Ruppe v. Utter, *supra* note 75; Steckroth v. Ferguson, 281 Mich. 279, 274 N.W. 792 (1937). Such an offer has no effect if the offeror dies before the notice period expires. Johnson v. Moreau, 323 Mass. 481, 82 N.E. 2d 803 (1948).

One partner cannot deliberately irritate the other into seeking dissolution and then claim the other's sole remedy is to offer his interest for sale; a first-offer agreement is only permissive and does not exclude application of UPA § 32 which gives a right to dissolution for the other partner's misconduct. Steckroth v. Ferguson, *supra.*

[86] See the agreement in Young v. Cooper, *supra* note 28, that offeror's interest could be offered to outsider if refused by other partners, but not at a lower price than offered to them. See also UPA § 27 (right of outsider who buys partner's interest).

[87] See McPherson v. J. E. Sirrine & Co., 206 S.C. 183, 33 S.E. 2d 501 (1944) (partner expelled for fomenting dissention).

[88] § 31(d).

[89] Gill v. Mallory, 274 App. Div. 84, 80 N.Y.S. 2d 155 (1948). Partners were expelled under a contract which required only the determination of a majority in interest that their association was not in the best interests of the firm and which provided that expulsion would have the same effect as voluntary retirement, *viz.*, payment of fair market value of partner's interest. In answer to plaintiffs' argument that the decision of the majority was selfish and not taken in good faith, the court held that the contract was not intended to make such an issue litigable. To similar effect see Smart v. Hernandez, 95 N.H. 492, 66 A. 2d 643 (1949). *Cf.* McPherson v. J. E. Sirrine & Co., *supra* note 87, where the court upheld expulsion under the contract but queried whether the expelled partner might not sue others individually for wrongful ouster,

likelihood of a lawsuit challenging the expulsion.[90] To minimize dispute further, sole power should be given the other partners to determine the existence of grounds for expulsion; if cause is not required by the terms of the agreement,[91] a high vote should be required.[92] The expelled partner's actual authority to act for the partnership should be made to end upon his receipt of the notice of expulsion; his power to bind the firm may in any case be terminated by publication of notice.[93]

Compulsory retirement may also be warranted upon the disability of a partner.[94] The usual agreement provides for continued profit sharing for a certain period of time, and then for an optional or compulsory purchase of the disabled partner's interest as on death or retirement.[95] The agreement should also consider the effect of death during the preliminary period of disability.[96]

Covenants Restricting Competition

The existence in the agreement of a covenant restricting competition by a partner on withdrawal may serve two purposes. It will afford more protection than equitable rules developed by the courts.[97] It may also serve to dissuade a partner from withdrawal, by making it impossible for him to do the work he knows best where he is living.[98]

The validity of restrictive covenants depends on whether they are reasonably limited in time and area.[99] In California they are expressly lim-

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[90] See the prolonged litigation, which finally ended in a suit for damages for the forced withdrawal, in Lynch v. Bailey, 275 App. Div. 527, 90 N.Y.S. 2d 359, *aff'd mem.*, 300 N.Y. 615, 90 N.E. 2d 484 (1949), 198 Misc. 685, 935, 99 N.Y.S. 2d 585, 100 N.Y.S. 2d 985 (1950) (suit dismissed). See also McPherson v. J. E. Sirrine & Co., *supra* note 87.

[91] Causes often listed as grounds are inactivity, neglect of business, immorality, professional misconduct, breach of the articles, and conflicting outside interest. MULDER AND VOLZ, *op. cit. supra* note 3, at 84.

[92] See Worcester, *supra* note 3, at 989. But a voting majority is enough. Gill v. Mallory, *supra* note 89.

[93] UPA § 35(1)(b)II; CAL. CORP. CODE § 15035(1)(b)II.

[94] A provision for compulsory retirement at a certain age will be of use chiefly in large partnerships where uniformity of treatment is desired. MULDER AND VOLZ, *op. cit. supra* note 3, at 83.

[95] See Miller v. Heyes, 17 Wash. 2d 467, 136 P. 2d 157 (1943) (partner's interest shifted to other partner without further payment after year's disability); 1 RABKIN AND JOHNSON, *op. cit. supra* note 3, Forms 1.23, 1.24.

[96] See Miller v. Heyes, *supra* note 95 (right to profit sharing held ended by death); W. Frank Carter, 36 B.T.A. 60 (1937) (provision continuing profit-sharing to end of year).

[97] See, *e.g.*, Goldstein v. Maisel, 64 N.Y.S. 2d 461, 463 (Sup. Ct. 1946), *modified and aff'd.*, 271 App. Div. 971, 67 N.Y.S. 2d 410 (1947) (former partner restrained from soliciting customers of business); *cf.* Continental Car-Na-Var Corporation v. Moseley, 24 Cal. 2d 104, 148 P. 2d 9 (1944) (use of "trade lists" and "trade secrets" not restrained); George v. Burdusis, 21 Cal. 2d 153, 130 P. 2d 399 (1942) (ex-partner who reserved right to solicit customers held not entitled to employ former employee of partnership for same purpose); Stone v. Lerner, 118 Colo. 455, 195 P. 2d 964, 4 A.L.R. 97 (1948) (protection denied where ex-partner purchased fee title to property leased by partnership and served notice to vacate).

[98] This purpose was carried too far in Lynch v. Bailey, 275 App. Div. 527, 90 N.Y.S. 2d 359 (1949), *aff'd mem.*, 300 N.Y. 615, 90 N.E. 2d 484, Comment, 14 ALBANY L. J. 62 (1950), where, had it been enforced, a covenant not to compete for four years within a radius of 100 miles from the principal offices of the firm would have excluded the retired partner of a national accounting firm from 20 major commercial centers.

[99] Haggin v. Derby, 209 Iowa 939, 229 N.W. 257 (1930) (limited to period of other partner's operation of business; town and adjacent territory); Keen v. Ross, 186 Ky. 256, 216 S.W.

ited to "the same city or town or a specified part thereof, where the partnership business has been transacted."[100] This language will lead the careful draftsman to list all cities in which business is carried on.

A covenant against competition should not be incorporated into the agreement unless the evaluation of the retiring partner's interest includes an amount reflecting the value of the good will, of the right of the survivors to use the firm name, or of the enterprise as a going concern.[101]

Tax Consequences of Dispositions on Death or Retirement

Disposition of the retired or deceased partner's interest may take either the form of an outright sale of the partner's interest or an arrangement by which the ex-partner or his representative continues to share in profits. Very different tax rules are applied to the two forms.[102]

Capital Partnerships. In the case of a capital partnership, business convenience and tax considerations both make a purchase agreement the only feasible alternative.

From the standpoint of the business, the withdrawing partner's capital balance will often be so large that profit sharing would have to continue for too long before payments were equivalent to full compensation for the amount of the ex-partner's interest. Furthermore, profits might not be sufficiently uniform to make a profit sharing arrangement fair.

Taxwise, a retiring partner benefits from a purchase agreement. His interest will be considered a capital asset so that he will realize only capital gain on the transaction.[103] The basis of the interests held by the remaining partners will be increased as a result of their additional capital expenditure.[104] The estate of a deceased partner will realize no gain or loss on the transaction under the rules permitting stepped-up basis on death.[105]

Service Partnership. Where a service partnership is involved, the income tax consequences of choosing a purchase arrangement as against a profit

605 (1919) (perpetual restriction, one town); Goldstein v. Maisel, *supra* note 97 (20 years, New York City); Beam v. Rutledge, 217 N.C. 670, 9 S.E. 2d 476 (1940) (5 years, 100 miles); RESTATEMENT, CONTRACTS § 516(d) (1932). The covenant should prohibit indirect competition as well. See Gable v. Carpenter, 136 Neb. 669, 287 N.W. 70 (1939) (covenantor's employees enjoined); Note, 93 A.L.R. 121 (1934) (employment by competitors).

[100] CAL. BUS. & PROF. CODE § 16602. *Compare* § 16601 (seller of good will of business may be restricted in competition to "specified county *or counties,* city *or cities*") (emphasis added). See Edwards v. Mullin, 220 Cal. 379, 30 P. 2d 997 (1934) (covenant encompassing more than half of state enforced as to single city and county where business carried on, under former statute similar to § 16601).

[101] The absence of any quid pro quo was cited to support non-enforcement in Marshall v. Irby, 203 Ark. 795, 158 S.W. 2d 693 (1942), and Lynch v. Bailey, *supra* note 98. *Compare* Proctor v. Hansel, 205 Iowa 542, 218 N.W. 255, 58 A.L.R. 153 (1928); Shaleen v. Stratte, 188 Minn. 219, 246 N.W. 744 (1933).

[102] See LITTLE, *op. cit. supra* note 3, cc. 10-11 (1952); Forster, *Tax Problems Resulting from the Death of a Partner,* 2 U.S.C. TAX INST. 103 (1950); Jackson, *Partnership Distributions, id.* at 65, 89.

[103] G.C.M. 26379, 1950-1 CUM. BULL. 58; LITTLE, *op. cit. supra* note 3, at 229-30, 256. The holding period on such interest commences from the formation of the partnership. Commissioner v. Lehman, 165 F. 2d 383 (2d Cir.), *cert. denied,* 334 U.S. 819 (1948).

[104] LITTLE, *op. cit. supra* note 3, §§ 11.5-11.7.

[105] INT. REV. CODE § 113(a)(5).

sharing arrangement are not clear. The major question relates to the nature of the ex-partner's interest. Since the capital investment in a service partnership ordinarily will be negligible, the ex-partner's principle claim will be to uncollected fees and to fees to be realized from work in progress. The courts have balked at holding that such an interest is a capital asset,[106] despite judicial recognition that upon sale a partnership interest is usually to be treated as a capital asset.[107] They have been reluctant to permit such easy conversion of ordinary income into capital gain.

Nevertheless, the seventh circuit, in a recent case, has squarely held a partnership interest consisting largely of uncollected fees to be a capital asset which entitled the ex-partner to treat his income from the sale as capital gain.[108] This holding extends recognition of the entity theory to the service partnership. The entity theory, which distinguishes between the partnership and the men who compose it, has already gained general acceptance where interests in capital partnerships are involved.

Under the new rule, the remaining partners should receive an increased basis on their interests as a result of their expenditure. However, it is not certain that they would be able to argue successfully that the purchased portion of the uncollected fees would, upon collection, consist of a return of capital and hence not be subject to tax as ordinary income.[109] Contentions that the interest in a service partnership is a capital asset almost certainly will be opposed by the Commissioner and hence may have to be litigated successfully in order to be sustained.[110]

If capital asset treatment is denied, the fact that the agreement is cast in the form of purchase and sale will produce different income tax consequences than if provision were made for continued profit sharing. The retiring partner or the deceased partner's estate will be required to treat as

[106] Helvering v. Smith, 90 F. 2d 590 (2d Cir. 1937); James Wesley McAfee, 9 T.C. 720 (1947); Louis Karsch, 8 T.C. 1327 (1947).

[107] See note 103 *supra*.

[108] Swiren v. Commissioner, 183 F. 2d 656 (7th Cir. 1950), *cert. denied*, 340 U.S. 912 (1951), Comment, 3 STANFORD L. REV. 357 (1951) (law partnership).

[109] LITTLE, *op. cit. supra* note 3, at 259-261; *cf.* text at note 113 *infra*. An even more difficult question would be raised in the case of a decedent partner's interest. Its treatment as a capital asset would seemingly render the estate immune from tax under the stepped-up basis provisions, and the survivors who purchased the interest would be in a position to argue that actual collection of the fees underlying the purchased interest would constitute return of capital. If both of these results were held to follow, any tax on such income could be avoided. INT. REV. CODE § 126 was designed to prevent this result in similar cases by making income taxable to the estate if it would have been ordinary income to the decedent. The regulations under this section treat payments made in purchase of an interest in earned but uncollected fees as coming within the section. U.S. Treas. Reg. 111, § 29.126-1, Example. As to payments attributable to an interest in "tangible assets" the regulations recognize that no gain would result, *i.e.*, Section 113(a)(5) would be applieable. *Ibid.* Were the courts to hold an interest in a service partnership to be a capital asset, it is arguable that Section 126 would not apply to payments received from the purchase thereof; on the other hand, no glaring inconsistency with the entity theory would result if the section were applied, and this result would seem likely in order to prevent complete avoidance of tax. All these difficulties may conceivably lead other courts to reject the new rule.

[110] G.C.M. 26379, 1950-1 CUM. BULL. 58, 59, warns that "payments made to a retiring partner which represent his distributive share of earnings for past service should be treated as ordinary income rather than the proceeds derived from a sale of his interest. (See Helvering v. Smith, 90 F. 2d 590 (2d Cir. 1937).)"

ordinary income the amount received in exchange for the right to earned but uncollected fees.[111] On the other hand, no deduction will be permitted the remaining partners for payments made in purchase of this interest.[112] As subsequent fees are collected, they will constitute income to the survivors. Only if the survivors can prove that income is due to the fees in which the ex-partner had claims will they be permitted to count such income as a return of the capital with which such claims were purchased.[113]

By means of an agreement for continued profit sharing these consequences may be avoided. Payments to the retired partner or deceased partner's estate will then be taxed as ordinary income, just as under a sale arrangement. However, the surviving partners will not be taxed on any more than their share in the profits.[114]

The estate tax will have little effect on the choice between sale or continued profit sharing. Whether payments to the estate are received under a profit sharing arrangement or under a purchase agreement, their present value is includible in the gross estate.[115]

Purchase Agreement

If a purchase agreement is to be used the details of such a plan remain to be worked out. These include: (1) an agreement that continuation of the business shall not be affected by death or retirement; (2) a procedure for purchase of the withdrawing partner's interest; (3) a valuation procedure; (4) an agreement that the ex-partner's rights as a partner or those of his estate will end with the purchase by the remaining partners; (5) provision for the time and manner of payment; and (6) protective conditions effective in the event of default.

Fairness requires that purchase of the deceased or withdrawing partner's interest be left optional with the remaining partners, and that the alternative of winding up the business be preserved.[116] While exercise of the option may be expected, factors may arise which make this unwise. The withdrawal may leave such a hole in the business as to make it exceedingly difficult to carry on, or the business may have become unprofitable, or there may not be sufficient assets with which to purchase at the agreed valuation.[117] After a specified time for deliberation, the survivors should be re-

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111 Helvering v. Smith, *supra* note 106 (retired partner); Bull v. United States, 295 U.S. 247 (1935) (estate).

112 W. Frank Carter, *supra* note 96.

113 Raymond S. Wilkins, 7 T.C. 519, 524 (1946), *aff'd.*, 161 F.2d 830 (1st Cir. 1947); LITTLE, *op. cit. supra* note 3, § 11.8; 1 RABKIN AND JOHNSON, *op. cit. supra* note 3, Form 1.03.

114 Charles F. Coates, 7 T.C. 125 (1946) (estate).

115 McClennen v. Commissioner, 131 F.2d 165 (1st Cir. 1942). When such payments are also taxable income to the estate under Section 126 (see note 109 *supra*), the additional estate tax required by the inclusion of the value of the right may be deducted from the amount includible as gross income. INT. REV. CODE § 126(c).

116 The option should provide that the purchase shall be made by the remaining partners according to some appropriate measure, such as their interest in the profits. Mulder and Volz, *supra* note 3, at 108-9.

117 *Id.* at 87. If insurance is relied on for funding the price of the decedent's interest, an agreement to buy as well as an agreement to sell will generally be advisable because of the certain availability of funds. Fahr, *supra* note 78.

quired to give notice of their choice to the ex-partner or his representative.[118]

Payment may be made by installments in order to ease the drain on the partnership assets.[119] The period over which payment is to extend will naturally depend on the size of the business and the liquidity of its assets.[120]

Once the option to purchase is exercised, the seller's interest in the partnership should cease.[121] However, the estate or retiring partner must be protected in case of default.[122] It is generally provided that the liability for the purchase price will be evidenced by an interest-bearing promissory note, endorsed by the remaining partners and perhaps secured by property equal to the value of the note.[123] Caution requires that the retiring partner or deceased partner's representative specifically be given the right to an account and the right to inspect the partnership books during the payment period.[124] Default should accelerate the debt,[125] and continuing default should entitle the seller to liquidation.[126]

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118 In Emerson v. Campbell, 84 A. 2d 148 (Del. Ch. 1951), an option given the "remaining partner" in a two-man partnership was nullified as in violation of the rule against perpetuities; the option was said to be unlimited in time, although the life of the survivor would seem to furnish an obvious yardstick.

119 This method should be provided for even where the partners are personally wealthy at the time of agreement, since it is always possible that reverses will be suffered. If insurance is used, a different arrangement will be necessary in the case of purchase on death.

120 Since the estate tax must ordinarily be paid within fifteen months, INT. REV. CODE § 822(a), it will naturally be to the interest of an estate to have the bulk of the payment made within that time.

121 Exercise may be indicated by notice, or preferably, by delivery of a note representing the debt.

122 In Wiltse v. Schaeffer, 327 Mich. 272, 42 N.W. 2d 91 (1950), the deceased's representatives, on the default of the partnership, were to have under the purchase agreement all the remedies incident to the winding up of the partnership under law. *Held,* this language gave no right to a lien on the property in the case of default. UPA § 42 provides generally that when the business is continued after death or retirement without a settlement of accounts and in the absence of other agreement, the partner or his representative becomes an ordinary creditor entitled to be paid either the value of his interest, with interest, or the profits attributable to the use of his property.

123 The debt arising from the purchase, whether secured or not, is always inferior to the claims of the creditors of the former partnership. UPA § 41(8).

124 This right is seemingly given by UPA § 43, if there is no contrary agreement; see also CAL. PROB. CODE § 571 (surviving partner must account to executor or administrator). *Contra:* Hermes v. Compton, 260 App. Div. 507, 23 N.Y.S. 2d 126 (1940), holding that since such right was available only on "dissolution" under the terms of the UPA section, it could not be invoked where the partnership was continued by the surviving partners. The court seems to confuse a "dissolution", which occurs whenever a partner leaves the partnership (§ 29 and Commissioner's note thereto), with a winding up of the business. *Cf.* O'Brien v. O'Brien, 294 Ky. 793, 817, 172 S.W. 2d 595, 607 (1943), *cert. denied,* 321 U.S. 767 (1944) (survivors have duty to disclose profits for current year to deceased partner's representatives).

125 The remaining partners should, on the other hand, be enabled to pay their debt in advance.

126 Some forms also provide for appointment of a receiver. UPA § 37 provides for winding up by the court only "upon cause shown," so that it would seem that a receivership would not be available at the option of the parties. Section 37 does, however, permit designation of the party who winds up the business. It would seem this appointive authority could be given the representative of the deceased partner, or his appointee in turn, in case of default. Such authority might be important if it were thought the business could be managed efficiently enough by others to enable payment in full of the obligation to the retiring partner of the deceased partner's representatives. Perhaps even a right to repurchase the ex-partner's interest should be provided for.

Continued Profit Sharing[127]

In professional and other service partnerships, continued profit sharing on the part of the deceased's estate for a specified period after death may be preferable to immediate purchase of decedent's rights by the remaining partners. Besides the tax advantages in such an arrangement, several other purposes are thereby served.

The main purpose will be to permit the estate to share in the income due in part to work unfinished or not paid for at the time of death. This purpose may be achieved by providing that part of all fees received after the partner's death shall be allocated between the estate and the survivors, the estate's share to be determined by the extent to which decedent's efforts were responsible for the fee. A cut-off period of from three to five years may be provided.[128] In addition, any unwithdrawn profits credited to the decedent's capital account should be paid. Finally, the decedent's interest in the assets, as shown on his capital account, should be paid. Since this interest will probably be minor, the book value would seem to afford a fair measure.[129]

A profit sharing arrangement may in addition reflect the fact that the partner built a clientele for the partnership, or may reflect a decision that the decedent's family should be protected on death.[130] If this is the purpose, it may be provided that the estate is to continue to share in a reduced proportion of the profits for a definite length of time. Any balance in the decedent's capital account resulting from accumulated profits or representing an interest in the assets of the business should be paid. To the extent this payment represents the value of the decedent's interest in the assets, it will amount to a purchase of the interest,[131] but such capital balances will be comparatively small in the ordinary professional partnership.[132]

The extent to which the estate will participate in the continued enterprise must be considered in relation to every section of the partnership agreement. Liability for partnership debts incurred after death may be

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127 In this section, "decedent" and "estate" refer also to the retiring partner. No consideration is given to local rules respecting the power of an estate to continue as a partner; see CAL. PROB. CODE §§ 571, 572.

128 Worcester, *supra* note 3, at 989.

129 The purchase method might be adopted by payment of a liquidated amount in purchase of the ex-partner's claim to future fees after withdrawal. The figure chosen may be, for example, 50% of the profits which would have been received had the ex-partner continued, or an amount equal to his actual share for the last full preceding fiscal year. Worcester, *supra* note 3, at 989. See also Raymond S. Wilkins, *supra* note 113 (one-fourth of amount of profits during two years before death divided by percentage in which ex-partner shared in profits); Pailthorpe v. Tallman, 87 N.Y.S. 2d 822 (Sup. Ct.), *aff'd mem.*, 276 App. Div. 823, 93 N.Y.S. 2d 712 (1949) (one-half of asset value plus cost of work in progress representing normal profit eventually earned for completed part of work). To this will be added, of course, the amount of the ex-partner's capital balance and any share he may have in the assets. However, the tax consequences which follow purchase agreements are probably less favorable than would follow an arrangement for continued profit sharing. See text following note 110 *supra*; LITTLE, *op. cit. supra* note 3, at 231-2.

130 MULDER AND VOLZ, *supra* note 3, at 92.

131 See LITTLE, *op. cit. supra* note 3, at 233-4.

132 For the form of such an agreement, see 1 RABKIN AND JOHNSON, *op. cit. supra* note 3, Form 1.04.

fairly limited to the capital left by the estate in the partnership, as long as there is to be no control over the conduct of the business.[133] Participation may even be limited to sharing in the profits but not in the losses, as in the case where the share in profits is reduced from what the decedent himself enjoyed.[134] Drawing account provisions must be reexamined, a time for withdrawals specified, exceptions made to any agreement to contribute additional capital, and so forth.[135]

Since there is always the chance that the partnership will be liquidated before the period in which profit sharing by the estate has expired, the agreement must settle the estate's rights in such a contingency. For example, the estate's interest may be closed out upon payment of its share of remaining profits and capital investment, with such payment to be made before any distributions to the other partners.[136]

The agreement should make it clear whether the period during which the estate is entitled to profits is to have the effect of making the partnership one for a fixed term. If it does have that effect, the surviving partners may be liable in damages for termination of the partnership before that time.[137]

In contrast to the purchase agreement, where the major administrative difficulty will be setting a value on the deceased partner's interest which then becomes a liquidated amount,[138] extensive supervision of partnership affairs may be required when the estate continues to share profits. In the first place, each determination of annual profit will have to be considered by the decedent's representative.[139] Furthermore, a liquidation may at any time require a reappraisal of the estate's rights. For these reasons the use of an independent trustee to administer the estate's interest should be considered.[140] Such a trustee may be given broad powers entitling him not only to receive the financial statements of the firm and to examine its books, but perhaps even to obtain a liquidation if not satisfied in his own judgment that the letter and spirit of the contract is being performed.[141]

In special circumstances the partners, or one of them, may wish to provide that on death a personal representative or other specifically designated person shall succeed to the decedent's interest and become a partner in the firm.[142] These agreements seem rare. Partners have such wide powers to

[133] In the absence of agreement, the individual property of the partner held by the estate will be liable for partnership debts. UPA § 40(g). A limitation on this liability to the interest held by the estate is valid. UPA § 40; Fuller, *supra* note 76, at 210-213.

[134] See the agreement to this effect in Charles F. Coates, *supra* note 114.

[135] See *ibid.*; 1 RABKIN AND JOHNSON, *op. cit. supra* note 3, comment to Form 1.04.

[136] See *supra* note 135.

[137] UPA § 31(1)(b). It would seem that such damages would be measured according to the provision for the estate's share on the contingency of liquidation, if there is one.

[138] Valuation is discussed in the following section.

[139] See *e.g.*, Hermes v. Compton, *supra* note 124, where decedent's representative alleged that excessive salaries to the surviving partners were reducing the estate's profits.

[140] See Darling, *supra* note 76, at 297-299.

[141] See Charles F. Coates, *supra* note 114. There is a conflict of authority over the right of the estate to withdraw its interest where the business is continued by the survivor under the agreement. Fuller, *supra* note 76, at 207-208.

[142] The problem raised by this situation is to be distinguished from that where one of the surviving partners is also appointed as an executor by the decedent partner, as in Keyes v. Hurlbert, 43 Cal. App. 2d 497, 111 P. 2d 447 (1941).

bind each other and must work in such close association that few would appear willing to run a business with someone not known well. If dissention arises, failure of the surviving partners to carry out the agreement may subject them to damages; failure of the decedent's nominee to comply may subject the estate to damages.[143] If the person named as succeeding partner is the executor of the estate he may often be unwilling to take the responsibility of running the business.[144] Because of their seemingly limited use, such agreements are not discussed further here.[145]

Valuation

Valuation of the retiring or deceased partner's interest is of paramount importance where a purchase agreement is employed. The major choices in valuation open in the case of an ordinary service partnership have already been discussed.[146] However, there is warrant for more extended treatment of the frustrating problems of valuation which arise where an interest in a capital partnership is involved.

The time-honored solution has been to rely on book value as the measure of the value of the interest to be sold. Whatever may be the justification for such valuation from the standpoint of sound accounting practice, it is obvious that very frequently the retired partner or the deceased partner's representative will see assets shift out of his hands that are worth a good deal more than the value at which they are carried on the books. Any permanently fixed value is likely to cause unfairness[147] and to be the subject of dispute as a consequence.[148]

As already mentioned, some agreements provide that a partner may at any time offer his interest for sale to the other partner, either at his own price or an appraised price, and that in the event of a refusal he shall have the option of buying the other partner out at the same price.[149] Such agreements present a partial way around the valuation problem, although they do not avoid it in the case of death. Chances for abuse exist if liquidation is left as the only alternative in the event this procedure does not result in a sale. The offeror may make an unreasonably high offer and back it by the threat of liquidation if it is not accepted.[150]

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143 Note, 46 MICH. L. REV. 970, 972 (1948).

144 See Estate of Friedman, 251 Wis. 180, 28 N.W. 2d 261 (1947), 46 MICH. L. REV. 970 (1948), one of the few cases arising recently where the executor was appointed as a partner. Shortly after his appointment, he obtained permission from the court to sell the decedent's interest, and suit was brought thereupon by a legatee. *Held,* the sale was valid.

145 They are treated extensively in Fuller, *supra* note 76, at 205-206, 208-210, 215-216. See also Note, 46 MICH. L. REV. 970 (1948).

146 See text at note 128 *supra*. See also note 172 *infra*.

147 See Hagan v. Dundore, *supra* note 24, where dispute was caused by the fact that the firm's books showed only tax values, *i.e.,* assets had been amortized at 20% a year and depreciation was taken at 10% instead of 2%.

148 Fahr, *supra* note 78, at 325. See, *e.g.,* Epperson v. Rosemond, 100 Cal. App. 2d 344, 223 P. 2d 655, 224 P. 2d 480 (1950) (trial court reversed for awarding sum reflecting appreciation of assets where agreement specified that book value of capital contributions was to be conclusively presumed as their value under the purchase agreement).

149 Text at note 85 *supra*.

150 This draftsman's nightmare became reality in Young v. Cooper, *supra* note 28.

It is often suggested that the agreement provide for re-evaluation at periodic intervals by the partners themselves. Even if this is done, the periodic reappraisal will often be overlooked by the partners so that an alternative, such as appraisal on death, must nevertheless be indicated.[151] In other words, the problem of valuation remains despite such a provision.

The most accurate method of obtaining a current valuation would appear to be valuation by an independent appraiser or arbitrator with experience in the firm's field of business, or by the firm's accountant if he is experienced in such work.[152] The arbitrator may be chosen by agreement of the surviving partners on the one hand and the retired partner or the decedent's representative on the other. Or the survivors may appoint one arbitrator, the estate another and these two the third. A certain firm or individual may be named in the agreement as first choice.[153]

The appraiser should be given some formula by which he is to be guided.[154] For example, if market value is selected as the basis of appraisal, should the existence of a willing purchaser be assumed even though that assumption is unjustified?[155] What treatment is to be given bad debts,[156] contingent items,[157] work in progress,[158] intangibles,[159] items not carried on the books,[160] past, present and prospective earnings,[161] the existing economic situation in the industry, and so forth?[162]

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151 Fahr, *supra* note 78, at 325; Currie, *supra* note 76, at 18-20; Forster, *supra* note 78, at 25. As to estate tax consequences of setting value by appraisal, see text at note 167 *infra*.

152 Because of the tendency of accountants toward conservatism, their valuation may be expected to favor the remaining partners. However, giving the business the benefit of the doubt may accord with what the parties intended at the time of the agreement.

153 Appraisals or valuations do not fall within the scope of the California arbitration statute. Kagel, *supra* note 27, at 813-817.

154 Fahr, *supra* note 78, at 324; Darling, *supra* note 76, at 288 *et seq.*; Worcester, *supra* note 3, at 991. Disputes are likely to follow if no formula is provided. See, for example, Aitchison v. Anderson, 183 F. 2d 922 (9th Cir. 1950) (award based on "book value" omitted valuation for lease, allegedly valued accounts receivable at too high a percentage, and allegedly overvalued inventory by 100%; *held* his award was conclusive on the parties under agreement so providing); Pailthorpe v. Tallman, *supra* note 129 (in absence of other directions auditor used book value which included property as completely depreciated; referee stated this should control); Rohrbacher's Estate, Hormann's Appeal, 168 Pa. 158, 32 Atl. 30 (1895) (purchase price held not to include amount for expenditures in improvements of plant).

155 Darling, *supra* note 76, at 288 *et seq.*

156 See Matter of Eddy, 175 Misc. 1011, 26 N.Y.S. 2d 115 (1941), *aff'd mem.*, 262 App. Div. 1015, 30 N.Y.S. 2d 148 (1941), *aff'd mem.*, 290 N.Y. 677, 49 N.E. 2d 628 (1943), where a receivable of $914,000 became uncollectible after sale; court stated that contract referred to capital value before liabilities taken into account(!)

157 See Durdin v. Barr, 121 S.W. 2d 420 (Tex. Civ. App. 1938) (retired partner claimed share in refund of unconstitutional excise tax). Possible liabilities resulting from renegotiation of government contracts should be considered in this regard.

158 See Hagan v. Dundore, *supra* note 24 (profits on partially completed contracts).

159 See *In re* Randall's Estate, 29 Wash. 2d 447, 188 P. 2d 71 (1947) (purchase agreement covered partner's interest in business, assets and good will; dispute as to valuation of good will, a liquor license and a lease, none of which were entered on the books; *held* these three items were not to be evaluated in fixing purchase price). As to inclusion of insurance policies on partner's lives, see Miller v. Hall, 65 Cal. App. 2d 200, 150 P. 2d 287 (1944); Moorman v. Moorman, 226 Ind. 192, 79 N.E. 2d 112 (1948); Block v. Mylish, 351 Pa. 611, 41 A. 2d 731 (1945); authorities cited note 78 *supra*.

160 See Kaufmann v. Kaufmann, 222 Pa. 58, 70 Atl. 956 (1908) (uninventoried leasehold subsumed under good will by court).

161 See the following section.

162 Darling, *supra* note 76, at 288 *et seq.*, 306-7.

The value determined by the auditors or arbitrators should in any event be made conclusive on the parties, to discourage dispute. Such an agreement will be respected by the courts.[163]

Provision should be made for closing the books on a certain date to determine the respective rights. The books may be specially closed by the firm's accountants; this procedure will involve additional expense but it is usually adopted where there is to be resort to arbitration.[164] If book value is to be used, the date chosen for valuation may be that of the fiscal year just ended or just following retirement or death.[165]

If the valuation set by the parties under a purchase provision is to control for the purposes of the estate tax, it must fulfill two important requirements. First, the decedent must have been required to give a first offer to the firm in the event he wished to sell during his life, with the same valuation controlling. Second, the remaining partners must have an option to purchase the interest at such valuation.[166] Since value is not fixed where reliance is placed on arbitration, there is no certainty that the value accepted by the parties in such a case will equal value for tax purposes.[167]

Good Will and Valuation of Earnings

In addition to the foregoing objections, book value may also be unsatisfactory as the basis for valuation of a business because consideration of the value of the going concern is excluded. The latter objection may be met by including a provision for the valuation of good will or profitability. One way to reflect this is to use as a basis a substantial percentage of the average profits over a period of several years.[168] Capitalization of profits is a related method of evaluation which is generally understood.[169] Profits, of course, are a primary measure of market value or value as a going concern.[170]

Mere provision that good will shall be included in the valuation of a partner's interest is not sufficient to assure that it will be taken into ac-

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163 Cases cited note 154 *supra.*

164 MULDER AND VOLZ, *op. cit. supra* note 3, at 103, 106.

165 This will avoid a warped accounting, especially in the case of a seasonal business. See Gardner v. Smith, 211 Cal. 350, 295 Pac. 36 (1931) (partner withdrew during profitless part of year; court made apportionment based on prior year's profit).

166 *Cf.* Wilson v. Bowers, 57 F. 2d 682 (2d Cir. 1932) (corporation); Claire Giannini Hoffman, 2 T.C. 1160 (1943), *aff'd,* 148 F. 2d 285 (9th Cir.), *cert. denied,* 326 U.S. 730 (1945) (same); U.S. Treas. Reg. 111, § 29.113(a)(5)-1(c); Mathews, *supra* note 78, at 732-4.

167 *Cf.* Hornstein, *supra* note 1, at 1050.

168 MULDER AND VOLZ, *op. cit. supra* note 3, at 107 (10% of total net profits earned in 3 years); Fahr, *supra* note 78, at 324 (15-20% of average profits of at least 5 years).

169 Fahr, *supra* note 78, at 325. See O'Brien v. O'Brien, *supra* note 124 (earnings capitalized at 8% of all earnings for period of years during which earnings exceeded 6% per annum); Cage v. Cravens, 297 S.W. 641 (Tex. Civ. App. 1927) (two and one-half times net income of previous year). In McPherson v. J. E. Sirrine & Co., *supra* note 87, the partnership had originally paid withdrawing partners two and one-half times the sum their interest would have earned for five previous years; this agreement was found unfair to the partnership and was subsequently changed.

170 Newell v. Commissioner, 66 F. 2d 103 (7th Cir. 1933) (earnings for six-year period were properly used as a measure of market value); MULDER AND VOLZ, *op. cit. supra* note 3, at 106.

count. The courts may require in addition that some value be attached to it on the partnership books if it is not valued in the agreement.[171]

The effect of the death or retirement of a partner and of certain conditions established elsewhere in the contract may logically be considered in valuing good will. For example, it would seem that the good will enjoyed by two partners of equal capacity would be diminished by the withdrawal or death of a partner.[172] Withdrawal, at least, can be avoided and good will preserved. Thus it has been suggested that a lower valuation be placed on the interest of a retiring partner, in order to discourage retirement.[173] Furthermore, good will would necessarily be impaired where, because of the absence of a covenant against competition, an ex-partner was enabled to continue in the same line of business;[174] this should be reflected in valuation. Finally, if the right of the remaining partners to use the firm name is valuable, recognition should be given to that fact in the valuation of the withdrawn partner's interest.[175]

LIQUIDATION

Liquidation may come at the end of the partnership term, by voluntary agreement, or by election of the surviving partners not to purchase a retired or deceased partner's interest.

The most misunderstood part of the liquidation process is the order of distribution of assets to the partners. Section 40 of the UPA, which is partially responsible for this confusion, sets up the following order of payment of liabilities (subject to contrary agreement):

I. Those owing to creditors other than partners,

II. Those owing to partners other than for capital and profits,

III. Those owing to partners in respect of capital,

IV. Those owing to partners in respect of profits. However, these liabilities can only be paid with assets, and partnership assets include "the contribution of the partners necessary for payment" of the liabilities above listed.[176] Payment of the liabilities to creditors may, because of losses on liquidation, eat heavily into the capital balances of the partners.

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171 *In re* Randall's Estate, *supra* note 159 (authorities analyzed); Thursby v. Kirby, 171 Misc. 310, 12 N.Y.S. 2d 279 (1939) (alternate ground). *But cf.* Succession of Conway, 215 La. 819, 41 So. 2d 729 (1949) (good will to be included unless expressly excluded; valuation reached by court approximately 50% of average annual profits over two year period).

172 See Newell v. Commissioner, *supra* note 170 (market value figured for tax purposes must take into account loss to business because of partner's death). In the case of service partnerships, good will ordinarily will not be considered an asset for tax purposes. Charles F. Coates, *supra* note 114; Sidney Hess, 12 T.C. 773 (1949) (facts found existence of only nominal good will because success of firm depended on survivor's skill, whereas before death of other partner it had depended on combined skills). *Cf.* Thursby v. Kirby, *supra* note 171 (good will exists in service partnership only where established business under established name). It is quite generally provided that good will shall not be included in the valuation of a partner's interest in service partnerships.

173 Darling, *supra* note 76.

174 Miller v. Hall, *supra* note 159; Thursby v. Kirby, *supra* note 171.

175 See CAL. BUS. & PROF. CODE §§ 14101, 14103 (right to use name must be sold separately from good will). *But see* O'Brien v. O'Brien, *supra* note 124 (where firm name could not be sold for 50 years, good will was not transferable and hence should not be part of price paid on deceased partner's interest).

176 UPA § 40(a).

Suppose that *A*'s capital balance is absorbed completely and that *B*'s balance has borne part of the loss which under the agreement should have been borne by *A*. Even though *A* had made a loan to the partnership which had not been repaid, it would be senseless to require payment to him out of the remaining firm assets when he has in the process of liquidation become indebted to *B*.[177] These various obligations existing as among the partners should be offset against each other.[178] If loans and other obligations were first repaid to the partners, the partnership agreement to share losses would be violated.[179]

The possibility of losses is due particular consideration in the case of distributions in partial liquidation. At the time of such distributions, it may not yet be apparent whether profit or loss is to be realized from the entire liquidation process. Each distribution should therefore be treated as if it were the final payment, in order to avoid breach of the partnership agreement to share losses.[180] It should be provided that distribution is first to be made to partners whose combined credits (from capital contributions, loans, etc.) exceed the agreed-upon share of the largest possible loss the partnership might suffer due to failure of any partner to bear his share. When such distribution has been made and the combined credits of the partners are in the loss sharing ratio, each may then be paid his share according to that ratio. Partners whose capital and loan accounts are less than their agreed-upon share of the largest possible loss the partnership might suffer should be paid nothing until credits are in the loss sharing ratio.[181]

Under the UPA, administration of the partnership assets for purposes of winding up is committed to those remaining partners who have not wrongfully dissolved the partnership.[182] It may be provided that liquidators shall be appointed by the controlling partners and that power to remove the liquidators be reserved.[183]

A surviving partner is entitled to reasonable compensation for his services in winding up.[184] The amount of this compensation may be left to the surviving partners to determine, and to an arbitrator in case of disputes.[185]

In some cases it may be possible to distribute the assets in kind, and an agreement to do so would appear valid under the UPA.[186] Alternately,

177 UPA § 40(d), (f).

178 Comment, 23 ROCKY MT. L. REV. 331 (1951).

179 UPA § 18(a); Rosenberger v. Kuesel, 292 Pa. 184, 140 Atl. 860 (1928); GRAHAM AND KATZ, ACCOUNTING IN LAW PRACTICE § 55 (2d ed. 1938).

180 See the erroneous results reached in Robinson v. Welker, 138 Ark. 334, 211 S.W. 181 (1919) (contributions to capital decreed repayable pro rata from remaining assets without apportionment of loss from liquidation); Leserman v. Bernheimer, 113 N.Y. 39, 20 N.E. 869 (1889) (additional contribution to capital given priority in payment; remaining assets distributed according to profit sbaring agreement without apportionment of losses from liquidation).

181 GRAHAM AND KATZ, *op. cit. supra* note 179, § 58.

182 § 37.

183 Worcester, *supra* note 3, at 993.

184 UPA § 18(f); Jacobson v. Wikholm, 29 Cal. 2d 24, 172 P. 2d 878 (1946). *Contra*: Ross v. Burr, 69 Cal. App. 286, 230 Pac. 986 (1924) (before UPA).

185 MULDER AND VOLZ, *op. cit. supra* note 3, at 114.

186 Rinke v. Rinke, 330 Mich. 615, 48 N.W. 2d 201 (1951) (division in kind by trial court approved). *Cf.* Clarke v. Fiedler, 44 Cal. App. 2d 838, 113 P. 2d 275 (1941) (no right to specific

it may be desirable to give the remaining partners first bid on purchase of assets during liquidation.[187]

In California, notice of dissolution should be published by a partnership whenever it is dissolved.[188] As a reminder, provision for such a notice should be included in the articles; its publication will end the authority of any but the liquidating partners to bind the partnership assets.[189]

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assets in absence of agreement). The tax pros and cons are discussed at great length in LITTLE, *op. cit. supra* note 3, cc. 8, 9.

[187] MULDER AND VOLZ, *op. cit. supra* note 3, at 115-116.

[188] CAL. CORP. CODE § 15035.5.

[189] UPA § 35(1)(b), (3)(c).