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Revised Uniform Limited Partnership Act: Provisions Governing Financial Affairs, The

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THE REVISED UNIFORM LIMITED PARTNERSHIP ACT: PROVISIONS GOVERNING FINANCIAL AFFAIRS

EDWIN W. HECKER, JR.*†

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I. INTRODUCTION

Two principal types of business organization, the corporation and the limited partnership, presently are fulfilling the need for a form of association that permits an investor to contribute capital and receive a share of the profits while remaining free from both management responsibility and personal liability in excess of the amount invested. Limited partnerships first received statutory recognition in this country in New York in 1822,¹ but because of the strict requirements contained in early statutes and the courts' strict construction of them,² limited partnerships did not come of age until promulgation in 1916 of the Uniform Limited Partnership Act (1916 Act). Since that time the 1916 Act has received almost universal acceptance.³

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1. 1822 N.Y. Laws ch. 244.

2. Lewis, *The Uniform Limited Partnership Act*, 65 U. PA. L. REV. 715, 720-23 (1917).

3. See 6 UNIFORM LAWS ANN. 111-12 (Supp. 1981).

The fact that limited partnerships, unlike corporations, generally are not treated as separate legal entities for federal income tax purposes,⁴ coupled with the advent of sophisticated tax shelter planning, has caused a tremendous growth in the number, size, and economic importance of limited partnerships over the past two decades. Previously, most limited partnerships were enterprises with relatively few limited partners who often were associated closely with the general partner or partners either personally, professionally, or geographically. Because of the tax benefits and limited liability in the limited partnership form, this pattern has changed. During the early 1970s, much of the risk capital invested in speculative fields, such as real estate, oil and gas, timber, equipment leasing, motion pictures, and cattle, was channeled through limited partnerships, with interests marketed publicly to thousands of passive investors throughout the country.⁵ While the Tax Reform Act of 1976 and the Revenue Act of 1978 limited some of the special tax benefits previously available in these fields of investment, one of the largest, real estate syndications, emerged relatively unscathed.⁶

The primary impetus leading to promulgation of the 1916 Act was the extremely restrictive interpretation given to prior limited partnership statutes by the courts.⁷ Cases espousing narrow interpretations almost invariably arose in the context of a creditor seeking to impose personal liability on one or more limited partners based on some technical defect in the formation or operation of the partnership.⁸ It is not surprising, therefore, that the primary focus of the drafters of the 1916 Act was on those provisions affecting the relationship of the firm and its members to third-party creditors. Because of this preoccupation with insulating limited partners from unlimited personal liability, provisions concerning the financial affairs of the partnership appear to have been less

4. I.R.C. §§ 701-702. If a limited partnership has too many corporate characteristics, however, it may be treated as a corporation for tax purposes. For discussions of the problem of tax classification of limited partnerships, see 1 Z. CAVITCH, *BUSINESS ORGANIZATIONS WITH TAX PLANNING* § 9.03 (1980); Note, *Tax Classification of Limited Partnerships*, 90 HARV. L. REV. 745 (1977); Note, *Tax Classification of Limited Partnerships: The IRS Bombards the Tax Shelters*, 52 N.Y.U.L. REV. 408 (1977).

5. See Glasser, *Gimme Shelter: Reform of Real Estate Tax Shelters*, 7 U. MICH. J.L. REF. 267, 267-68 (1974); Roulac, *Resolution of Limited Partnership Disputes: Practical and Procedural Problems*, 10 REAL PROP., PROB. & TR. J. 276, 279-80 (1975).

6. See I.R.C. § 465(c)(3)(D); Wiesner, *Tax Shelters—A Survey of the Impact of the Tax Reform Act of 1976*, 33 TAX L. REV. 5, 49-69 (1977) (predating the Revenue Act of 1978).

7. See UNIFORM LIMITED PARTNERSHIP ACT § 1, Comment (1916 version) [hereinafter cited as 1916 ACT].

8. See, e.g., *Haggerty v. Foster*, 103 Mass. 17 (1869).

thoughtfully and less carefully drafted. In addition, as previously noted, the 1916 Act was drafted during a period in which limited partnerships were small, collegial concerns, more closely resembling general partnerships than corporations in all respects except the liability of their members. Many modern, publicly owned limited partnerships, however, in respects other than taxation, more closely resemble corporations than general partnerships. The combination of these two factors has resulted in a statute widely in force that, with respect to financial matters, leaves significant questions either unanswered or answered in a manner that is ill-suited to modern limited partnerships.

Perhaps impelled by this state of affairs, the National Conference of Commissioners on Uniform State Laws in 1976 promulgated a revised Uniform Limited Partnership Act (1976 Act). Its purpose is "to modernize the prior uniform law while retaining the special character of limited partnerships as compared with corporations."⁹ According to its drafters, the 1976 Act "clarifies many ambiguities and fills interstices in the prior uniform law by adding more detailed language and mechanics. In addition, some important substantive changes and additions have been made."¹⁰

The purpose of this Article is to examine those sections of the 1976 Act that principally affect the financial affairs of limited partnerships. This examination will consist primarily of a comparison of the 1976 Act with the corresponding provisions of the 1916 Act, but it will also refer to analogous principles of corporate law where relevant. Because of the context in which the 1976 Act was promulgated, and because of the above stated goals of the drafters, the discussion will consider both the degree to which the 1976 Act clarifies ambiguities and fills interstices in the 1916 Act and the degree to which it makes desirable substantive changes in limited partnership law.

II. CONTRIBUTIONS TO CAPITAL

A. *Form of Contribution*

Section 501 of the 1976 Act specifies that the capital contribution of a partner, either general or limited, "may be in cash, property, or services rendered, or a promissory note or other obligation to contribute cash or property or to perform services."¹¹ This section is analogous to corporate law provisions governing the quality of consideration necessary for the issuance of stock and which are intended to protect creditors of the enter-

9. UNIFORM LIMITED PARTNERSHIP ACT Commissioners' Prefatory Note (1976 version) [hereinafter cited as 1976 ACT].

10. *Id.*

11. *Id.* § 501.

prise by providing a fund on which they may rely in extending credit.¹² The following discussion first will focus on contributions of cash, property, or services rendered, then will consider contributions consisting of an obligation to furnish such items in the future, and finally, will examine problems concerning valuation.

Section 4 of the 1916 Act provides that the contributions of limited partners "may be cash or other property, but not services."¹³ Since there is no provision governing contributions of general partners, the clear implication is that their contributions may consist of services as well as cash or property.¹⁴ The reason for this dichotomy regarding services is unclear. It might be rationalized in terms of creditor protection, and there is some language in the cases to support this view.¹⁵ In other words, services rendered may be the contribution of a general partner without prejudicing creditors because he or she remains personally liable for partnership obligations. A limited partner, however, because he or she will have limited liability, must contribute something more tangible to the capital fund. Unfortunately, this theory does not withstand analysis. Services are as capable of adding realizable value to an enterprise as cash or property. Moreover, services rendered have long been recognized by corporate law as valid consideration for the issuance of stock, notwithstanding the limited liability of shareholders.¹⁶

Actually, the reason for the distinction between general and limited partners with respect to services probably is purely historical. The predecessors of the modern limited partnership developed as a means to permit the investment of capital by the clergy and by noble classes who could not, or did not deign to, engage directly in commerce.¹⁷ As a result, those who drafted the 1916 Act appear to have assumed that cash or other property was the only proper form of investment by limited partners.¹⁸ The cases decided under the 1916 Act, however, make it clear that a limited partner may *perform* services for the limited partnership as long

12. See, e.g., CAL. CORP. CODE § 409(a)(1) (West Cum. Supp. 1981); DEL. CODE ANN. tit. 8, § 152 (Cum. Supp. 1980); ILL. ANN. STAT. ch. 32, § 157.18 (Smith-Hurd 1954); N.Y. BUS. CORP. LAW § 504 (McKinney 1963).

13. 1916 ACT, *supra* note 7, § 4.

14. 1976 ACT, *supra* note 9, § 101, Comment. See *Plasteel Prods. Corp. v. Eisenberg*, 170 F. Supp. 100 (D. Mass.), *aff'd on other grounds sub nom. Plasteel Prods. Corp. v. Helman*, 271 F.2d 354 (1st Cir. 1959).

15. See *Henningsen v. Barnard*, 117 Cal. App. 2d 352, 255 P.2d 837 (1953); *Silvola v. Rowlett*, 129 Colo. 522, 272 P.2d 287 (1954).

16. 11 W. FLETCHER, CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 5186 (rev. perm. ed. 1971). See, e.g., statutes cited note 12 *supra*.

17. See *Lewis*, *supra* note 2, at 716-17.

18. See 1916 ACT, *supra* note 7, § 1, Comment; *Lewis*, *supra* note 2, at 716-17, 719, 723-24.

as such services do not constitute his or her capital contribution.¹⁹ Barring any sound policy basis for the continued ban on contributions of services rendered by limited partners, the change introduced by section 501 is commendable. It adds flexibility to the law and removes an artificial consideration from the decision whether to incorporate or operate as a limited partnership.

Section 501's reference to contributions of cash or property both continues the law in effect under section 4 of the 1916 Act and reflects the prevailing view in the corporate field.²⁰ These terms are relatively straightforward, offering little potential for serious problems.²¹

On the other hand, permission to make a capital contribution in the form of a promissory note or other obligation to contribute cash, property, or services in the future introduces a radical change. It has been stated that section 17 of the 1916 Act, which imposes liability on a limited partner for "any unpaid contribution which he agreed in the certificate to make in the future,"²² implicitly authorizes contributions by means of promissory notes or other obligations to contribute cash or property in the future.²³ This view misconstrues the 1916 Act. Section 4, as already noted, provides that contributions of a limited partner "may be cash or other property."²⁴ Section 2 requires that the certificate of limited partnership contain a statement of the "amount of cash and a description of and the agreed value of the other property contributed by *each* limited partner," and the "*additional* contributions, if any, agreed to be made by each limited partner."²⁵

19. Compare *Silvola v. Rowlett*, 129 Colo. 522, 272 P.2d 287 (1954) with *Plasteel Prods. Corp. v. Eisenberg*, 170 F. Supp. 100 (D. Mass.), *aff'd on other grounds sub nom. Plasteel Prods. Corp. v. Helman*, 271 F.2d 354 (1st Cir. 1959). Of course, there is the danger that such services may constitute participation in control with a resultant loss of limited liability. See 1916 ACT, *supra* note 7, § 7. This danger is removed by § 303(b)(1) of the 1976 Act, which provides that a limited partner may be a contractor for, or an agent or employee of, the limited partnership or of a general partner without being deemed to be participating in control of the business.

20. See 11 W. FLETCHER, *supra* note 16, § 5186. See, e.g., statutes cited note 12 *supra*.

21. See *Wilson v. United States*, 246 F. Supp. 613, 622-23 (N.D. Cal. 1965) (contribution of fractional interest in former partnership sufficient); *Henningsen v. Barnard*, 117 Cal. App. 2d 352, 360-61, 255 P.2d 837, 842 (1953) (contribution by check sufficient; fact that limited partner contributing on behalf of third party as well as himself irrelevant).

22. 1916 ACT, *supra* note 7, § 17(1)(b).

23. Kessler, *The New Uniform Limited Partnership Act: A Critique*, 48 FORDHAM L. REV. 159, 168 (1979).

24. 1916 ACT, *supra* note 7, § 4. In the corporate context an unsecured promissory note, being a mere promise to pay, generally is not held to be property. N. LATTIN, *THE LAW OF CORPORATIONS* § 119, at 468 (2d ed. 1971).

25. 1916 ACT, *supra* note 7, § 2(1)(a) VI-VII (emphasis added).

Section 17 then imposes liability on a limited partner for the difference between his or her actual contribution and the amount stated in the certificate as having been contributed, and for any unpaid contribution that he or she agreed in the certificate to make in the future.²⁶ Read in this context, the reference to unpaid contributions in section 17 seems clearly to relate only to the additional contributions, if any, of a limited partner above and beyond the required initial contribution of cash or property.

Nor does section 501's validation of obligations to contribute cash, property, or services find support by analogy in the corporate sphere. Some statutes expressly state that notes or other obligations to pay for stock in the future are not sufficient to support the present issuance of shares as fully paid and nonassessable.²⁷ In other jurisdictions, in which the statute speaks only in terms of "property," it generally is held that such an obligation does not constitute property, at least if it is not secured by collateral other than the shares themselves.²⁸ The reason, again, is creditor protection—the notion that corporate capital ought to represent something more substantial and realizable than the mere promises of shareholders to pay for their stock at some future date.²⁹ Similarly, a promise of future services generally is not valid consideration for the present issuance of stock, either because the controlling statute expressly so provides³⁰ or because "services rendered" as used in the statute correctly is interpreted as not extending to future services.³¹ Future services traditionally have been viewed as the type of consideration most prejudicial to creditors because they are valuable only if the enterprise remains a going concern. To the extent they remain unperformed, they are totally valueless on liquidation. Moreover, unlike goodwill or other intangible items that may prove worthless if the business fails, future services have no salable, commercial value at any time.³²

26. *Id.* § 17(1)(a)-(b).

27. *See, e.g.*, CAL. CORP. CODE § 409(a)(1) (West Cum. Supp. 1981) (unless secured or stock issued pursuant to employee stock purchase plan); ILL. ANN. STAT. ch. 32, § 157.18 (Smith-Hurd 1954) (never constitutes payment); N.Y. BUS. CORP. LAW § 504(b) (McKinney 1963) (never constitutes payment).

28. *Sohland v. Baker*, 15 Del. Ch. 431, 141 A. 277 (Sup. Ct. 1927); N. LAT-TIN, *supra* note 24, § 119. DEL. CODE ANN. tit. 8, § 152 (Cum. Supp. 1980), by reason of a 1974 amendment, recognizes promissory notes, but only for the excess of the purchase price over the amount that will be allocated to capital (generally par value).

29. *Sohland v. Baker*, 15 Del. Ch. 431, 451-52, 141 A. 277, 286 (Sup. Ct. 1927).

30. *See, e.g.*, CAL. CORP. CODE § 409(a)(1) (West Cum. Supp. 1981); ILL. ANN. STAT. ch. 32, § 157.18 (Smith-Hurd 1954); N.Y. BUS. CORP. LAW § 504(b) (McKinney 1963).

31. *See, e.g.*, *Maclary v. Pleasant Hills, Inc.*, 35 Del. Ch. 39, 109 A.2d 830 (1954); DEL. CODE ANN. tit. 8, § 152 (Cum. Supp. 1980); 11 W. FLETCHER, *supra* note 16, § 5187.

32. *See Herwitz, Allocation of Stock Between Services and Capital in the Organization of a Close Corporation*, 75 MARY L. REV. 1098, 1105-06 (1962).

Whether section 501's break with the 1916 Act and corporate law is desirable depends on the extent to which creditors actually rely on the partners' capital contributions and the extent to which actual protection is achieved by means of restrictions on the quality of those contributions. While most creditors might wish that their debtors have substantial amounts of tangible, unencumbered assets, this factor probably is not paramount in the decision to extend credit. Assets assume primary importance only if the business fails and is liquidated, an event which the creditor usually does not expect to occur. In the normal case, the obligations of a business will be paid from its earnings. If this is true, the prospective creditor is more interested in the present and future earnings of an enterprise than its assets.³³

Even if creditors are interested secondarily in a firm's assets, provisions that prohibit the present acquisition of an equity interest in exchange for an obligation to perform services or to contribute cash or property in the future hardly seem to be an appropriate method of protecting this interest. Such prohibitions, in fact, may be counterproductive. For example, failure to recognize the present economic significance of the future services of a highly talented individual may well prevent his or her association with the firm, to its and its creditors' detriment. In addition, the capital contributions of the partners will equal the firm's net assets only at the time of organization. After the partnership has engaged in business for some months or years, it will have acquired other assets, incurred liabilities, and either will have earned or lost money. At this point, the initial contributions of the partners necessarily must be largely irrelevant to prospective creditors. For this reason, such creditors will rely principally on current financial data supplied either by the firm itself or by a commercial credit investigation service, rather than on the historical capital contributions of the partners as revealed by the certificate of limited partnership.³⁴ Finally, in order for restrictions on the quality of capital contributions to protect creditors even remotely, they would have to be accompanied by quantitative provisions imposing substantial minimum capital requirements. This the partnership law has never done.³⁵ Thus, by adding flexibility

33. B. MANNING, A CONCISE TEXTBOOK ON LEGAL CAPITAL 13-14 (1977); Herwitz, *supra* note 32, at 1109.

34. B. MANNING, *supra* note 33, at 22-23, 91-95; Herwitz, *supra* note 32, at 1109.

35. In the corporate field, minimum capital requirements have been nominal. Today, most states have eliminated even the nominal \$500 or \$1,000 requirement, with the result that a shareholder need pay only the par or stated value of his or her stock, and there is no limit on how low this figure may be set. *See, e.g.*, DEL. CODE ANN. tit. 8, § 154 (1974); ILL. ANN. STAT. ch. 32, § 157.19 (Smith-Hurd Cum. Supp. 1980-1981); N.Y. BUS. CORP. LAW § 506 (McKinney 1963). California, recognizing the ineffectiveness of the concepts of par value and legal capital, has eliminated them from its corporate code. *See* CAL. CORP. CODE §§ 202(d)-(e), 205 (West 1977 & Cum. Supp. 1981). The apparent result is that

without significantly sacrificing the interests of creditors, section 501's provisions are commendable.³⁶

In liberalizing the law with respect to obligations to perform services or to contribute cash or other property, however, section 501 has created two other interrelated problems. The first is whether the obligation or the underlying subject matter of the obligation should be considered as the partner's contribution. Both the theory and the language of section 501 strongly suggest the former.³⁷ This conclusion also is supported directly by section 101(2), which defines "contribution" as "any cash, property, services rendered, or a promissory note or other binding obligation to contribute cash or property or to perform services."³⁸ The necessary result of these two sections appears to be that the obligation, itself, is a form of property that may constitute a partner's capital contribution.³⁹

The further problem of valuation of such a contribution remains. This issue is critical because it affects both the financial relations of the partners, *inter se*, and the liability of a partner to the limited partnership and ultimately to its creditors.⁴⁰ Because a promise to contribute cash or property or to perform services in the future is worth less to the partnership than such items presently in hand, one might expect that the obligation to be performed in the future would be discounted to its present value.⁴¹ This

the entire consideration received for the issuance of shares should be allocated to the capital account. See Ackerman & Sterrett, *California's New Approach to Dividends and Reacquisitions of Shares*, 23 U.C.L.A. L. REV. 1052, 1052 n.4 (1976); Dreyfuss, *Distributions to Shareholders Under the New California General Corporation Law*, 9 LOY. L.A.L. REV. 839, 846 (1976).

36. In addition, the 1976 Act attempts to protect creditors from a partner who defaults on his or her obligation by specifically imposing liability for nonperformance. 1976 ACT, *supra* note 9, § 502. See text accompanying notes 71-79 *infra*.

37. The 1976 ACT, *supra* note 9, § 501 states, "The contribution of a partner may be . . . a promissory note or other obligation to contribute cash or property or to perform services."

38. *Id.* § 101(2) (emphasis added). The Comment to § 101 states, "*Contribution*: this definition makes it clear that a present contribution of services and a promise to make a future payment of cash, contribution of property or performance of services are permissible forms for a contribution." Potential interpretive problems raised by § 503 and § 504, which govern the allocation of profits, losses, and distributions in the absence of agreement, and which speak in terms of contributions "to the extent they have been received by the partnership and have not been returned," are considered in the text accompanying notes 124-26 *infra*.

39. See Gregory, *The Financial Provisions of the Revised Uniform Limited Partnership Act: Articles 5 and 6*, 9 ST. MARY'S L.J. 479, 481 (1978).

40. See, e.g., 1976 ACT, *supra* note 9, §§ 101(10), 502(a), 503-504, 604-605, 607-608.

41. See K. SOLOMON, *LAWYER'S HANDBOOK OF ACCOUNTING THEORY AND PRACTICE* 128 (1971).

approach apparently is not the one taken by the 1976 Act. According to section 201, the certificate of limited partnership must set forth "the amount of cash and a description and statement of the agreed value of the other property or services contributed by each partner and which each partner has agreed to contribute in the future."⁴² While not a model of clarity, the reference to the "amount" of cash appears to require that present and future cash payments be reported identically. Consistency would require a similar approach in valuing property and services. Thus, section 201 seems to contemplate that obligations to contribute cash or property or to perform services in the future are to be valued as if the underlying subject matter of the obligation had been contributed presently.

Section 502(a),⁴³ which is designed to protect both the partners and partnership creditors, reinforces this conclusion. It states that

a partner is obligated . . . to perform any promise to contribute cash or property or to perform services If a partner does not make the required contribution of property or services, he is obligated . . . to contribute cash equal to that portion of the value (as stated in the certificate of limited partnership) of the stated contribution that has not been made.⁴⁴

This provision, of course, will become operative only if a partner does not perform his or her obligation when performance is due. At that point, the present value of the obligation will equal its face amount. Consequently, the cross-reference to value as stated in the certificate of limited partnership must mean the face amount of the obligation because that is the only sensible measure of a defaulting partner's liability.⁴⁵

Regarding valuation in general, section 201 requires that contributions other than cash be set forth in the certificate of limited partnership at their "agreed value,"⁴⁶ a carryover of the terminology of the 1916 Act.⁴⁷ The definition of this term again is important with respect to both potential liability to partnership creditors and the relations of the partners, *inter se*. The corporate experience suggests at least two possible definitions. First, section 201 may contemplate a statement of the actual, objective, or so-called "true" value of the property or services. Second, it simply may require a good faith, though possibly erroneous, valuation.⁴⁸

With regard to partnership creditors, the primary significance of the valuation issue derives from section 207, which creates a cause of action in

42. 1976 ACT, *supra* note 9, § 201(a)(5).

43. *See id.* § 502(a).

44. *Id.*

45. *See id.* § 101(2), Comment.

46. *Id.* § 201(a)(5).

47. 1916 ACT, *supra* note 7, § 2(1)(a)VI.

48. For a summary of the corporate law on this issue, see N. LATTIN, *supra* note 24, § 122(b).

favor of one who suffers loss by reliance on a false statement in the certificate of limited partnership.⁴⁹ In a case arising in this context under the 1916 Act, "agreed value" was interpreted to mean actual value.⁵⁰ This holding, however, is diluted by findings of fact indicating a knowing and fairly gross overvaluation of the contributed property. Such findings were necessary because section 6 of the 1916 Act imposes liability only for knowingly false statements in the certificate of limited partnership.⁵¹ This standard of culpability generally is continued in section 207 of the 1976 Act,⁵² with the result that even if "agreed value" is interpreted to mean actual value, the practical effect with respect to creditors is much the same as the good faith test prevalent in corporate law.⁵³

The question of valuation is important to the partners because the agreed value of each partner's contribution will constitute his or her initial capital account. Absent an agreement to the contrary, partnership profits and losses will be allocated, and distributions will be made, on the basis of the value of the partners' contributions as stated in the certificate.⁵⁴ An incorrect valuation will distort these ratios inequitably. In addition, gains or losses occasioned by the disposition of partnership property are allocated among the partners. If contributed property is undervalued or overvalued at the time of contribution, a subsequent disposition may result in allocation of an accounting gain or loss among all the partners when it should be realized or borne solely by the contributor.⁵⁵

B. *Liability for Contribution*

It is unfortunate, but a partner may not have made the contribution to capital that the certificate of limited partnership attributes to him or her or may not fulfill an agreement to make contributions in the future. The following discussion will examine a number of problems relative to the defaulting partner's liability.

49. 1976 ACT, *supra* note 9, § 207.

50. *Walraven v. Ramsay*, 335 Mich. 331, 55 N.W.2d 853 (1952).

51. 1916 ACT, *supra* note 7, § 6.

52. 1976 ACT, *supra* note 9, § 207. Actually, § 207 predicates the liability of limited partners on knowing conduct and of general partners on knowing or negligent conduct. The class of potential plaintiffs, however, is restricted to those who suffer loss by reliance on the false statement. Such losses usually will occur only if the partnership becomes insolvent, and, in view of general partners' unlimited personal liability, lowering the standard of culpability to encompass negligence should have little practical effect.

53. See, e.g., CAL. CORP. CODE § 409(b) (West Cum. Supp. 1981); DEL. CODE ANN. tit. 8, § 152 (Cum. Supp. 1980); ILL. ANN. STAT. ch. 32, § 157.18 (Smith-Hurd 1954); N.Y. BUS. CORP. LAW § 504(a) (McKinney 1963).

54. 1976 ACT, *supra* note 9, §§ 503-504.

55. K. SOLOMON, *supra* note 41, at 151. See S. DAVIDSON, HANDBOOK OF MODERN ACCOUNTING 29-12 (1970); H. SELLIN, ATTORNEY'S HANDBOOK OF ACCOUNTING § 10.01[3]-(1979).

As noted previously, the 1916 Act contemplates not only present contributions of cash or property by limited partners, but also the possibility of obligations to make additional contributions in the future.⁵⁶ Thus, defaults may arise in two principal ways. First, a limited partner may fail to contribute part or all of the cash or property that the certificate of limited partnership describes as his or her present contribution.⁵⁷ Section 17 of the 1916 Act addresses this problem by providing that the limited partner is liable to the partnership "[f]or the difference between his contribution as actually made and that stated in the certificate as having been made."⁵⁸ Moreover, regarding contributions of property, section 17 states that a limited partner holds "as trustee" for the partnership "[s]pecific property stated in the certificate as contributed by him, but which was not contributed."⁵⁹ By incorporating this trust law terminology, section 17 provides a basis on which the partnership apparently could recover the actual property rather than its cash equivalent.

The second type of default that may occur under the 1916 Act is the refusal or inability of a limited partner to make an additional, agreed, future contribution. In this situation section 17 clearly imposes liability to the partnership "[f]or any unpaid contribution which he agreed in the certificate to make in the future at the time and on the conditions stated in the certificate."⁶⁰ The 1916 Act, therefore, contains direct and relatively unambiguous sanctions for the two types of default regarding contributions that may occur within its framework.

Under the 1976 Act the situation is more complex. Partners' contributions fall into three categories: (1) present contributions of cash, property, or services rendered; (2) present contributions of obligations to contribute cash or property or to perform services in the future; and (3) obligations to make additional contributions in the future that do not purport to be present contributions.⁶¹ Correspondingly, a partner may default in at least the following four ways: (1) by failing to contribute part or all of the cash, property, or services rendered described in the certificate as having been contributed; (2) by failing to contribute the obligation described in the certificate as having been contributed; (3) by presently contributing the

56. 1916 ACT, *supra* note 7, § 2(1)(a)VI-VII.

57. *See* Bell Sound Studios, Inc. v. Enneagram Prods. Co., 36 Misc. 2d 879, 234 N.Y.S.2d 12 (Civ. Ct. N.Y. 1962).

58. 1916 ACT, *supra* note 7, § 17(1)(a).

59. *Id.* § 17(2)(a).

60. *Id.* § 17(1)(b).

61. *See* 1976 ACT, *supra* note 9, §§ 101(2), 201(a)(5)-(6), 501. Because a binding obligation to contribute cash or property or to perform services may be a present contribution, the reference to "additional" contributions in § 201(a)(6) indicates the drafters envisioned the third category described in the text.

obligation, but failing to perform when performance is due; and (4) by failing to make an additional, agreed, future contribution.⁶²

It seems the drafters did not recognize the monster they had created. Section 502(a), the only section in the 1976 Act purporting to deal with the liability to the partnership of a partner who defaults with respect to his or her contribution, provides:

Except as provided in the certificate of limited partnership, a partner is obligated to the limited partnership to perform any promise to contribute cash or property or to perform services, even if he is unable to perform because of death, disability or any other reason. If a partner does not make the required contribution of property or services, he is obligated at the option of the limited partnership to contribute cash equal to that portion of the value (as stated in the certificate of limited partnership) of the stated contribution that has not been made.⁶³

Of the four default situations, only the third clearly falls within section 502(a). The fourth situation, factually the most similar to the third, also might be covered. The reference in the first sentence of section 502(a) to failure "to perform any promise" apparently is not limited solely to obligations that purport to be present contributions.⁶⁴ The second sentence is more troublesome. It merely may expand on the idea begun in the first sentence, to make it clear that the partnership has a right to cash in the event promised property or services are not delivered.⁶⁵ As such, it could relate both to obligations that purport to be present contributions and to those that do not. The amount of a defaulting partner's cash liability, however, is described as "the value (as stated in the certificate of limited partnership) of the stated contribution that has not been made." Because additional future contributions arguably are not required to be valued in the certificate of limited partnership,⁶⁶ it may be that the drafters did not

62. Other situations could be imagined. For example, one could make an additional, agreed, future contribution of an obligation to contribute cash or property or to perform services in the future, followed by a failure to perform the obligation when due.

63. 1976 ACT, *supra* note 9, § 502(a).

64. Use of the term "promise" appears to present no difficulty, as future contributions are described in *id.* § 201(a)(6) as those "agreed" to be made.

65. See *id.* Commissioners' Prefatory Note, § 502, Comment.

66. Compare *id.* § 201(a)(5) with *id.* § 201(a)(6). The result may depend on whether these two subsections are mutually exclusive. Although the language of subsection (a)(5) is broad enough to include additional future contributions, this does not appear to be the drafters' intent. See *id.* § 101, Comment. Moreover, it would seem permissible for the partners simply to agree under subsection (a)(6) to honor capital assessments, the amount of which would be determined in the future. See *Dycus v. Belco Indus., Inc.*, 569 P.2d 553 (Okla. Ct. App. 1977). Stating a value in the certificate would be impossible in such a situation.

intend section 502(a) to encompass the fourth situation.⁶⁷ On the other hand, if the second sentence expresses an *alternative* thought, independent of the first sentence, the fact that it is inapplicable to the fourth situation would not preclude applicability of the first sentence.

What that alternative thought might be is suggested by the first situation, *i.e.*, failure to contribute part or all of the cash, property, or services rendered described in the certificate as having been contributed. The first sentence of section 502(a), which refers only to failure to perform promises, clearly does not apply. The second sentence, however, by focusing on failure to make "the required contribution of property or services" could be viewed as an attempt to impose liability for the difference between the contribution actually made and that stated in the certificate as having been made. The major defect in this construction is that, by speaking exclusively in terms of property and services, section 502(a) would not impose liability for failure to make cash contributions. Additionally, the comments of the drafters indicate that they did not intend the second sentence to be independent of the first, but merely an elaboration of it.⁶⁸

The second situation, *i.e.*, failure to contribute a promissory note or other obligation described in the certificate as having been contributed, is not covered under any interpretation of section 502(a). The first sentence, again, applies only to failure to perform the obligation when performance is due. The second sentence, even if independent of the first, extends only to the underlying property or services, not to the obligation to furnish them.

Thus, of the four major types of potential defaults by partners regarding their contributions, only one clearly is encompassed by section 502(a). The explanation for this deficiency is not readily apparent. The drafters might have felt that section 207, which imposes liability for false statements in the certificate of limited partnership, provides sufficient protection in cases involving failure to make a contribution stated to have

67. Because it applies only to "the required contribution of property or services," the second sentence of § 502(a) also is not broad enough to cover cases in which the additional future contribution is agreed to be an obligation to contribute cash or property or to perform services.

68. 1976 ACT, *supra* note 9, § 502, Comment provides:

Although Section 17(1) of the prior uniform law required a partner to fulfill his promise to make contributions, the addition of contributions in the form of a *promise to render services* means that a partner who is unable to perform *those services* because of death or disability as well as because of an intentional default is *required to pay the cash value of the services* unless the certificate of limited partnership provides otherwise. (Emphasis added.) The Commissioners' Prefatory Note states, "[T]hose who fail to perform *promised services* are required, in the absence of an agreement to the contrary, to *pay the value of the services* stated in the certificate of limited partnership." (Emphasis added.)

been made.⁶⁹ The liability imposed by section 207, however, normally will run only to partnership creditors. As such, it will not protect other partners from dilution of their investments.⁷⁰ Alternatively, it may be that the drafters were so preoccupied with the problems stemming from their validation of obligations to contribute cash or property or to perform services in the future that they lost sight of the other possibilities. Whatever the reason, in terms of scope, section 502(a) hardly can be called an improvement over section 17 of the 1916 Act.

In the situation clearly covered, *i.e.*, failure to perform an obligation to furnish cash, property, or services in the future, the first sentence of section 502(a) affirms the legal obligation of the partner to perform, while the second prescribes the nature and amount of his or her liability. A statement that a partner is obligated to the partnership to perform the promise that is the subject matter of his or her capital contribution, even in the event of death or disability, is unremarkable in the case of promises to furnish cash or property. The general rule of contract law regarding personal services, however, is that death or disability of the promisor will excuse performance and any liability that otherwise would flow from nonperformance.⁷¹ This rule is subject to an exception that performance will not be excused if the contract clearly indicates that intent.⁷² At first blush, section 502(a) seems to have reversed the general rule and the exception, with the result that death or disability would not discharge the promising partner or his or her estate from performance, unless the certificate of limited partnership provided otherwise.

Such a reversal could be justified on the basis of the special context in which the promise to perform services in the future is made. Because the promise may constitute a contribution to capital, giving the promisor an equity interest in the limited partnership, nonperformance may affect adversely both the other partners and partnership creditors. The promisor may have been allocated partnership profits and losses and may have received distributions on the basis of the stated value of the promised services.⁷³ If, for any reason, the services are not performed, the effect will be the same as an overstatement of the promisor's contribution, with a resulting dilution in the other partners' investments. Section 502(a) also

69. *Id.* § 207.

70. Section 207 does not confine explicitly the class of potential plaintiffs to creditors, but rather, creates a cause of action in favor of "one who suffers loss by reliance" on a false statement. A partner, however, would have difficulty establishing the requisite reliance.

71. RESTATEMENT OF CONTRACTS § 459 (1932); 6 A. CORBIN, CONTRACTS §§ 1334-1335 (1962).

72. RESTATEMENT OF CONTRACTS § 459 & Comment e (1932); 6 A. CORBIN, *supra* note 71, § 1334.

73. See 1976 ACT, *supra* note 9, §§ 503-504; text accompanying notes 113-26 *infra*.

could be seen as embodying the theory that a partnership's capital represents a trust fund for the protection of its creditors, giving them a cushion of assets on which to rely for repayment of their claims.⁷⁴ Under this theory, to the extent promised services are not performed, creditors may be prejudiced.

While these two concerns may form the basis of section 502(a), a closer analysis of that section indicates that it actually does not depart from general contract principles, even to the extent of transposing the general rule and its exception. In the context of a simple employment relationship, an employer has a right to restitution of the unearned portion of a prepaid salary in the event death or disability excuses the employee's performance.⁷⁵ By permitting a promise of future services to be exchanged for a present equity position in the enterprise, the 1976 Act creates a situation analogous to a salary paid in advance. If death or disability prevents performance of the services, the partnership should be entitled to restitution in an amount equal to the difference between the value of the services actually performed and the original value of the property interest exchanged therefor. By providing that the promisor "is obligated at the option of the limited partnership to contribute cash equal to that portion of the value (as stated in the certificate of limited partnership) of the stated contribution that has not been made," section 502(a) merely restates this restitutionary measure of liability. Significantly, it does not purport to authorize recovery by the partnership of actual damages that might be suffered from loss of the promised services.⁷⁶

The statement that a partner who fails to contribute promised property or services "is obligated at the option of the limited partnership" to contribute an equivalent amount of cash is somewhat puzzling. Use of the term "option" suggests the availability of an alternative course of action, but what that alternative might be is not clear. One possibility is that the limited partnership has the option of not enforcing the obligation. This interpretation, however, not only results in section 502(a)'s belaboring the obvious, but also is defective in that it would apply, by its own terms, only to obligations to furnish property or services. It seems doubly absurd to codify a practical alternative open to any promisee, but to exclude from its operation obligations to contribute cash.

74. See Kessler, *supra* note 23, at 168-69; text accompanying notes 27-36 *supra*.

75. See RESTATEMENT OF CONTRACTS § 468(2), Illustration 5 (1932); 6 A. CORBIN, *supra* note 71, § 1368.

76. Actual damages for breach of a contract for personal services normally will include the cost of obtaining equivalent services. 5 A. CORBIN, *supra* note 71, § 1096. See RESTATEMENT OF CONTRACTS § 329, Illustration 5 (1932). It should be noted that § 502(a)'s restitutionary measure of recovery also applies in cases in which general contract principles would not excuse liability for nonperformance, such as intentional default. 1976 ACT, *supra* note 9, § 502(a) & Comment.

The only other apparent possibility is that the drafters intended to make available the option of specific enforcement of the obligation. This interpretation, if not qualified, would change radically the law of contracts in cases involving personal services or nonunique personal property.⁷⁷ It should not be adopted on the basis of such an ambiguous reference.⁷⁸ The problem is compounded by the drafters' explanations of section 502(a), which completely abandon the term "option" in favor of mandatory language.⁷⁹ In the last analysis, it may be that the drafters were attempting both to make clear the continuing obligation of a deceased or disabled partner and to preserve the option of specific performance, but only in situations in which it otherwise would be available. If this is the case, the single sentence they have chosen appears inadequate to the task.

Finally, the effect of an assignment of a partner's interest on the obligation to make a contribution should be noted. A simple assignment will not make the assignee a limited partner, nor will it result necessarily in the assignor ceasing to be a partner.⁸⁰ In such cases the assignment should have no effect whatsoever on the assignor's obligation to make a contribution. The assignee, however, may become a limited partner if the assignor so provides, in accordance with authority granted by the certificate of limited partnership, or if all other partners consent.⁸¹ If the assignee becomes a limited partner, section 704(b) provides that he or she also becomes "liable for the obligations of his assignor to make and return contributions as provided in Article 6."⁸² This same section contains an excep-

77. See RESTATEMENT OF CONTRACTS §§ 360, 379 (1932); 5A A. CORBIN, *supra* note 71, §§ 1143, 1204.

78. Kessler, *supra* note 23, at 168, states categorically that "[t]he partnership cannot force the limited partner to perform the promised services; it can only compel him to contribute in cash the difference between the value of any partial performance and the agreed value of the services as stated in the certificate." *But see* Gregory, *supra* note 39, at 482 ("Where the limited partner has received substantial profits from the partnership, it seems that the partnership could opt for equivalent services rather than cash value.").

79. For the drafters' explanation of § 502(a), see note 68 *supra*.

80. 1976 ACT, *supra* note 9, § 702. If the assignor assigns all of his or her interest, he or she will cease to be a partner unless the partnership agreement provides otherwise. *Id.*

81. *Id.* § 704(a).

82. *Id.* § 704(b). It should be noted that although § 704(b) speaks of liabilities for making and returning contributions as provided in Article 6, Article 6 imposes liability only with respect to contributions that have been returned. Liability for an unmade contribution is imposed by § 502(a), which is contained in Article 5. Thus, either the reference to making a contribution or the reference to Article 6 is in error. The discussion in text is based on the premise that the reference to Article 6 is erroneous. If, instead, the reference to making a contribution is the error, some of the problems discussed would be eliminated. The latter interpretation may be supported by the drafters' apparent recognition in §

tion "for liabilities unknown to the assignee at the time he became a limited partner and which could not be ascertained from the certificate of limited partnership."⁸³ Section 704(c) states that if the assignee becomes a limited partner, "the assignor is not released from his liability to the limited partnership under Sections 207 and 502."⁸⁴ While these rules largely are sensible, they do raise a few questions.

First, the exception to automatic assumption of liability by the assignee is analogous to typical corporate law provisions exempting from personal liability a good faith transferee of watered stock.⁸⁵ In such cases these provisions often expressly retain the liability of the transferor as a necessary concomitant to release of the transferee.⁸⁶ Section 704(c) is not so limited. It literally provides that the assignor remains liable regardless of whether the assignee is exempted. Since the certificate of limited partnership is required to set forth all obligations to make contributions,⁸⁷ it would seem that an assignee rarely, if ever, would be exempt from this category of liability. Thus, the result of an assignment in which the assignee becomes a limited partner is that the partnership and its creditors will acquire a second obligor. While this result will preclude an assignment to an impecunious assignee as a ruse to avoid one's obligations, it also means that a partner with an obligation to contribute capital in the future will be unable to divorce himself or herself in good faith from the business. As such, section 704(c) appears to be more restrictive than necessary to accomplish its purpose.

The exact nature of the assignor's and assignee's liability in such a case also is unclear. The practical effect of section 704(b) is that the assignee assumes the assignor's obligation by operation of law. By analogy to the law of suretyship, it could be concluded that the assignee becomes the principal obligor with the assignor remaining secondarily liable.⁸⁸ Such a result may be both equitable and in accord with the parties' intent in most instances, but its propriety is at least questionable when the subject matter of the obligation is services. Unfortunately, the 1976 Act offers no guidance in resolving this issue.

704(c) that it is § 502 that imposes liability for nonperformance of an obligation to make a contribution.

83. *Id.* § 704(b).

84. *Id.* § 704(c). This section perpetuates an error begun in § 19(7) of the 1916 Act. Section 207 imposes liability for false statements in the certificate of limited partnership, but this liability runs to one who suffers loss by reliance on the false statement, not to the partnership.

85. *See, e.g.*, CAL. CORP. CODE § 411 (West 1977); DEL. CODE ANN. tit. 8, § 162(c) (1974); ILL. ANN. STAT. ch. 32, § 157.23 (Smith-Hurd 1954); N.Y. BUS. CORP. LAW § 628(b) (McKinney 1963).

86. *See, e.g.*, DEL. CODE ANN. tit. 8, § 162(c) (1974); N.Y. BUS. CORP. LAW § 628(b) (McKinney 1963).

87. 1976 ACT, *supra* note 9, § 201(a)(5)-(6).

88. *See* RESTATEMENT OF SECURITY § 83(c) & Comment e (1941).

Finally, there appears to be a gap in the coverage of the statute with respect to the continuing liability of an assignor. It is possible for an assignor to terminate his or her status as a partner by a simple assignment of all of his or her interest in the partnership without the assignee becoming a limited partner.⁸⁹ Surprisingly, the 1976 Act nowhere expressly states that such an assignor remains liable for the performance of his or her obligation to make a contribution. Section 704(c) clearly is confined to situations in which the assignee becomes a limited partner. Although a similar result could be reached when the assignee does not become a limited partner on general principles of contract law, both certainty and symmetry militate in favor of an explicit statutory statement to this effect.

C. *Nonenforcement of Obligation*

The foregoing discussion has noted the possibility that a partner's obligation to contribute cash or property or to perform services might not be enforced. This eventuality has at least a theoretical impact on the other partners and on partnership creditors, and can occur in three different situations. The first involves the existence of a contractual duty that is discharged by compromise, and is covered by section 502(b). With respect to the other partners, section 502(b) states, "Unless otherwise provided in the partnership agreement, the obligation of a partner to make a contribution . . . may be compromised only by the consent of all the partners."⁹⁰ This provision is derived from section 17 of the 1916 Act⁹¹ and continues the general rule that recognizes the other partners' interest in performance of obligations to contribute capital by requiring unanimous consent to a compromise. Unlike section 17, however, section 502(b) explicitly authorizes the partnership agreement to vary the general rule in the interest of expediency.⁹² Unanimity may be a workable rule in the context of

89. 1976 ACT, *supra* note 9, § 702.

90. *Id.* § 502(b). The corresponding provision of the 1916 Act was drafted in terms of both waiver and compromise. 1916 ACT, *supra* note 7, § 17(3). "Compromise" denotes the settlement of a disputed claim and must be supported by consideration. 6 A. CORBIN, *supra* note 71, § 1278. "Waiver," on the other hand, has been used to describe not only agreements based on sufficient consideration, but also unilateral, donative discharges from contractual duties. 3A *id.* §§ 752, 766. Because it is uncertain in what sense the 1916 Act used the term "waiver," it equally is unclear whether the 1976 Act represents a conscious contraction of the methods by which an obligation may be discharged or merely the elimination of a redundancy.

91. 1916 ACT, *supra* note 7, § 17(3).

92. The law is unsettled under the 1916 Act on the question whether, absent specific statutory permission, the partners may vary a particular provision by an agreement that will be effective at least among themselves. Compare Lanier v. Bowdoin, 282 N.Y. 32, 24 N.E.2d 732 (1939) with Dycus v. Belco Indus., Inc., 569 P.2d 553 (Okla. Ct. App. 1977).

a relatively small, collegial firm, but it is totally unrealistic in the context of a large, publicly held limited partnership. Section 502(b) appears to have sufficient flexibility to accommodate the needs of both types of enterprises. In addition, a partnership agreement that varies the general rule would be executed by all partners and most commonly would vest the power to compromise in the general partners, whose self-interest on this issue usually would be aligned with that of the firm. Since they remain personally liable for partnership debts, one would not expect them to compromise other partners' obligations to make capital contributions without good cause. Compromise of their own obligations, in view of their ultimate unlimited liability, in many cases would be futile and, in any event, would be subject to strict standards of fiduciary accountability.⁹³

Regarding partnership creditors, section 502(b) provides:

Notwithstanding the compromise, a creditor of a limited partnership who extends credit, or whose claim arises, after filing of the certificate of limited partnership or an amendment thereto which, in either case, reflects the obligation, and before the amendment or cancellation thereof to reflect the compromise, may enforce the original obligation.⁹⁴

This provision carries over the rule of the 1916 Act⁹⁵ and represents a modification of the trust fund theory of limited partnership capital.

It has been recognized that creditors may enforce the liability of a limited partner to the partnership under section 17 of the 1916 Act,⁹⁶ and one would expect the same result under section 502(a). If the liability has been compromised, however, the duty to the partnership has been extinguished and an alternative theory of liability becomes necessary. The drafters of the 1916 and 1976 Acts apparently found a substitute in the "holding-out" theory, also borrowed from corporate law.⁹⁷ In the present context, this theory would treat the contributions section of the certificate

93. See *Newburger, Loeb & Co. v. Gross*, 563 F.2d 1057, 1067-68, 1079-80 (2d Cir. 1977), *cert. denied*, 434 U.S. 1035 (1978). See also *Riviera Congress Assocs. v. Yassky*, 18 N.Y.2d 540, 223 N.E.2d 876, 277 N.Y.S.2d 386 (1966); *Watson v. Limited Partners of WCKT, Ltd.*, 570 S.W.2d 179 (Tex. Civ. App. 1978); *Bassan v. Investment Exch. Corp.*, 83 Wash. 2d 922, 524 P.2d 233 (1974); *Roulac*, *supra* note 5, at 287-91.

94. 1976 ACT, *supra* note 9, § 502(b).

95. 1916 ACT, *supra* note 7, § 17(3). While continuing the basic policy of § 17(3), § 502(b) of the 1976 Act corrects a problem of overbreadth. See text accompanying notes 224-27 *infra*.

96. See *Donroy, Ltd. v. United States*, 301 F.2d 200 (9th Cir. 1962); *Linder v. Vogue Invs., Inc.*, 239 Cal. App. 2d 338, 48 Cal. Rptr. 633 (1966); *Engleman v. Malchow*, 91 Cal. App. 2d 341, 205 P.2d 413 (1949); *Kittredge v. Langley*, 252 N.Y. 405, 169 N.E. 626 (1930). But see *Bell Sound Studios, Inc. v. Enneagram Prods. Co.*, 36 Misc. 2d 879, 234 N.Y.S.2d 12 (Civ. Ct. N.Y. 1962).

97. See B. MANNING, *supra* note 33, at 46-48.

of limited partnership as a continuing representation on which creditors are entitled to rely until notified to the contrary. This theory, as embodied in section 502(b), logically can protect only those who become creditors during the period that the certificate of limited partnership indicates the continuing vitality of the compromised obligation. In effect, section 502(b) presumes that such persons relied on the certificate in extending credit and thus are entitled to protection from compromise of the obligation.⁹⁸ Such a presumption is contrary to fact in the case of tort claimants. Moreover, if most other creditors do not rely on the certificate of limited partnership in making the decision whether to extend credit,⁹⁹ section 502(b) singles out one group for protection on the superficial basis of a coincidence of timing.¹⁰⁰

Creditors, in general, probably will have standing to enforce the uncompromised liability of a partner under section 502(a), and at least some creditors expressly are given standing by section 502(b) even after a compromise. The cases decided under the corresponding provisions of the 1916 Act seem to be developing a test for creditor standing based on the solvency of the partnership.¹⁰¹ Under any theory of partner liability, such a test is sound.¹⁰² That the partner's liability initially is to the partnership is

98. Cf. 1976 ACT, *supra* note 9, § 207 (imposes liability for false statements in certificate of limited partnership, but requires showing of actual reliance by plaintiff). Section 207(2) extends this potential liability to statements originally true that have become false through a change in circumstances. The class of defendants, however, is confined to culpable general partners, who have unlimited personal liability for partnership obligations in any event. In addition, § 202(e) grants a 30-day grace period in which amendments to reflect a change in a partner's obligation to make a contribution may be filed without liability. *Id.* § 202(b)(1), (e).

99. See text accompanying notes 33-36 *supra*.

100. Cf. 1976 ACT, *supra* note 9, § 608(a)-(b) (discussed in text accompanying notes 232-40 *infra*). In the analogous situation of a shareholder who fails to pay the full consideration for his or her shares, California and Delaware extend liability to all creditors, without regard to the times at which their claims arose. CAL. CORP. CODE §§ 410, 414 (West 1977); DEL. CODE ANN. tit. 8, §§ 162(a)-(b), 325 (1974). The corresponding provision of the corporation law of Illinois implies the same result, while that of New York is silent on this issue. See ILL. ANN. STAT. ch. 32, § 157.23 (Smith-Hurd 1954); N.Y. BUS. CORP. LAW § 628 (McKinney 1963).

101. See cases cited note 93 *supra*.

102. There are two definitions of "insolvency." A debtor is insolvent under the equity test if he or she is unable to meet his or her obligations as they mature. Under the bankruptcy test, a debtor is insolvent if his or her liabilities exceed assets. To the extent an insolvency test is adopted to determine creditor standing under § 502, it is probable that the bankruptcy definition will be employed. Not only is this definition more consistent with the trust fund theory, but it also essentially is codified by § 607, which imposes a limitation on the ability of a partner-

made clear by section 502(a). Thus, enforcement of this liability by a creditor requires an exercise of equity jurisdiction based on the inadequacy of the creditor's legal remedies against the partnership. As long as the firm remains solvent, its creditors will not have suffered such injury as would justify the disruption of relations among the partners that such a suit necessarily would entail.¹⁰³

The second situation in which a partner may not be required to fulfill his or her obligation to supply cash, property, or services in the future already has been alluded to: the partnership may choose not to enforce the obligation. The decision whether to pursue a partnership cause of action normally will be made solely by the general partner or partners.¹⁰⁴ This result is not in conflict with section 502(b), which requires unanimous consent to compromise an obligation to make a contribution. As has been discussed, section 502(b)'s requirement of unanimity is subject to change by agreement, most commonly one vesting the power to compromise in the general partner or partners. In addition, unlike a compromise, a simple decision not to enforce does not discharge the promisor's duty. As long as the statute of limitations has not run, there remains the possibility of enforcement by a derivative suit instituted by any partner on behalf of the partnership.¹⁰⁵ Similarly, because the duty has not been discharged, the preceding discussion of enforcement by creditors is applicable to this situation.

The third situation in which a partner's obligation may not be enforced derives from the introductory clause of section 502(a), which states, "Except as provided in the certificate of limited partnership, a partner is obligated . . . to perform any promise to contribute cash or property or to perform services"¹⁰⁶ This clause clearly permits the certificate to prescribe conditions under which a partner's duty automatically will be discharged. Although not expressly so limited, this provision seems designed especially for service partners. Such persons often will contribute future services not only because they possess some special expertise or talent, but also because they do not have the personal capital to make contributions in other forms. Section 502(a) permits service partners to share

ship to make distributions of assets to partners. 1976 ACT, *supra* note 9, § 607. If a partner receives a return of his or her contribution under circumstances that render the partnership involvent under this test, he or she will incur liability to the partnership. *Id.* § 608(b). Because this liability is similar to liability for failure to make a promised contribution, and because § 502(b) controls the compromise of both types of liability, it seems likely that the bankruptcy definition will be used in all cases arising under § 502.

103. See, e.g., CAL. CORP. CODE § 414(a) (West 1977); DEL. CODE ANN. tit. 8, §§ 162(a)-(b), 325 (b) (1974).

104. See 1976 ACT, *supra* note 9, § 403.

105. See *id.* §§ 1001-1004.

106. *Id.* § 502(a).

in future earnings of the firm with the security of knowing that if they become disabled or die, they or their estates will not be saddled with a monetary obligation equal to the value of the unperformed services. Since the original certificate of limited partnership must be executed by all partners,¹⁰⁷ the effect, with respect to the other partners, often will be equivalent to the rules regarding compromises under section 502(b).

The requirement of inclusion in the certificate also seems intended to put partnership creditors on notice that the obligation may not be performed. Although in most cases the notice will be constructive only, no grave injustice should result. If, as argued previously, most creditors actually do not rely on the partners' capital contributions in determining whether to extend credit, they have no cause for complaint if an obligation to make a contribution is discharged by operation of a pre-existing, publicly filed document.

"Certificate of limited partnership," however, is defined by the 1976 Act to include the certificate as originally filed and as thereafter amended.¹⁰⁸ If the original certificate does not contain a provision under the authority of section 502(a), it is possible to insert one by amendment. From the creditors' perspective the crucial issue is retroactivity. While such amendments would be expected to apply only prospectively, it is possible that one might be attempted as a means of excusing an existing, although unmaturing, obligation. The similarity to a compromise is clear, but the governing law is not. Unless the policy of section 502(b) regarding existing creditors is to be subverted, the term "compromise" should be interpreted to encompass this type of amendment.¹⁰⁹

From the standpoint of the other partners, the issue is one of consent to the dilution of one's investment and can arise whether the amendment is retrospective or prospective. In this regard, it is important to recognize that amendments to the certificate of limited partnership need be executed only by one general partner and "each other partner designated . . . as a new partner or whose contribution is described as having been increased."¹¹⁰ In the present context this means that a provision excusing an obligation to make a contribution theoretically could be inserted in the certificate by the action of a single general partner. Such a procedure stands in sharp contrast with section 502(b)'s requirement of unanimous consent to the compromise of an obligation. Even if the partnership agree-

107. *Id.* § 204(a)(1).

108. *Id.* § 101(1).

109. Section 502(b)'s reference to an "amendment . . . to reflect the compromise" may be urged in support of this interpretation. The quoted language, however, merely appears to be a recognition of the duty to amend whenever a partner's obligation to make a contribution is compromised. *See id.* § 202(b)(1).

110. *Id.* § 204(a)(2). *Cf.* 1916 ACT, *supra* note 7, § 25(1)(b) (requiring amendments to be executed by all partners).

ment provides that unanimous consent to the specific compromise is unnecessary, all partners may be said to have given a general consent in advance by executing the agreement. No such claim can be made in the present situation unless it can be argued that the other partners have consented by becoming members of a limited partnership governed by the 1976 Act. Such an argument loses what little force it may have when the probability of the other partners having read the partnership agreement is compared with the probability of their having perused the intricacies of the 1976 Act. Moreover, to the extent such an amendment is prospective, it cannot be argued that it constitutes a "compromise" within the meaning of section 502(b).

Because the self-interests of general partners often may be against this sort of maneuver and because of their fiduciary duties,¹¹¹ the problem should not be overemphasized. Additionally, the notion of consent as applied to execution of a partnership agreement may be unrealistic in the case of large limited partnerships. Nevertheless, the ease with which amendments to take advantage of the exception in section 502(a) may be effected remains a deficiency in the 1976 Act. If the other partners are to be protected fully, they must secure a provision in the partnership agreement giving them the right to vote on this type of amendment.¹¹² The difficulty of obtaining such a provision suggests that it might have been better for the 1976 Act to have given it to them.

III. PROFITS, LOSSES, AND DISTRIBUTIONS

A. *Allocation Among Partners*

In sections 503 and 504, the 1976 Act provides that, in the absence of a controlling provision in the partnership agreement, profits and losses are to be allocated among the partners and distributions of cash or other assets are to be made "on the basis of the value (as stated in the certificate of limited partnership) of the contributions made by each partner to the extent they have been received by the partnership and have not been returned."¹¹³ The commentary to these sections notes that the 1916 Act contains no provisions governing the sharing of profits, losses, and distributions in the absence of agreement.¹¹⁴ Although section 2 of the 1916 Act requires the certificate of limited partnership to state the basis on which limited partners share in profits, there is no similar requirement regarding general partners.¹¹⁵ It also is possible that a certificate might omit such a

111. See text accompanying note 93 *supra*.

112. See 1976 ACT, *supra* note 9, §§ 302, 405. But see *id.* §§ 302, Comment, 303.

113. *Id.* §§ 503-504.

114. *Id.* §§ 503, Comment, 504, Comment.

115. 1916 ACT, *supra* note 7, § 2(1)(a)IX.

statement and still be accepted for filing.¹¹⁶ In these cases it would be necessary to resort to the Uniform Partnership Act to determine how profits and losses would be shared.¹¹⁷ Section 18 of that Act provides that, absent agreement, profits and losses are to be shared equally by the partners.¹¹⁸ While equal sharing of profits and losses may be a sound default rule in the context of a small general partnership, it hardly comports with the expectations of one who invests in a large, modern limited partnership. Such an investor would expect a return proportionate to the amount invested. This apparently is the effect of sections 503 and 504. Although the practical significance of these sections is reduced by the fact that virtually all professionally drafted limited partnership agreements will contain provisions specifically addressing the question of profits, losses, and distributions, they still are important in filling a gap in the 1916 Act in a way that is appropriate to modern limited partnerships.

Because there are separate, though identical, rules for sharing profits and losses and for sharing distributions, the clear implication is that two different things are visualized. The 1976 Act does not make explicit the exact nature of the distinction, but it is not really necessary that it do so. It seems fairly clear that section 503 merely refers to the basis on which net partnership profits or losses are to be apportioned among the partners on the partnership books. Section 504 relates to the basis on which the right of the partners actually to withdraw cash or other assets from the business is to be allocated. It is important to note that the issue dealt with by section 504 cannot arise unless the partners have agreed that actual distributions will be made.¹¹⁹ If no such agreement exists, any net profits will be allocated among the partners, but will remain in the firm essentially as reinvestments. It is equally important to recognize that a distribution bears no necessary relationship to a partner's allocable share of net partnership profit; it may be less than, equal to, or greater than such share. In other words, the term "distribution" seems intended to encompass payments out of current net profits, profits from previous years that may have been closed out into the partners' capital accounts, and original capital con-

116. "A limited partnership is formed if there has been substantial compliance in good faith with the requirements of paragraph (1)." *Id.* § 2(2).

117. "In any case not provided for in this act the rules of law and equity, including the law merchant, shall govern." *Id.* § 29. The Uniform Partnership Act provides, "[T]his act shall apply to limited partnerships except in so far as the statutes relating to such partnerships are inconsistent herewith." UNIFORM PARTNERSHIP ACT § 6(2). See *Bedolla v. Logan & Frazer*, 52 Cal. App. 3d 118, 127-28, 125 Cal. Rptr. 59, 66 (1975); *Horn v. Builders Supply Co.*, 401 S.W.2d 143, 148 (Tex. Civ. App. 1966).

118. UNIFORM PARTNERSHIP ACT § 18(a).

119. See 1976 ACT, *supra* note 9, § 601 (discussed in text accompanying notes 127-31 *infra*). But see *Kessler*, *supra* note 23, at 170.

tributions.¹²⁰ Finally, as the Comment to section 504 makes clear, distributions may be made on a completely different basis than that on which profits and losses are allocated.¹²¹ For example, the partners may agree that while profits and losses are to be allocated in proportion to capital contributions, each will have the right to withdraw an equal amount annually.

As previously stated, the default rules of sections 503 and 504 provide for the sharing of profits, losses, and distributions on the basis of the partners' contributions as listed in the certificate of limited partnership. This will result in a relatively static ratio and must be distinguished from one based on the amount in the various partners' capital accounts at subsequent points in time, such as at the beginning or end of any given accounting period. For example, if in a given year the partnership has a net profit, and some partners receive a distribution while others do not, the profit allocated to the latter normally is closed out into their capital accounts.¹²² Although such profit shares essentially constitute internal reinvestments in the enterprise, the proportion on which future allocations of profits, losses, and distributions will be based will not reflect this fact. In comparison, sections 503 and 504 do take into account additional capital investments from external sources because such investments will be reflected in the certificate of limited partnership.¹²³ The contrast in treatment becomes striking when one considers that the source of such an additional, external investment may be a previous distribution of cash or other assets from the partnership. For this reason, sections 503 and 504 may provide added incentive for the partners to reach their own agreement regarding these matters.

A final issue raised by these sections concerns their reference to contributions "to the extent they have been received by the partnership and have not been returned." This language, which has strong connotations of physical transfer, may cause some interpretive problems in the context of obligations to deliver cash or property or to perform services in the future. As discussed previously, however, the 1976 Act appears to consider the obligation to be a form of property.¹²⁴ If this is correct, such an obligation would be capable of being "received" by the partnership. "Return," when employed by the 1976 Act in connection with a partner's contribution, is a term of art that triggers certain consequences with respect to a particular distribution of cash or other assets.¹²⁵ As such, it also would seem to be

120. 1976 ACT, *supra* note 9, § 608(c) (discussed in text accompanying notes 132 & 133 *infra*) provides a method to determine whether a distribution constitutes a return of part or all of a partner's contribution.

121. *Id.* § 504, Comment.

122. H. SELLIN, *supra* note 55, § 10.01[4].

123. See 1976 ACT, *supra* note 9, §§ 101(1), 202(b)(1).

124. See text accompanying notes 37-39 *supra*.

125. See, e.g., 1976 ACT, *supra* note 9, §§ 601(2), 608.

capable of application to contributions that consist of obligations. Moreover, an interpretation of sections 503 and 504 that encompasses obligations to be performed in the future generally would be in accord with the parties' intent. If a binding obligation may constitute a present contribution, the normal expectation would be that it would generate a present benefit. Otherwise, there would be little reason for a person to obligate himself or herself presently.

One commentator, while agreeing with the above analysis in the allocation of profits and losses, has suggested that any distributions should be offset against the obligation to the extent it remains unperformed.¹²⁶ This suggestion is sound when applied to distributions that represent a return of part or all of the partner's contribution, but seems overly broad if intended to apply to distributions of earnings when the obligation is not in default. Again, if an obligation is to constitute a present contribution, it should be recognized not only for bookkeeping purposes under section 503, but also for actual distributions of income under section 504. In addition, if the obligation has not matured, offsetting a distribution that is not a return of the partner's contribution would be inconsistent with the terms of the bargain originally struck.

B. *Interim Distributions*

Section 601 of the 1976 Act states that, except as otherwise provided in Article 6, a partner is entitled to distributions of cash or other assets prior to his or her withdrawal from the firm, and prior to its dissolution:

- (1) to the extent and at the times or upon the happening of the events specified in the partnership agreement; and
- (2) if any distribution constitutes a return of any part of his contribution under Section 608(c), to the extent and at the times or upon the happening of the events specified in the certificate of limited partnership.¹²⁷

This section merely states the simple principle that the right to receive distributions, and any mechanism for determining that right, must be agreed on by the partners. The only real problem it presents is where that agreement must appear. Section 601 distinguishes distributions that represent a return of part or all of a partner's contribution from those that do not. The agreement respecting the former must appear in the certificate of limited partnership, while that respecting the latter may be contained in the partnership agreement. The rationale for this distinction again seems to be the trust fund theory. The premise is that partnership creditors are more endangered by a return of capital to the partners than by a distribution of current or accumulated earnings and, therefore, are entitled at least to constructive notice of when capital distributions may occur.

126. Shapiro, *The Need for Limited Partnership Reform: A Revised Uniform Act*, 37 MD. L. REV. 544, 562-63 (1978).

127. 1976 ACT, *supra* note 9, § 601.

The difficulty is that section 601, in permitting the right to noncapital distributions to be contained in the partnership agreement, does not coincide with the requirements of the 1976 Act governing the contents of the certificate of limited partnership. Section 201 provides, in apparently mandatory language, that the certificate shall state both "any right of a partner to receive, or of a general partner to make, distributions to a partner which include a return of all or any part of the partner's contribution" and "any right of a partner to receive distributions of property, including cash from the limited partnership."¹²⁸

It might be argued that section 201 is not mandatory with respect to noncapital interim distributions.¹²⁹ The primary basis for such an interpretation is the introductory phrase of section 601, which states that "[e]xcept as provided in this Article," a partner is entitled to interim distributions as set forth in section 601. This phrase could be viewed as expressly overriding section 201, with the result that inclusion in the certificate is permissive only. The more likely interpretation of this phrase, however, is that it is simply a method of superimposing a financial solvency limitation on distributions, contained in section 607, onto the provisions of section 601.¹³⁰ This interpretation is supported by the Comment to section 201, which states that the items it covers are matters "required" to be set forth in the certificate.¹³¹ In light of this conflict, the only safe course is to include all distribution rights in the certificate as well as in the partnership agreement.

Section 608(c), which provides the method for determining whether a distribution constitutes the return of a contribution, is another reason why all distribution rights should be set forth in the certificate. Section 608(c) states:

A partner receives a return of his contribution to the extent that a distribution to him reduces his share of the fair value of the net assets of the limited partnership below the value (as set forth in the certificate of limited partnership) of his contribution which has not been distributed to him [previously].¹³²

This section, which has no counterpart in the 1916 Act, requires a comparison between the agreed original value of a partner's contribution and his or her present equity in the partnership, based on current fair values. To the extent a distribution causes the former figure to exceed the latter, it will constitute a return of part or all of the partner's contribution. Because

128. *Id.* § 201(a)(9)-(10). *Cf.* 1916 ACT, *supra* note 7, §§ 2(1)(a)IX, 15 (certificate to state share of profits or other income to which each limited partner is entitled).

129. *See* Kessler, *supra* note 23, at 169-70, 170 n.74.

130. *See* text accompanying notes 134-44 *infra*.

131. 1976 ACT, *supra* note 9, § 201, Comment.

132. *Id.* § 608(c).

this is an individualized test, and because profits and losses may be allocated on a different basis than distributions, a given distribution may represent a return of the contributions of some partners, but not of others.¹³³ For this reason alone, it is imperative that all distribution rights be contained in the certificate.

Integrally related to sections 601 and 608(c) is section 607, which imposes a limitation on distributions similar to that of sections 15 and 16(1)(a) of the 1916 Act. This limitation provides that "[a] partner may not receive a distribution from a limited partnership to the extent that, after giving effect to the distribution, all liabilities of the limited partnership, other than liabilities to partners on account of their partnership interests, exceed the fair value of the partnership assets."¹³⁴ This section, like its predecessors, imposes an insolvency test, defined in the bankruptcy sense, and is the simplest and most lenient of the possible restrictions on distributions.¹³⁵ The complete exclusion from the computation of liabilities to partners on account of their partnership interests makes it clear that section 607 does not attempt to protect different classes of partners from each other or from themselves. In fact, because the only group receiving protection is partnership creditors, who presumably would receive substantially equivalent protection under a state's fraudulent conveyance law, the substantive necessity of section 607 may be open to question.¹³⁶ Its primary significance is as a method to determine the extent and duration of the liability under section 608 of a partner who receives a distribution.¹³⁷

Section 607, while similar to sections 15 and 16 of the 1916 Act, changes the law in some important respects. Sections 13 and 23 of the 1916

133. For example, profits and losses may be allocated in proportion to the partners' contributions, but distributions may be made on an equal basis. In such a case, if initial contributions were unequal in amount, a subsequent distribution may be a return of part or all of a small contributor's contribution while representing a distribution of current or accumulated profits with respect to a large contributor.

134. 1976 ACT, *supra* note 9, § 607.

135. Compare *id.* with CAL. CORP. CODE §§ 166, 500-503 (West 1977 & Cum. Supp. 1981); DEL. CODE ANN. tit. 8, §§ 160, 170 (1974 & Cum. Supp. 1980); ILL. ANN. STAT. ch. 32, §§ 157.6, .41, .48 (Smith-Hurd 1954 & Cum. Supp. 1980-1981); N.Y. BUS. CORP. LAW §§ 510, 513 (McKinney 1963 & Cum. Supp. 1980-1981).

136. See, e.g., UNIFORM FRAUDULENT CONVEYANCE ACT §§ 2, 8. In a related context, repayment by the limited partnership of loans or other debts owing to partners, the 1976 Act eliminates a similar insolvency restriction that is contained in the 1916 Act. Compare 1976 ACT, *supra* note 9, § 107 with 1916 ACT, *supra* note 7, § 13. The apparent basis for this change is the sufficiency of general fraudulent conveyance statutes. See 1976 ACT, *supra*, § 107, Comment.

137. See text accompanying notes 218-31 *infra*.

Act permit limited, but not general, partners to loan money to and transact business with the partnership on the same footing as outsiders.¹³⁸ As a result, sections 15 and 16 include in the insolvency computation any creditor claims of limited partners, but exclude those of general partners. Sections 107 and 804 of the 1976 Act eliminate the distinction between limited and general partners regarding the ability to assert claims against the partnership as creditors.¹³⁹ Consequently, section 607 includes all such claims in computing insolvency. While this change may be viewed as the logical quid pro quo for the elevated status given to general partners by sections 107 and 804, it will result in making impermissible some distributions that would be permissible under the 1916 Act.

Perhaps more significant is the difference between the claims based on equity interests that are excluded from the respective computations. Section 15 of the 1916 Act states that a limited partner may not receive a distribution of profits unless, after giving effect to the distribution, "partnership assets are in excess of all liabilities of the partnership except liabilities to limited partners on account of their *contributions* and to general partners."¹⁴⁰ Section 16 imposes a substantially identical limitation on the return of a limited partner's contribution.¹⁴¹ Read literally, this formula requires the excess of the value of a limited partner's equity interest in the partnership over the value of his or her capital contribution to be considered as a liability in determining whether the partnership is insolvent. The surely unintended effect is that any profits allocated to limited partners on the partnership books will not be available for distribution. This situation is corrected by section 607, which excludes the entire equity section of the balance sheet from the computation, with the result that an amount equal to net assets may be distributed.¹⁴²

Since section 607 on its face applies to all distributions, whether of current or accumulated profits or of the partners' contributions, it might be expected that the 1976 Act would impose correlative liability for receipt of any of these various types of distributions in violation of section 607. The only section imposing liability, however, is restricted expressly to distributions that are a return of part or all of a partner's contribution.¹⁴³ Although it might appear that there is a significant gap in the coverage of the 1976 Act in this respect, the combined effect of sections 607 and 608(c) makes it clear that this is not the case. Under section 608(c), a distribution constitutes a return of a partner's contribution to the extent it reduces his or

138. 1916 ACT, *supra* note 7, §§ 13(1), 23(1)(a), (d).

139. 1976 ACT, *supra* note 9, §§ 107, 804(1).

140. 1916 ACT, *supra* note 7, § 15 (emphasis added).

141. *Id.* § 16(1)(a).

142. See 1976 ACT, *supra* note 9, § 101(10). See also *Reiter v. Greenberg*, 21 N.Y.2d 388, 235 N.E.2d 118, 288 N.Y.S.2d 57 (1968).

143. 1976 ACT, *supra* note 9, § 608(b).

her share of the partnership's net assets below the stated value of his or her contribution. Because a distribution will violate section 607 only if it exceeds net assets, to the extent a distribution violates section 607 it necessarily will be a return of the recipient's contribution.¹⁴⁴

The rights of a partner with respect to an accrued, but unpaid, distribution are governed by section 606, which provides, "At the time a partner becomes entitled to receive a distribution, he has the status of, and is entitled to all remedies available to, a creditor of the limited partnership with respect to the distribution."¹⁴⁵ This section replaces section 16(4) of the 1916 Act, which gives a limited partner who unsuccessfully demands the return of his or her contribution the right to have the partnership dissolved and its affairs wound up.¹⁴⁶ The drafters and most commentators agree that the remedy granted by section 16(4) is drastic; it fails to consider the competing interests of other partners, who usually will wish the business to continue.¹⁴⁷ Premature dissolution, if accompanied by the termination and winding up of the business, may sacrifice going concern value and may also have severe tax consequences.¹⁴⁸ Of course, it could be argued that the other partners easily can prevent these drastic consequences simply by returning the contribution demanded.¹⁴⁹

Section 606, on the other hand, has been described by one commentator as a dangerous dilution of outside creditor protection because it permits a partner with an equity claim to compete with such creditors for partnership assets.¹⁵⁰ While the Comment to section 606 disavows such an intent by stating that "as between the partners" a partner entitled to a distribution is given creditor status,¹⁵¹ the statutory language is not so

144. A similar situation exists under the 1916 Act. *See* 1916 ACT, *supra* note 7, §§ 15, 16(1)(a), 17(2); A. BROMBERG, CRANE AND BROMBERG ON PARTNERSHIP § 46, at 263 n.26 (1968). Moreover, as discussed in text accompanying notes 140-42 *supra*, it seems possible to violate §§ 15 and 16(1)(a) even if a distribution does not exceed net assets. Nevertheless, because the limitations contained in these two sections are identical in effect, it would not seem possible to violate § 15 without also violating § 16. As a result of this redundant coverage, the liability imposed by § 17(2) appears more than sufficient.

145. 1976 ACT, *supra* note 9, § 606.

146. 1916 ACT, *supra* note 7, § 16(4).

147. 1976 ACT, *supra* note 9, § 606, Comment; Gregory, *supra* note 39, at 486; Shapiro, *supra* note 126, at 564.

148. For a succinct description of these tax consequences, which may include the realization of ordinary income, see Note, *Procedures and Remedies in Limited Partners' Suits for Breach of the General Partner's Fiduciary Duty*, 90 HARV. L. REV. 763, 780-83 (1977).

149. If the partnership is insolvent and the limited partner is proceeding under § 16(4)(b), it will not be possible to return his or her contribution without violating § 16(1)(a).

150. *See* Kessler, *supra* note 23, at 171.

151. 1976 ACT, *supra* note 9, § 606, Comment.

limited. Even so, the possibility of harmful competition seems minimal. As long as the partnership remains an ongoing enterprise generating sufficient earnings to pay creditors' claims as they mature, there is no cause for complaint. Direct competition between partners and creditors for partnership assets most commonly will occur on the liquidation of an insolvent partnership. In such situations section 804 will control the distribution of assets among the various parties, and this section clearly subordinates liabilities for accrued, but unpaid, distributions to claims of creditors.¹⁵²

Section 605 relates to the form a particular distribution may take and contains two separate, but related, rules. The first essentially is a recodification of section 16(3) of the 1916 Act, and states that "[e]xcept as provided in the certificate of limited partnership, a partner, regardless of the nature of his contribution, has no right to demand and receive any distribution from a limited partnership in any form other than cash."¹⁵³ The primary significance of this provision is that it permits the enterprise to retain assets, such as patents or real estate, that may be uniquely necessary to the continuance of its operations, even over the objection of the partner who originally contributed them. Presumably because any distribution of such assets at the demand of a single partner could have a disruptive effect not only on the other partners, but also on partnership creditors, any exceptions to the general rule must be contained in the certificate of limited partnership.¹⁵⁴

The second sentence of section 605 relates to the converse situation, and states that

[e]xcept as provided in the partnership agreement, a partner may not be compelled to accept a distribution of any asset in kind from a limited partnership to the extent that the percentage of the asset distributed to him exceeds a percentage of that asset which is equal to the percentage in which he shares in distributions from the limited partnership.¹⁵⁵

This provision seems important chiefly for tax reasons. For example, if a partnership makes a current distribution of property in kind, ordinarily neither the partnership nor the distributee partner will recognize a gain or

152. *Id.* § 804(1)-(2).

153. *Id.* § 605. *Cf.* 1916 ACT, *supra* note 7, § 16(3) (primary difference is that under § 16(3) a limited partner may receive property other than cash, even if the certificate does not so provide, if all other partners consent).

154. Section 201, which governs the contents of the certificate of limited partnership, makes only oblique reference to this situation when it states that the certificate shall set forth "any right of a partner to receive distributions of property, including cash from the limited partnership." 1976 ACT, *supra* note 9, § 201(a)(9). *Cf.* 1916 ACT, *supra* note 7, § 2(1)(a)XIV (certificate required to state any right of limited partner to receive property other than cash in return of his or her contribution).

155. 1976 ACT, *supra* note 9, § 605.

loss, and the partnership's basis in the property will carry over to the distributee.¹⁵⁶ In such a case section 605 will prevent the partnership from distributing a disproportionate share of low basis property to a particular partner. Similarly, it will protect a partner from being forced to accept a disproportionate amount of assets, the subsequent disposition of which will give rise to ordinary income rather than capital gain.¹⁵⁷ Apparently because it is believed that the interests of the other partners and of partnership creditors generally will be aligned in these types of situations, any exceptions to this second general rule of section 605 may be contained in the partnership agreement rather than in the certificate of limited partnership.¹⁵⁸

There are, however, some situations that may result in an unfair shifting of tax benefits and burdens that are not encompassed by section 605. One reason for this is that its first sentence provides that a partner has "*no right to demand and receive*" a distribution other than in cash. The second sentence states that a partner "*may not be compelled to accept*" a disproportionate distribution in kind. Thus, section 605 does not preclude the general partners from voluntarily favoring a particular partner by distributing to him or her a disproportionate amount of high basis property, provided that the distributee is willing to accept the favoritism. Although the Comment to section 605 states that the second sentence protects the other partners as well as the distributee,¹⁵⁹ the statutory language does not support this view.

In some circumstances a distributee partner may be prejudiced by a distribution solely in cash, a medium that he or she is compelled to accept by the first sentence of section 605. To the extent a cash distribution exceeds a partner's basis in his or her partnership interest, a gain will be recognized.¹⁶⁰ Moreover, to the extent the partnership has substantially appreciated inventory or unrealized receivables, a cash distribution may be treated as a sale by the partner of his or her interest in those assets, and any gain will be treated as ordinary income rather than as capital gain.¹⁶¹ The areas left untouched by section 605 once again demonstrate the importance of a carefully drafted certificate of limited partnership and partnership agreement.

IV. WITHDRAWAL

A. *Power to Withdraw*

The following discussion will consider the ability of a partner volun-

156. I.R.C. §§ 731, 732(a)(1).

157. *See id.* § 735(a).

158. *But see* 1976 ACT, *supra* note 9, § 201(a)(9).

159. *Id.* § 605, Comment.

160. I.R.C. § 731(a)(1).

161. *Id.* § 751(a)-(b).

tarily to withdraw or retire from a limited partnership and the effect of such a withdrawal. Since both the 1916 and 1976 Acts differentiate between general and limited partners regarding these issues, the examination of their respective provisions will be segregated similarly.

The 1916 Act does not use the term "withdraw" and contains no provision that speaks directly to the power of a general partner to withdraw from the firm. Nevertheless, section 20 clearly implies such a power by providing that the retirement of a general partner dissolves the partnership unless certain conditions are met.¹⁶² Elucidation of this power must be derived from the Uniform Partnership Act, indirectly referred to by section 9's provision that "[a] general partner shall have all the rights and powers and be subject to all the restrictions and liabilities of a partner in a partnership without limited partners."¹⁶³

The Uniform Partnership Act also does not use the terminology of "withdrawal," but the provisions concerning dissolution make it clear that a partner in a general partnership has the power to withdraw at any time.¹⁶⁴ Thus, it can be concluded that a general partner of a limited partnership formed under the 1916 Act has the power to withdraw at will.

Whether he or she has the right to withdraw is a separate issue. General partnerships may be either partnerships at will or partnerships for a particular term or undertaking. In the case of the former, a partner has not only the power, but also the right, to withdraw at any time.¹⁶⁵ In the latter, a partner has the power to withdraw prior to expiration of the term or accomplishment of the undertaking, but such withdrawal will be a breach of contract giving the other partners a statutory cause of action for damages.¹⁶⁶ Because section 2 of the 1916 Act requires the certificate of limited partnership to set forth "[t]he term for which the partnership is to exist,"¹⁶⁷ one could conclude that while a general partner of a limited partnership always has the power to withdraw, he or she never would have the right. As a result, withdrawal prior to expiration of the term would be a breach of contract for which the remaining partners presumably could recover damages under section 38 of the Uniform Partnership Act.¹⁶⁸ On the other hand, section 2 requires only substantial compliance, and it would seem possible for a certificate substantially to comply without stating a definite term.¹⁶⁹ In such a case a general partner would have both the power and the right to withdraw at will.

162. 1916 ACT, *supra* note 7, § 20.

163. *Id.* § 9(1). This conclusion is reinforced by *id.* § 29; UNIFORM PARTNERSHIP ACT § 6(2).

164. UNIFORM PARTNERSHIP ACT §§ 29, 31(1)(b), (2).

165. *Id.* § 31(1)(b).

166. *Id.* §§ 31(2) & Comment, 38(2)(a)II.

167. 1916 ACT, *supra* note 7, § 2(1)(a)V.

168. UNIFORM PARTNERSHIP ACT § 38(2)(a)II.

169. 1916 ACT, *supra* note 7, § 2(2). See A. BROMBERG, *supra* note 144, § 90B, Published by University of Missouri School of Law Scholarship Repository, 1981

The effect of withdrawal of a general partner will be dissolution of the firm under section 20 of the 1916 Act, unless the business is continued by the remaining general partner or partners, either under a right to do so stated in the certificate of limited partnership or with the consent of all members.¹⁷⁰ Section 20 treats dissolution and continuation of the business under either of its two conditions as mutually exclusive. This is significant because if there is even a technical dissolution, any limited partner may demand the return of his or her contribution.¹⁷¹ If the demand is not met, he or she may force liquidation of the firm.¹⁷² Even if those who wish to continue the business are willing to return the contributions demanded, the demands may outstrip the firm's liquid assets, with the end result again being liquidation. Thus, to insure continuation of the enterprise there must be at least one remaining general partner at the time of withdrawal and the right to continue must be stated in the certificate. If there is not at least one remaining general partner, the continuation provisions of section 20 are inoperative by their own terms. If the right is not given by the certificate, unanimous consent to continuation is necessary. Consequently, any single partner has the power to force dissolution and winding up.

The operation of these provisions, especially in the case of a limited partnership for a definite term, can be severe. The simple withdrawal of a general partner may give limited partners the right to demand the return of their contributions, which in turn may force an end to the enterprise.¹⁷³ The only justification for this result is that the limited partner's original investments may have been made in reliance on the continued association of a particular general partner with the firm, especially since control of the business is vested exclusively in the general partners.¹⁷⁴ It may be questioned, however, whether this possible reliance interest is sufficient to justify the potentially drastic relief afforded by the 1916 Act.

The 1976 Act, in section 602, speaks specifically to the power of a general partner to withdraw:

A general partner may withdraw from a limited partnership at any time by giving written notice to the other partners, but if the withdrawal violates the partnership agreement, the limited partnership may recover from the withdrawing general partner damages for breach of the partnership agreement and offset the damages against the amount otherwise distributable to him.¹⁷⁵

at 517 & n.1; Bromberg, *Partnership Dissolution—Causes, Consequences, and Cures*, 43 TEX. L. REV. 631, 641 (1965). See also 1916 ACT, *supra*, § 16(2)(c).

170. 1916 ACT, *supra* note 7, § 20. See *id.* §§ 2(1)(a)XIII, 9(1)(g).

171. *Id.* § 16(2)(a).

172. *Id.* § 16(4). See note 148 and accompanying text *supra*.

173. UNIFORM PARTNERSHIP ACT § 38(2)(b) is similar. If a partner wrongfully dissolves the firm, the innocent partners have a statutory option to continue the business, but only if all agree. See *id.* § 38(2)(a)I.

174. 1916 ACT, *supra* note 7, §§ 7, 9(1), 10.

175. 1976 ACT, *supra* note 9, § 602.

The primary virtue of section 602 is that it obviates the necessity of referring to the Uniform Partnership Act to determine the power and the right of a general partner to withdraw from a limited partnership. It makes clear that a general partner always will have the power to withdraw. Whether he or she also will have the right depends on the terms of the partnership agreement.

On its surface, section 602 does not appear to change existing law significantly. The clause giving the partnership a cause of action for damages if the withdrawal "violates the partnership agreement," however, is troublesome. Although it is clearer under the 1976 Act than under the 1916 Act that a limited partnership may exist at will,¹⁷⁶ it is obvious that a definite term or particular undertaking also may be agreed on.¹⁷⁷ The difficulty is that any such term or undertaking must be set forth in the certificate of limited partnership.¹⁷⁸ Similarly, the certificate must include any agreement respecting "the time at which or the events on the happening of which a partner may terminate his membership in the limited partnership."¹⁷⁹ While many partnership agreements restate the items included in the certificate, this is not always the case. As a result, section 602's exclusive reference to the partnership agreement seems too narrow.¹⁸⁰

The effect of a general partner's withdrawal under the 1976 Act is much the same as it is under the 1916 Act. It will result in dissolution and winding up under section 801, unless the business is continued by the remaining general partner or partners under a right stated in the certificate, or unless all partners agree within ninety days to continue the business and, if necessary, to appoint one or more additional general partners.¹⁸¹ The primary difference between the 1916 and 1976 Acts involves the withdrawal of a sole general partner. Under section 20 of the 1916 Act, at least a technical dissolution is inevitable in such a situation. Under section 801, dissolution may be prevented by appointment of a successor general partner within ninety days after the withdrawal. The more serious problem that exists under the 1916 Act, the ability of a single dissenter to prevent continuation of the business unless there are both a remaining general partner and a right to continue stated in the certificate, is not rectified by the 1976 Act. In fact, section 801 may be a step backwards because, unlike

176. *Id.* § 201(a)(11). *See id.* § 603.

177. *Id.* § 201(a)(11).

178. *Id.*

179. *Id.* § 201(a)(8). This provision closely parallels § 603, which controls withdrawal of limited partners. On its face, however, it applies to all partners, both general and limited. *See id.* § 101(8).

180. *Id.* § 101(9) defines "partnership agreement" as "any valid agreement, written or oral, of the partners as to the affairs of a limited partnership and the conduct of its business." Although this definition is broad enough to encompass the certificate as a part of the partnership agreement, the remainder of the 1976 Act seems to view the two terms as mutually exclusive. *See, e.g., id.* §§ 601, 605.

181. *Id.* § 801(3). *See id.* §§ 201(a)(12), 401.

section 20, it mandates not only dissolution, but also winding up, in every instance in which it applies. Retention of the requirement of unanimity is questionable from a policy standpoint and seems inconsistent with section 606, which gives partners creditor status with respect to accrued, but unpaid, distributions, but which removes their right to have the firm dissolved.¹⁸²

Finally, it should be noted that "an event of withdrawal of a general partner," as used in section 801, is a term of art with a broader meaning than the simple voluntary retirement from the business contemplated by section 602. It encompasses such additional occurrences as assignment of a general partner's entire partnership interest, removal, insolvency, death, and incompetency.¹⁸³

In contrast to its coverage of general partners, the 1916 Act is explicit and restrictive regarding the withdrawal of a limited partner. Provided that the partnership is solvent, section 16 permits a limited partner to withdraw his or her contribution in the following four circumstances: (1) if all members consent; (2) if the partnership has been dissolved; (3) if the date set in the certificate for return of the limited partner's contribution has arrived; or (4) if no time is set in the certificate for either dissolution or return of the limited partner's contribution, on six months' prior written notice to all members.¹⁸⁴ Section 16 focuses exclusively on severance of a limited partner's financial, not personal, relationship with the firm. Because severance of personal ties is not addressed by the 1916 Act and withdrawal of a capital contribution does not necessarily import such a severance, it seems possible for a limited partner to remain a member even after the return of his or her contribution.¹⁸⁵ Conversely, a person could relinquish membership while leaving his or her capital at the risk of the business.¹⁸⁶ Normally, however, a limited partner would not wish to disassociate himself or herself from the partnership without the return of his or her contribution. Thus, section 16 effectively restricts the ability of a limited partner to withdraw at will (on six months' notice) to situations in which the certificate specifies neither a time for dissolution nor a time for return of the limited partner's contribution.

182. See *id.* § 606 & Comment. One explanation for the difference between § 606 and § 801 is the possibility of investment in reliance on a particular general partner. See text accompanying note 174 *supra*. This possibility is present in cases falling under § 801, but not in those falling under § 606.

183. 1976 ACT, *supra* note 9, §§ 101(3), 402.

184. 1916 ACT, *supra* note 7, § 16(1)(a)-(b), (2). See *id.* § 2(1)(a)V, VIII.

185. See *Wilson v. United States*, 246 F. Supp. 613, 623 (N.D. Cal. 1965). Such a limited partner would continue to possess the rights enumerated in 1916 ACT, *supra* note 7, § 10.

186. Cf. 1916 ACT, *supra* note 7, § 11 (providing that person who contributes capital to business in the erroneous belief that he or she is a limited partner may avoid general liability by renouncing his or her interest in income of business).

This restriction presumably stems from the role of limited partners as suppliers of capital and the necessity of maintaining a reliable and predictable amount of capital in the business. Moreover, this limitation on the freedom of limited partners to withdraw is justifiable. The power of a general partner to withdraw at will is supported on an agency basis.¹⁸⁷ It is fundamental that an agency relationship is dependent on the continuing consent of both the principal and the agent and that either may withdraw such consent at any time, even though to do so may be a breach of contract.¹⁸⁸ Both as an agent rendering services for the partnership and as a principal with unlimited liability for the acts of other agents, a general partner may not be forced to continue in the business against his or her will. In contrast, a limited partner is not in an agency relationship by virtue of his or her membership in the firm. In fact, the 1916 Act does not treat such investors as true partners in any sense.¹⁸⁹ He or she may not contribute services to the partnership's capital, and his or her liability is limited to the amount invested.¹⁹⁰ For these reasons, section 16's restrictions on withdrawal strike a good balance between the interests of the partnership and the interests of its limited partners.

Unlike the withdrawal of a general partner, withdrawal of a limited partner will not dissolve the partnership under the 1916 Act.¹⁹¹ If, however, a limited partner rightfully, but unsuccessfully, attempts to withdraw his or her contribution, he or she may have the partnership dissolved and its affairs wound up.¹⁹²

Section 603 of the 1976 Act provides for the withdrawal of limited partners as follows:

A limited partner may withdraw from a limited partnership at the time or upon the happening of events specified in the certificate of limited partnership and in accordance with the partnership agreement. If the certificate does not specify the time or the events upon the happening of which a limited partner may withdraw or a definite time for the dissolution and winding up of the limited partnership, a limited partner may withdraw upon not less than 6 months' prior written notice to each general partner at his address on the books of the limited partnership at its office in this State.¹⁹³

187. A. BROMBERG, *supra* note 144, §§ 75(a), 90B(b).

188. RESTATEMENT (SECOND) OF AGENCY § 1(1), 118 & Comment b-c (1957).

189. 1916 ACT, *supra* note 7, § 1, Comment; A. BROMBERG, *supra* note 144, § 90B(a); Bromberg, *supra* note 169, at 640.

190. 1916 ACT, *supra* note 7, §§ 1, 4.

191. *Id.* §§ 1, Comment, 20 (by implication). See *Wilson v. United States*, 246 F. Supp. 613, 623 (N.D. Cal. 1965); *Brown v. Brown*, 15 Ariz. App. 333, 337, 488 P.2d 689, 693 (1971); Bromberg, *supra* note 169, at 641, 643.

192. 1916 ACT, *supra* note 7, § 16(4).

193. 1976 ACT, *supra* note 9, § 603.

Although this provision is derived from section 16 of the 1916 Act,¹⁹⁴ it differs from its source in a number of respects. First, it purports only to govern the severance of a limited partner's personal relationship with the firm and not his or her financial relationship. The latter is covered separately in section 604, discussed below.¹⁹⁵ For this reason, section 16's requirement that the partnership be solvent has been omitted. Similarly, the reference to withdrawal on dissolution has been dropped. If the partnership has been dissolved, the element of personal association already will have been terminated. The question of distribution of assets properly is left to section 804, the general provision governing liquidating distributions.¹⁹⁶

A second change made by section 603 is the elimination of express permission to withdraw on the consent of all other members. The purpose and effect of this change are unclear; there appears to be no reason why a limited partner should not be able to withdraw if no one objects. It is possible that the drafters believed the express permission of section 16 was superfluous, but the same criticism could be made in other situations in which unanimous consent provisions have been retained.¹⁹⁷ In addition, one would expect an elimination on the ground of superfluity at least to be mentioned in the drafters' comments.¹⁹⁸ Because it is uncertain whether the drafters affirmatively intended to change the law in this regard and, if so, what the policy basis of the change might be, it is hoped that section 603 will not be interpreted as impliedly prohibiting withdrawal on unanimous consent.

Section 603 also makes several changes in the operative details of those provisions that have been carried over from section 16. A limited partner may withdraw either at the time or on the occurrence of the events specified in the certificate of limited partnership. Thus, contingent powers to withdraw specifically are authorized. In either case, however, a limited partner must comply with any procedures established by the partnership agreement. He or she also may withdraw on six months' prior written notice if the certificate specifies neither the time or events giving a right to withdraw nor a definite time for dissolution and winding up of the partnership. Inclusion of the adjective "definite" is especially significant because it permits withdrawal on six months' notice in situations where the certificate sets a term for the partnership that is indefinite or is measured by events of indefinite occurrence.¹⁹⁹ Finally, the necessary recipients of the notice sensibly have been confined to the general partners.

194. *Id.* § 603, Comment.

195. See text accompanying notes 206-15 *infra*.

196. See 1976 ACT, *supra* note 9, § 804.

197. See, e.g., *id.* §§ 301(a)(1), 704(a)(2), 801(2).

198. Compare *id.* § 603, Comment with *id.* § 703, Comment.

199. See *id.* § 201(a)(11); A. BROMBERG, *supra* note 144, § 90B, at 517 n.1; Bromberg, *supra* note 169, at 641 & n.58.

Notwithstanding these changes, the ability of a limited partner to withdraw remains more restricted than that of a general partner. As discussed previously, the 1916 Act's distinction in treatment seems to be premised on the differing roles of general and limited partners—general partners are both principals and agents in the business while limited partners are inactive suppliers of capital. Thus, general partners always must have the power to sever their personal relationships with the firm, but limited partners need not, and should not, be given a coextensive power to sever their financial relationships. The 1976 Act continues the basic difference in the respective roles of general and limited partners.²⁰⁰ Although the restrictions on withdrawal contained in section 603 are similar to those of section 16, on their face they are wide of the mark because they concern exclusively a limited partner's personal, rather than financial, relationship with the firm. It may be questioned, therefore, whether there is any countervailing partnership interest that would justify these restrictions on a limited partner's power to disassociate his or her person, as distinguished from finances, from the enterprise.

The answer may be found in section 604, which entitles any withdrawing partner, general or limited, to a distribution in the amount of his or her interest in the partnership.²⁰¹ A partner normally will not wish to withdraw without a concurrent recovery of his or her investment. As a practical matter, the combination of sections 602 and 604 implements the policy permitting general partner withdrawal at will, while the combination of sections 603 and 604 implements the policy protecting the financial integrity of the firm against precipitous limited partner withdrawal.

The view that section 603 ultimately is concerned with matters of finance is reinforced by section 702, which states that unless the partnership agreement provides otherwise, a partnership interest is assignable, and a person ceases to be a partner on the assignment of his or her entire partnership interest.²⁰² Assuming the availability of potential assignees, section 702 effectively permits a limited partner to discontinue his or her personal relationship with the firm at will. Whether the assignment is gratuitous or for value, however, it will not occasion the distribution of any partnership assets.

Finally, although a limited partner is considered to be a "partner" by the 1976 Act,²⁰³ his or her withdrawal continues to have no effect with regard to dissolving the partnership.²⁰⁴ Unlike the situation under the 1916 Act, however, a limited partner who does not receive the distribution to which he or she is entitled possesses no statutory right to have the firm

200. See 1976 ACT, *supra* note 9, §§ 303(a), 403.

201. *Id.* § 604. See text accompanying notes 206-15 *infra*.

202. 1976 ACT, *supra* note 9, § 702.

203. *Id.* § 101(8).

204. *Id.* § 801 & Comment (by implication).

dissolved and its affairs wound up. Rather, he or she merely is given the status of a partnership creditor with respect to the distribution.²⁰⁵

B. *Distribution on Withdrawal*

Section 604, which has no counterpart in the 1916 Act, provides a method for determining the distribution to which a partner is entitled on withdrawal. It states:

Except as provided in this Article, upon withdrawal any withdrawing partner is entitled to receive any distribution to which he is entitled under the partnership agreement and, if not otherwise provided in the agreement, he is entitled to receive, within a reasonable time after withdrawal, the fair value of his interest in the limited partnership as of the date of withdrawal based upon his right to share in distributions from the limited partnership.²⁰⁶

As in section 601(1),²⁰⁷ the reference to "partnership agreement" is troublesome in light of section 201's apparent requirement that, if agreed on, the certificate shall state "the amount of, or the method of determining, the distribution to which . . . [a withdrawing partner] may be entitled respecting his partnership interest, and the terms and conditions of the . . . distribution."²⁰⁸ Once again, because section 604 begins with the phrase, "Except as provided in this Article," it may override section 201, with the effect that the latter's provision is permissive rather than mandatory.²⁰⁹ Unlike the situation under section 601, however, there appears to be no logical explanation of why the drafters would wish to make a certificate provision regarding this important matter permissive only, and why, in either case, they would choose such an obscure and tortured method of accomplishing the result. Moreover, their intent not to do so is even clearer in the case of section 604. Not only does the Comment to section 201 speak in terms of the matters "required" to be set forth in the certificate, but it specifically states that one of the two principal functions of the certificate is "to place creditors on notice of the facts concerning the capital of the partnership and the rules regarding additional contributions to and *withdrawals from* the partnership."²¹⁰ Consequently, the introductory "except" phrase again merely seems to be a means to incorporate the general insolvency limitation on distributions, contained in section 607, into the framework of section 604.²¹¹

If the partners have not agreed on the distribution to which a withdrawing partner is entitled, section 604 provides for a distribution equal to

205. *Id.* § 606. See text accompanying notes 145-52 *supra*.

206. 1976 ACT, *supra* note 9, § 604.

207. See text accompanying notes 127-31 *supra*.

208. 1976 ACT, *supra* note 9, § 201(a)(8). See *id.* § 201(a)(9)-(10).

209. See Kessler, *supra* note 23, at 169-70 & n.74.

210. 1976 ACT, *supra* note 9, § 201, Comment (emphasis added).

211. See text accompanying notes 134-44 *supra*.

"the fair value of his interest in the limited partnership as of the date of withdrawal based upon his right to share in distributions from the limited partnership."²¹² In this single clause, the drafters have created a statutory right to a distribution, provided a method of determining the amount of the distribution, and fixed the effective date for such determination.

The most critical concept embodied in this portion of section 604 is that the value of a partner's interest in the partnership is to be calculated on the basis of his or her other distribution rights. Partners may share in distributions in any manner on which they agree, and absent agreement, they share in proportion to the stated value of their respective capital contributions to the extent received by the partnership and not returned.²¹³ Thus, if distributions are made in proportion to each partner's capital contribution, a withdrawing partner's distributive share will be equal to the fair value of the partnership's net assets as of the date of withdrawal multiplied by the percentage of total contributions that his or her contribution represents. If distributions are made equally to all partners, a withdrawing partner's distributive share will be equal to the fair value of

212. It is clear that the drafters intended § 604 to be read alternatively; a withdrawing partner is entitled to receive either the distribution provided by the partnership agreement or, if the agreement is silent, the fair value of his or her interest in the partnership. 1976 ACT, *supra* note 9, § 604, Comment. This also is the interpretation uniformly assumed by the commentators. See Gregory, *supra* note 39, at 485; Kessler, *supra* note 23, at 171; Shapiro, *supra* note 126, at 565-66. Unfortunately, § 604 abandons the clear two-sentence structure used in other default provisions. See, e.g., 1976 ACT, *supra*, §§ 503-504, 603. Instead, it states that a withdrawing partner "is entitled to receive any distribution to which he is entitled under the partnership agreement and, if not otherwise provided in the agreement, he is entitled to receive . . . the fair value of his interest in the limited partnership." *Id.* § 604 (emphasis added). This language makes it possible to interpret § 604 as entitling a withdrawing partner to any distribution provided in the agreement and, in addition, to the fair value of his or her interest in the partnership, unless the agreement negates the latter. For example, a partnership agreement might provide that a withdrawing partner is entitled to the return of his or her original capital contribution. See, e.g., 1 J. RABKIN & M. JOHNSON, CURRENT LEGAL FORMS Form 2.01 (1980). In such a case, § 604 could be interpreted to entitle a partner not only to the return of his or her contribution, but also to any accretions to that contribution derived from profitable operations. Such an interpretation would be contrary both to the intent of the drafters and to the intent of the partners, who usually would view their agreement regarding distribution rights as exclusive. Moreover, because § 604 entitles a partner to the fair value of his or her interest in the partnership, which generally would include his or her original capital contribution, there would be considerable overlap between the distribution covered by the agreement and that granted by § 604. For all of these reasons, § 604 should be interpreted as providing for mutually exclusive alternatives.

213. 1976 ACT, *supra* note 9, § 504. See text accompanying note 113 *supra*.

the partnership's net assets as of the date of withdrawal divided by the total number of partners. In this regard, it is important to note that partnership profits and losses may be allocated on a different basis than that on which distributions are made.²¹⁴ Section 604's exclusive reference to distributions makes it clear that, to the extent there is a difference, the partners' distribution rights will control.²¹⁵

C. *Liability on Return of Contribution*

Although it is possible for a partner to receive the return of part or all of his or her contribution in the context of an interim distribution,²¹⁶ such a return most often will occur on withdrawal.²¹⁷ Both the 1916 and 1976 Acts provide for the liability of a partner who receives the return of his or her contribution either rightfully or wrongfully, and also for compromise of the liability of a partner in the latter instance. While the 1976 Act makes a number of changes in detail, it continues the basic thrust of the 1916 Act. The following discussion first will outline the three basic rules common to both Acts, noting the changes effected by the 1976 Act, and will conclude with an examination of the policy choices represented by those three rules.

Both Acts distinguish a rightful from a wrongful distribution of a partner's contribution on the dual bases of whether it violates the arrangement of the partners, *inter se*, and whether the partnership is insolvent or will be

214. 1976 ACT, *supra* note 9, §§ 503-504 & Comment. See text accompanying note 121 *supra*.

215. It should be mentioned that in § 604 the drafters have departed from their otherwise uniform use of the term "partnership interest," in favor of "interest in the limited partnership." Compare 1976 ACT, *supra* note 9, § 604 with *id.* §§ 301(a), 701-703, 704(a), (c), 804(3). Because "partnership interest" is defined as "a partner's share of the profits and losses of a limited partnership and the right to receive distributions of partnership assets," *id.* § 101(10), it has been suggested that the change was necessary to avoid circularity. Kessler, *supra* note 23, at 171 n.89. The circularity, however, would seem no worse than § 604's internal circularity in defining a partner's right to a distribution on withdrawal by reference to his or her right to share in partnership distributions. Alternatively, the drafters may have believed different terminology was required because the distributive share is to be calculated without regard to the partnership's method of allocating profits and losses. Unfortunately, a similar problem is solved in § 804(3) by providing that on winding up, a partnership's assets are to be distributed, *inter alios*, to partners "respecting their partnership interests, in the proportions in which the partners share in distributions." The confusion is compounded by the Comment to § 804 which, like § 604, speaks of "interests in the partnership." Probably the safest conclusion is that no difference in meaning was intended and that § 604's terminology merely is the result of a drafting oversight.

216. 1976 ACT, *supra* note 9, §§ 601(2), 608(c). See text accompanying notes 132 & 133 *supra*.

217. 1976 ACT, *supra* note 9, §§ 604, 608(c).

rendered insolvent by the distribution.²¹⁸ Because the ultimate question most often will be the extent of the recipient partner's liability to partnership creditors, the latter criterion is more significant.²¹⁹

Under the 1916 Act, a limited partner holds as trustee for the partnership any money or other property received as a wrongful return of his or her contribution.²²⁰ The 1976 Act eliminates the term "trustee," but recodifies the trust fund theory by imposing monetary liability in the amount of the contribution wrongfully returned.²²¹ It also broadens the class of partners covered to include general as well as limited partners and adds a six-year statute of limitations.²²²

The liability of a limited partner who has received a wrongful return of his or her contribution may be compromised under the 1916 Act by the unanimous consent of the partners.²²³ No compromise, however, is effective against a partnership creditor "who extended credit or whose claim arose after the filing and before a cancellation or amendment of the certificate."²²⁴ This provision, which is based on the holding-out theory, attempts to protect those who may have extended credit to the partnership in reliance on the certificate of limited partnership during the period it reflected the withdrawn capital contribution. As drafted, however, it is broader than necessary to accomplish this purpose. The original certificate, of course, will not reflect the contributions of subsequently admitted limited partners. Thus, it would be impossible for creditors who extend credit during the period between the original filing date and the date of an amendment reflecting the admission of a new limited partner to rely on the certificate with respect to the contribution of that limited partner.²²⁵

218. 1916 ACT, *supra* note 7, § 16(1)-(2); 1976 ACT, *supra* note 9, §§ 607-608(a)-(b).

219. Both Acts formulate the recipient partner's liability initially as liability to the partnership, but it may be enforced by partnership creditors if the partnership is, or becomes, insolvent. *See* cases cited note 96 *supra*.

220. 1916 ACT, *supra* note 7, § 17(2)(a)-(b).

221. 1976 ACT, *supra* note 9, § 608(b).

222. *Id.*

223. 1916 ACT, *supra* note 7, § 17(3). Although § 17(3) begins by stating that "[t]he liabilities of a limited partner as set forth in this section can be waived or compromised," it is apparent that it is not meant to apply to the liability under § 17(4) of a limited partner who has received the return of his or her contribution rightfully. While this conclusion is suggested by the mere placement of the subsections, it is made definite by the fact that the number of classes of creditors to which a partner is exposed is greater under § 17(3) than under § 17(4). Thus, if § 17(3) applied to the compromise of liability premised on § 17(4), it would result in an increase, rather than a decrease, in potential liability.

224. *Id.* § 17(3).

225. The certificate must be amended on the admission of any new or substituted limited partner. *Id.* § 24(2)(b)-(c).

Nevertheless, such creditors apparently have the right to enforce any liability arising from the wrongful return of such a limited partner's contribution. The 1976 Act, in addition to authorizing compromises by less than unanimous consent if permitted by the partnership agreement²²⁶ and expanding its coverage to include general partners, corrects this defect. It states that, notwithstanding the compromise of a partner's obligation to repay a wrongfully withdrawn contribution, "a creditor . . . who extends credit, or whose claim arises, after the filing of the certificate of limited partnership or an amendment thereto which, in either case, reflects the obligation, and before the amendment or cancellation thereof to reflect the compromise, may enforce the original obligation."²²⁷

Even if a limited partner has secured the return of his or her contribution rightfully, the 1916 Act imposes continuing liability "for any sum, not in excess of such return with interest, necessary to discharge [the partnership's] liabilities to all creditors who extended credit or whose claims arose before such return."²²⁸ Because the partnership must be solvent at the time of a distribution in order for it to be rightful, the effect of this provision is to shift partially the risk of subsequent insolvency from existing creditors to the withdrawing limited partner, who will bear this risk as long as any existing creditor remains unpaid.²²⁹ The provision also suffers from a problem of overbreadth in the case of subsequently admitted limited partners similar to that present in the provision governing compromises of liability for wrongful returns. The drafters of the 1976 Act have accepted the proposition that there should be continuing liability, but have ameliorated some of the harshness of the 1916 Act in the following ways: the provision authorizing recovery of interest in addition to the principal amount of the contribution has been omitted; a short, one-year statute of limitations has been added; and the class of creditors covered has been narrowed to include only those "who extended credit to the limited partnership during the period the contribution was held by the partnership."²³⁰ It should

226. See text accompanying notes 90-93 *supra*.

227. 1976 ACT, *supra* note 9, § 502(b). Use of the term "obligation" is not strictly accurate in this context because the certificate will reflect only the contribution, not the obligation to repay it. The intent of the drafters, however, is clear. Their choice of terminology probably is because this same sentence also governs the effect of the partners' compromise of an obligation to make a contribution in the future. Such an obligation would be set forth in the certificate. *Id.* § 201(a)(5)-(6).

228. 1916 ACT, *supra* note 7, § 17(4). This subsection literally imposes liability on any "contributor," but it is clear from the title of § 17, the remainder of its provisions, and the entire 1916 Act that only limited partners were intended to be covered. See PA. STAT. ANN. tit. 59, § 531(d) (Purdon Cum. Supp. 1980-1981) (substituting "limited partner" for "contributor").

229. See *Kittredge v. Langley*, 252 N.Y. 405, 169 N.E. 626 (1930).

230. 1976 ACT, *supra* note 9, § 608(a).

be noted that this last modification has two separate effects. It corrects the overbreadth problem by eliminating those who extended credit prior to the time the contribution was made and, by deleting the phrase "or whose claims arose," it effectively excludes tort claimants regardless of when the tort occurred. Finally, consistent with the other provisions of the 1976 Act, the class of partners subject to liability has been broadened to include general partners.²³¹

Notwithstanding all the changes, it is clear that the basic policies concerning the return of partners' contributions that are embodied in the 1916 Act have been carried over by the 1976 Act. The nature, effect, and possibly even the wisdom of these policies remain to be considered. As is already apparent, three separate situations are involved. In the first, which will be referred to as "wrongful return," the return of a partner's contribution is wrongful because the partnership is insolvent or will be rendered insolvent by the distribution.²³² The second, which will be referred to as "compromise," is similar to the first except that the partner's liability for receipt of a wrongful distribution is compromised by his or her fellows. In the third, which will be referred to as "rightful return," the distribution is rightful because the partnership is neither insolvent nor will it be rendered insolvent by the distribution.

The creditors whose rights are involved directly or indirectly also may be divided into three categories, depending on the time at which they became creditors of the partnership. Those who became creditors before the return of a contribution will be referred to as "prior creditors"; those who became creditors subsequent to the return, but before amendment of the certificate to reflect that fact will be referred to as "interim creditors"; and those who became creditors only after amendment of the certificate will be referred to as "subsequent creditors."

In the case of a wrongful return, the recipient will remain liable to the partnership for a period of six years, and this liability apparently will redound to the benefit of all three classes of creditors.²³³ If this liability is

231. *Id.*

232. *See id.* § 607.

233. Although § 608(b), which imposes liability in the wrongful return situation, is drafted only in terms of liability to the partnership, the case law under the 1916 Act makes it fairly clear that this liability may be enforced by creditors on insolvency of the partnership. *See cases cited note 96 supra*. Moreover, because in the compromise and rightful return situations the classes of creditors protected are defined in a way that excludes subsequent creditors, it may be inferred that in the wrongful return situation they are intended to be included in the group receiving protection. Compare 1976 ACT, *supra* note 9, § 608(b) with *id.* §§ 502(b), 608(a). This approach should be distinguished from that of the Uniform Fraudulent Conveyance Act. Section 8, which specifically applies to conveyances by insolvent partnerships, protects only existing creditors. Other provisions of general application, however, expressly include subsequent creditors and may be

compromised by the partnership, subsequent creditors are excluded while prior and interim creditors continue to receive protection. Finally, in the rightful return situation, only the interests of prior creditors are recognized. Thus, on the surface, the 1976 Act achieves symmetry—as the degree of the recipient's real or supposed culpability gradually decreases from the wrongful return to the rightful return situation, so does the number of different classes of creditors to which he or she is exposed. Beyond this, however, the scheme of liability for a withdrawn contribution under the 1976 Act raises some serious questions.

The contrast between the wrongful return situation and the compromise situation is particularly striking. As noted before, in the case of a wrongful return both interim and subsequent creditors receive protection, but in the case of a compromise, subsequent creditors are eliminated. It might be argued that subsequent creditors are not deserving of protection because they knowingly have extended credit to an insolvent partnership. But this argument is equally applicable to the wrongful return situation, in which liability to subsequent creditors is preserved. It also is applicable to interim creditors in either of the two situations, and possibly even to existing creditors if the partnership was insolvent prior to the distribution, rather than being rendered insolvent by it. Indeed, even though the partnership may be insolvent under the bankruptcy definition employed by section 607, if it is able to meet its obligations as they mature, an extension of credit may be reasonable.

It could be argued that interim and subsequent creditors should be differentiated in the compromise situation because the latter, having extended credit subsequent to amendment of the certificate to reflect the compromise, could not have relied on the continuing viability of the recipient partner's contribution. Once again, however, the same may be said in the wrongful return situation, in which liability is preserved.²³⁴ In addition, most creditors probably do not rely on the certificate of limited partnership in any meaningful way.²³⁵ Thus, any distinction between interim and subsequent creditors on this basis is largely fictional. Finally, the fact that claims of interim tort, as well as contract, creditors are preserved in the compromise situation further undercuts the credibility of any distinction premised on reliance on the certificate.²³⁶

relied on in some cases. Compare UNIFORM FRAUDULENT CONVEYANCE ACT § 8 with *id.* §§ 5-7. See *Hartnett v. Doyle*, 16 Tenn. App. 302, 64 S.W.2d 227 (1932); *Bridgman, Uniform Fraudulent Conveyance Act in Minnesota*, 7 MINN. L. REV. 530, 531, 537 (1923).

234. It should be noted that the certificate must be amended whether the return of a contribution is rightful or wrongful and, if wrongful, whether or not there is a compromise. 1976 ACT, *supra* note 9, § 202(b)(1).

235. See text accompanying notes 33-36 *supra*.

236. See 1976 ACT, *supra* note 9, § 502(b).

It must be stressed that the only functional difference between the two situations is that in one the partner's liability for a wrongfully returned contribution has been compromised by his or her fellow partners. As previously discussed in a slightly different context, because the compromise extinguishes the partner's liability to the partnership, the drafters must have felt that any continuing liability to creditors must be on the basis of the holding-out theory.²³⁷ The logic of this theory, of course, precludes liability to those who become creditors subsequent to amendment of the certificate. This purely theoretical reason is insufficient to justify the disparate treatment that necessarily flows from it. A partner who wrongfully receives the return of his or her contribution either should or should not be liable, as a matter of policy, to persons who become creditors after the return.²³⁸ Regardless of which way this basic issue is resolved, distinctions should not be drawn on the basis of whether the creditor acquired that status before or after amendment of the certificate, nor on whether the other partners have compromised the recipient's liability to the partnership.

With respect to rightful returns, it seems paradoxical that a partner should incur any liability whatsoever. To the extent that the return of a contribution may be rightful and at the same time dangerous to existing creditors, it would appear that the statute is defective. It is clear, however, that such a situation could exist. For example, a partnership may have a positive net worth and yet be unable to meet its obligations as they become due. In such a case a distribution of liquid assets to a partner, although permissible under section 607, could well jeopardize the position of partnership creditors.

There are two ways in which this situation could be remedied. The first would be to make the standard for rightful distributions in section 607 more stringent, *e.g.*, by imposing an equity insolvency test in addition to the bankruptcy test.²³⁹ The second, that chosen by the drafters, would be

237. See text accompanying notes 96-98 *supra*.

238. A partner who actually withdraws assets of the business at a time when it is insolvent probably should incur liability in the amount of the withdrawal to both existing and future creditors. See UNIFORM FRAUDULENT CONVEYANCE ACT §§ 5-6 (certain analogous conveyances fraudulent as to present and future creditors). Such a result seems necessary, particularly in the case of tort claimants and trade creditors, if the distinction between ownership and creditor status is to retain significance. This situation may be distinguished from the compromise of an obligation to make a future contribution. See text accompanying notes 94-100 *supra*. In the latter case, hard assets are not removed from the enterprise and, more importantly, the partnership is not necessarily insolvent.

239. Nevada's version of § 17(4) of the 1916 Act reads as follows:

When a contributor has rightfully received the return in whole or in part of the capital of his contribution, he is nevertheless liable to the partnership for any sum, not in excess of such return with interest,

to impose continuing liability on the recipient partner for some period, notwithstanding the fact that the distribution was rightful. This method seems less preferable. In addition to being less straightforward in attacking the problem, it makes the recipient partner potentially liable on the basis of subsequent business reversals even though the return of his or her contribution, at the time it was accomplished, in no way threatened the security of partnership creditors. On the other hand, the first method would protect creditors when protection is warranted²⁴⁰ and at the same time would allow a partner to sever cleanly his or her relationship with the business when protection is not warranted.

Finally, one may question why existing, but not interim, creditors are protected in the rightful return situation. The only plausible explanation, other than a simple desire to limit the partner's exposure to as narrow a class as possible, is a recognition by the drafters that creditors, in fact, do not base their credit decisions on information contained in the certificate of limited partnership.²⁴¹ This, of course, has serious implications regarding the validity of the choices made with respect to wrongful returns and compromises.

V. CONCLUSION

Commercially, the limited partnership has come of age. Recognizing this, the National Conference of Commissioners on Uniform State Laws promulgated the 1976 Act to modernize the law, to clarify ambiguities and fill interstices by adding more detailed language and mechanics, and to make some important substantive changes and additions.²⁴² With respect to those provisions affecting the financial affairs of limited partnerships, it must be concluded that the drafters met with only partial success in their pursuit of these goals.

Chief among the drafters' substantive successes are the expansion of permissible forms of capital contributions, provision of a framework

necessary to discharge its liabilities to all creditors who extended credit or whose claims arose before such return, unless at the time of the return he received all of the capital of his contribution and:

- (a) The assets of the partnership exceeded its liabilities; and
- (b) The partnership was able to meet its liabilities as they matured.

NEV. REV. STAT. § 88.180(4) (1979). The approach suggested in the text, in contrast to that of Nevada, would raise the standard for all distributions rather than only for those that constitute the return of a contribution. In support of this broadened scope, it is submitted that creditors are interested in assets distributed by a limited partnership, not in how those assets may be classified for legal or accounting purposes.

240. See B. MANNING, *supra* note 33, at 60.

241. The exclusion of existing tort claimants, however, may militate in favor of the "narrowest possible class" theory.

242. 1976 ACT, *supra* note 9, Commissioners' Prefatory Note.

governing withdrawal, inclusion of a method for determining when a partner has received the return of his or her contribution, and addition of default rules concerning allocation of profits, losses, and distributions. Although the practical significance of the default rules is reduced by the fact that these issues almost always will be covered by the partnership agreement, they nevertheless fill a major gap in the 1916 Act in a way that is appropriate to modern limited partnerships.

On the other hand, the 1976 Act continues certain provisions of the 1916 Act that seem questionable. Primary among these is section 801, which permits any partner to veto continuation of the business on the withdrawal of a general partner unless there are both a remaining general partner and a right to continue granted by the certificate. Another significant failure is the recodification, apparently without any consistent underlying theme, of the rules regarding the liability of a partner who has withdrawn his or her contribution. While the drafters were successful in clarifying ambiguities and filling interstices in this area, a more general rethinking of the substantive issues would have been desirable.

In expanding the authorized forms of capital contributions, the drafters well may have created as many new interpretive problems as they have attempted to solve in other areas. Their preoccupation with obligations to perform services in the future apparently has caused them to neglect issues that may be raised by partners who default with respect to other types of contributions. The question whether all or only certain distribution rights must be contained in the certificate of limited partnership also is one that could and should have been avoided with slightly more care and coordination.

Thus, the results are mixed. While the 1976 Act must be regarded as an improvement over the rather skeletal provisions of the 1916 Act, more could have been done. Some substantive changes have been made, but many of the policies embodied in the 1916 Act have been continued. Regardless of whether one agrees or disagrees with the basic policy choices made, in light of the present economic importance of limited partnerships, greater foresight, clarity, and precision in drafting are required.

