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A Statutory Approach to Partner Dissociation

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A STATUTORY APPROACH TO PARTNER DISSOCIATION

LARRY E. RIBSTEIN*

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I. INTRODUCTION

The National Conference of Commissioners on Uniform State Laws has decided to revise the Uniform Partnership Act (U.P.A.). Therefore, the time is ripe for reexamination of this venerable uniform law.¹ This Article will recommend reform of one of the most distinctive features of general partnership² under the U.P.A.—the easy dissolvability of the partnership entity.³

Revising the U.P.A. dissolution provisions creates the problem of find-

1. The Uniform Partnership Act was completed in 1914 and has been adopted in 49 states. See UNIFORM PARTNERSHIP ACT, 6 U.L.A. 1 (Supp. 1986) (hereinafter U.P.A.).

2. This article will not deal with limited partnerships. As is discussed throughout this article, the personal liability of general partners (i.e., their contribution of credit to the partnership) is significant in determining appropriate statutory dissociation provisions. Thus, very different provisions may be appropriate for limited partners. Moreover, the potential tensions between the interests of general and limited partners and the fact that the limited partnership statute may have to be designed to accommodate publicly held firms (*compare* Section II [B] below concerning general partnerships) may require treating general partners in limited partnerships differently from those in general partnerships.

3. The term "entity" is used in this Article to refer to the particular relationship that dissolves under the Uniform Partnership Act on the occurrence of dissociation of a partner or other dissolution cause. The partnership "entity" in this sense is distinguished from the underlying business which may continue with new management after dissolution. For a further discussion of the aggregate-entity issue, see *infra* text accompanying notes 144-47.

ing a middle ground between two extremes. Complete illiquidity of partnership interests is unsuited to the partnership standard form. Most people would hesitate to make partnership-type commitments, often including substantial investments of human and financial capital and personal credit, without being able to react to changes in risk by terminating their commitments. Because free transferability of partner property rights is not feasible, dissolution at will provides an important escape route. But dissolution at will gives the dissolving partner the power to appropriate firm assets and inflict significant costs on the other partners. Thus, the U.P.A. escape route amounts to handing each partner a cache of dynamite.

Because I intend to propose specific statutory provisions rather than merely to describe the relevant policy considerations, Part II begins with an analysis of the role and general approach of the partnership statute. Part III defines the problem of permitting partner "dissociation" and identifies some possible statutory approaches, including transfer of interests, buyout, liquidation and dissolution. Part IV describes the U.P.A. dissolution provisions in the context of the alternative approaches to partner dissociation.

Part V analyzes the costs and benefits of the various statutory approaches to partner dissociation identified in Part III. Part V concludes, in light of the costs of illiquidity, that the parties would prefer a standard form that provides for partner dissociation at will to one that does not. However, the power to dissociate at will should be designed to minimize such costs of high liquidity as opportunistic conduct by dissociating partners and as disruption of the going concern.

Parts VI and VII discuss how the statute should deal with partner dissociation in the face of relevant provisions in the partnership agreement. Part VIII summarizes my findings in the form of proposed statutory provisions concerning partner dissociation. The proposed statute embodies a "scalpel" approach that better balances the costs and benefits of partner dissociation than does the U.P.A. "dynamite" approach of dissolution at will.

II. THE ROLE AND APPROACH OF THE STATUTE

A. The Functions of a Statutory Standard Form

Dissolution and continuation provisions are standard elements of a partnership agreement. Providing for partner exit at the formation stage

or at a time prior to when exit actually occurs, permits the partners to determine how to handle exit in a calm and deliberative atmosphere, before they know who will gain and lose from a particular rule, and before negotiating positions are fixed. By such mechanisms as controlling the amount paid to a departing partner and the method of payment, the partners can adjust the level of liquidity to the circumstances of their particular business.⁴

If the parties can and do include dissociation provisions in their partnership agreements, why have a statute? A statutory standard form acts as a mechanism for reducing the costs of entering into a partnership relationship.⁵ These costs include the time spent by the parties and their lawyers, the risk that haggling over details will cause the relationship to founder at the formation stage,⁶ and the costs resulting from error in formulating the parties' agreement.⁷ The costs of entering into a partnership relationship are likely to be quite substantial because of the long-term nature of the arrangement and the many details attending the enforcement of and compensation for the partners' various contributions to the firm.⁸ Although private parties can develop standard forms, statutory forms encourage judicial development of an official meaning that reduces formulation error.⁹

The partnership statute is also valuable in regulating relations between the partners and third parties because it would be costly for the partners to negotiate specialized terms with numerous creditors. That is particularly true of relatively small and short-term credit transactions where the transaction costs of specialized agreements are large in relation to the size of the transactions.

4. Some contractual alternatives are discussed *infra* notes 121-24.

5. The costs and problems involved in drafting a partnership agreement are explored in Hillman, *Private Ordering Within Partnerships*, 41 U. MIAMI L. REV. 425, 433-442 (1987).

6. This has been referred to as the risk of "queering the deal." See W. KLEIN & J. COFFEE, *BUSINESS ORGANIZATION AND FINANCE*, 63-65 (2d ed. 1986). See also Hetherington and Dooley, *Illiquidity and Exploitation: A Proposed Statutory Solution to the Remaining Close Corporation Problem*, 63 VA. L. REV. 1, 37 (1977); Hillman, *supra* note 5, at 435, n. 29.

7. These formulation errors have been considered to be a primary factor in the development of standard terms. They include administrative errors (such as typographical errors), ambiguity, incompleteness, inconsistency, interpretation error, and formulations that do not suit the parties' relationship. See Goetz & Scott, *The Limits of Expanded Choice: An Analysis of the Interactions Between Express and Implied Contract Terms*, 73 CAL. L. REV. 261, 265-73 (1985).

8. As to the difficulties of contracting for buyout in the analogous close corporation setting, see Hetherington and Dooley, *supra* note 6, at 36-38.

9. See Goetz and Scott, *supra* note 7, at 288.

Of course, the courts can apply “off-the-rack” rules to partnership disputes even without a partnership statute. In the present context, the courts would supply these rules largely from the common law of agency. For example, a partnership, if it were not distinguished from other agency relationships, would be terminable at will unless deemed to be an agency coupled with an interest.¹⁰ A partnership statute offers the advantages of predictability and of rules that are better suited to the partnership relationship than the law generally applicable to agency relationships.

It follows from the above discussion that the effect of having no statutory standard form may be the deterrence of otherwise efficient business relationships if the costs of entering into a customized agreement outweigh the perceived benefits of the relationship without an agreement.

B. Devising An Appropriate Standard Form

Although a statutory standard form can reduce the costs of forming a partnership, standard form provisions that provide rules that few parties would voluntarily adopt impose costs on the partnership relationship. Even if the parties can draft around the standard form, they often consciously or inadvertently adopt an inappropriate standard form. The partners frequently underestimate the benefits of a dissociation agreement because of the optimistic attitude that prevails on formation of the venture, when the partners must either trust each other or forego the deal.¹¹ Alternatively, particularly in light of the informality of partnership formation,¹² the partners may operate the business without any consideration of the standard form because they do not know they are a partnership, perhaps because they elected not to incur the costs of obtaining proper legal advice.

If the partners adopt statutory dissociation provisions they would not have agreed to in the absence of transaction costs, this may increase the likelihood that the dissociating partner will engage in conduct that benefits him but is costly to the other partners.¹³ Also, partners who learn they are at risk of such conduct may limit their risk by reducing their investments of time and capital to a lower level than would have been optimal if the statute had addressed the costs of dissociation.

10. See *infra* discussion at notes 62-65.

11. See Hetherington and Dooley, *supra* note 6, at 37.

12. See U.P.A. §§ 6 and 7. U.P.A. §§ 47, 6 U.L.A. 22-24, 38-39.

13. The costs of dissociation are discussed *infra* § V.C.3.

The parties may risk application of an inappropriate standard form even if they do enter into a customized agreement. First, the courts interpret customized agreements with a bias toward the standard form. For example, the courts have frequently strained to interpret partnership agreements so as to provide for payment of the fair market value of the partner's interest in the partnership rather than the lesser amount explicitly adopted by the partners,¹⁴ although the parties may have reduced the payout as a way of internalizing expected high costs of discontinuity.¹⁵ Second, a standard form that includes provisions most partners would not agree to may "booby trap" the agreement by imposing consequences the partners did not expect and therefore neglected to draft around. For example, a partnership agreement that merely provides for "dissolution" or "termination" in specified circumstances may surprise the partners by failing to protect them from U.P.A. consequences in the event of the occurrence of an unprovided for U.P.A. cause.

In light of the foregoing, design of standard form dissociation provisions that most parties would select in the absence of transaction costs is extremely important. The appropriate dissociation provisions are determined to some extent by other aspects of the U.P.A. standard form, which I will assume as given for purposes of this Article. Each partner exercises substantial control within the firm and can create partnership liabilities vis a vis third parties. Partners are, in turn, personally liable for the debts of the business.¹⁶ It follows from these features that the

14. See, e.g., *Skillman v. First Nat. Bank of Kansas City*, 524 S.W.2d 51 (Mo. Ct. App. 1975) ("value of his interest in the capital account" to be paid in the event of partner disability refers to fair market value rather than book value); *Bass v. Dalton*, 213 Neb. 360, 329 N.W.2d 115 (1983) (agreement providing that retiring partner not entitled to compensation for interest in partnership property interpreted as not referring to interest in profits, which is a debt of the partner rather than a partnership asset under U.P.A. § 40); *Schumann v. Samuels*, 31 Wis. 2d 373, 142 N.W.2d 777 (1966) (where "book value" is not defined it is interpreted to refer to market value). Some courts have even referred to a "judicial hostility" to agreements that limit payment to book rather than market value. See *Mahan v. Mahan*, 107 Ariz. 517, 489 P.2d 1197 (1971); *Anderson v. Wadena Silo Co.*, 310 Minn. 288, 246 N.W.2d 45 (1976); *Bohn v. Bohn Implement Co.*, 325 N.W.2d 281 (N.D. 1982). This is similar to the problem of bias in favor of official meanings discussed in Goetz and Scott, *supra* note 7, at 290-91. There appears to be a trend toward acceptance of sub-market continuation agreements. See *G&S Investments v. Belman*, 145 Ariz. 285, 700 P.2d 1358 (Ariz. App. 1984); *Bohn v. Johnson*, 371 N.W.2d 781 (N.D. 1985).

15. See *infra* § VI.

16. Although the need for limited liability business associations has been forcefully demonstrated (see R. POSNER, *ECONOMIC ANALYSIS OF LAW*, 370-71 (3d ed. 1986); Easterbrook and Fischel, *Limited Liability and the Corporation*, 52 U. CHI. L. REV. 89 (1985)), the arguments in favor of limited liability do not preclude the need for an alternative standard form providing for

partners would want to limit a partner's ability to bring in powerful new members by transferring their shares¹⁷ and would therefore insist on some other way of withdrawing their shares and escaping exposure to personal liability.

The specific terms of the escape route that should be offered in the partnership standard form depend not only on the characteristics of individual liability and limited transferability that are inherent in partnership, but also on the number of partners of the individual firm. For example, the danger that a buyout or liquidation right will aid a squeeze out by the dissociating partner may be greater in a firm with relatively few partners than in a firm with many partners. This happens because of the increased likelihood in the former situation that the dissociating partner will be able to use the buyout or liquidation right to exploit a dominant position in connection with the resulting auction of the business.¹⁸ This difference among firms means that standard form dissociation provisions that are wholly appropriate for one partnership may be inappropriate and inefficient for another.

Despite variation among firms, the relatively closely-held firm is a suitable model for designing statutory dissociation provisions because economies of scale of transaction costs make large firms more likely than smaller ones to enter into customized agreements. Thus, throughout this Article, where I must choose between designing the statute for a firm with many members and a firm with few members, I will opt for the small firm model.

III. ELEMENTS AND METHODS OF DISSOCIATION

A. *Defining Dissociation*

This Article addresses the question how should the partnership statute deal with partner *dissociation*.¹⁹ Dissociation refers to the termination of the partner's legal relationship with the firm. It should be distinguished from "withdrawal," which connotes a voluntary act that may or may not trigger the consequences of dissociation. I first discuss the legal *elements* of dissociation from the firm—termination of obligations to co-partners

personal liability. Whether such a standard form is, in fact, desirable is beyond the scope of this Article.

17. See *infra* text following note 21.

18. See *infra* text accompanying notes 88-94.

19. This is a more general topic than partnership *dissolution*, which, as I will discuss in § III(B), is only one of several ways to achieve partner dissociation.

and to creditors and termination of the partner's investment in the firm. I then identify some alternative *methods* of dissociating.

A partner's obligations to co-partners normally consist of duties to contribute capital and services and fiduciary duties. The partners have a fiduciary obligation under U.P.A. § 21 to account for unauthorized benefits from transactions related to the partnership. The partners' contribution obligations arise under current law, if at all, from the partnership agreement because the U.P.A. does not mandate such contributions. Even without an explicit agreement, however, a court might imply an obligation to contribute services from the parties' expectation that they would all work in the business.

As long as the statute does not attach contribution obligations to partnership status, it need not provide for termination of these obligations. Thus, the agreement may cut off further contribution obligations even of one who remains a partner, and an ex-partner who refuses or fails to make an agreed contribution will be held responsible for breach of contract.²⁰ On the other hand, since the statute attaches fiduciary obligations to partnership status, the statute must specify when these duties terminate.

Termination of obligations to creditors has two components—responsibility for liabilities as of the date of dissociation and liability for post-dissociation obligations. Even if the continuing partners assume pre-dissociation obligations, the dissociating partner's obligations can be discharged only with the actual or implied consent of the creditors, who initially extended credit in reliance on the personal liability of all of the partners. Creditors normally will not consent unless they are paid or at least offered additional consideration. Thus, an obligation to obtain the dissociating partner's discharge from existing liabilities differs significantly from one merely to assume these debts. Post-dissociation obligations should be binding on the dissociating partner only to the extent necessary to accommodate the interests of relying creditors.

20. A partner's promise to perform services, like other personal service contracts, is rarely, if ever, specifically enforceable. See RESTATEMENT (SECOND) OF CONTRACTS, § 359 and comments. More often, the breach will give rise to an action for damages. See *Hart v. Myers*, 59 Hun 420, 13 N.Y.S. 388 (Sup. Ct. 1891), *aff'd* 128 N.Y. 578, 28 N.E. 250 (1891)(liability for the cost of a substitute employee); *Olivier v. Uleberg*, 74 N.D. 453, 23 N.W. 2d 39, 165 A.L.R. 974 (1946) (liability for the value of the promised but unperformed services); Annotation, *Liability of Partner for Failure to Perform Personal Services*, 165 A.L.R. 981 (1946). Nonperformance of promised services could also be a basis of judicial dissolution for misconduct or incapacity of the nonperforming partner. See U.P.A. § 32(1)(b), (c) & (d), 6 U.L.A. at 394.

Finally, termination of the partner's investment in the firm obviously necessitates payment for the partner's share of the value of the firm by the partnership, the partners or third parties through transfer, buyout or liquidation.

B. Methods of Achieving Partner Dissociation

1. In General

In order to understand the policy choices involved in statutory dissociation provisions, we must evaluate alternative *methods* by which the statute can effectuate these elements: transfer, liquidation, buyout and dissolution. The choice of methods cuts across the elements of dissociation in the sense that choice of a single method may determine more than one but not necessarily all elements. For example, the choice between buyout and liquidation under the U.P.A. affects only the method of terminating partners' capital contributions and pre-dissolution obligations and not their obligations among themselves and to post-dissolution creditors.

2. Transfer

The first alternative is "transfer." Transfer refers to sale of the partnership interest to a third party by means of a transaction wholly between the dissociating partner and the third party.²¹ A partner could fully dissociate by transfer in the sense discussed in Section III (A) *if* (1) the partner's status terminated upon transfer; (2) the third party was willing to pay the full value of the partner's interest and assume partnership liabilities; (3) the partnership creditors discharged the dissociating partner from pre-dissociation debts; and (4) the transferor had no liability for post-dissociation debts to creditors with notice of the transfer.

Partner dissociation by transfer of interests is not feasible for a number of reasons, all attributable to some extent to the partners' personal liability for partnership debts. First, the non-transferring partners would insist on the right to screen transferees who acquired management rights, particularly if these rights were accompanied by agency power to bind the partnership. Although this does not prevent transfer of partnership

21. Auction of the partnership assets may result in acquisition of the firm by the non-dissociating partners and one or more third parties. Although the net result is similar to transfer, the transaction is different because it involves action on the part of the firm or the partners as a group and not merely the dissociating partner and the third party.

status without management rights, a transferee would pay little for the right to assume risk without control.

Second, a third party would be unwilling, without being paid a substantial risk premium, to assume personal liability for pre-transfer partnership debts in light of the difficulty of obtaining adequate information about these liabilities. Third, even if the transferee did assume the liabilities, the transferor would not thereby be discharged. Discharging the transferor would sharply increase the costs of extending credit to partnerships by creating uncertainty as to the nature of the risk undertaken. Partnerships and creditors would therefore be forced to incur the costs of contracting around the statute, thus reducing the value of the standard form.

3. *Buyout and Liquidation*

A partner's inability to dissociate by means of a sale of his interest to a third party necessitates a form of dissociation that utilizes the assets of the partnership or of the other partners. Two methods for utilizing these assets include "buyout" and "liquidation."²² "Buyout" refers to the dissociating partner's right to obtain the purchase of his or her interest by the remaining partners or the partnership at a price determined by mutual agreement or, failing agreement, by the court. "Liquidation" refers to the dissociating partner's right to compel a sale of all of the partnership assets at an auction. At the auction, the outcome of the bidding determines the price.

The difference between the liquidation and buyout rights may be more apparent than real. Liquidation, because it secures a cash payment for all of the partnership's assets, can result in piecemeal sale and discharge of the partnership's pre-dissolution liabilities.²³ On the other hand, liquidation may involve sale of the partnership as a going concern. This type of liquidation differs from buyout only in that the rules of the sale are different. In a buyout, the non-dissociating partners have the legal right to continue the business if they can purchase the interest of the other at

22. There are obviously many more ways to achieve one or more of the elements of dissociation identified in § III(B). Some of these methods amount to a limited dissociation that is more properly characterized as a distribution than termination of a partner's association with the firm. Beyond this, I have simplified the discussion in order to draw out the relevant policy considerations, which can then be applied to other possible permutations of the specific alternatives discussed here.

23. The question of whether liquidation should be accompanied by discharge is discussed *infra* § V(E).

an agreed upon or judicially determined price. In liquidation, neither partner group has a legal advantage and the continuing party is the one who makes the highest bid for the business. The important issue in distinguishing liquidation and buyout is not, therefore, whether the business continues, but who continues it.²⁴

4. *Dissolution*

“Dissolution” as used in this article refers to the end of the partnership entity. U.P.A. §§ 29 and 30 provide that the partnership continues after dissolution until completion of winding up, at which point the partnership terminates. For present purposes, what is important is not the distinction between dissolution and termination but that under the U.P.A. any continuation of the business as a going concern after dissolution technically is by a new entity. By contrast, transfers of stock do not affect a corporate entity. Whether and to what extent dissolution is necessary to accomplish partner dissociation is discussed below.²⁵

IV. PARTNER DISSOCIATION UNDER THE U.P.A.

A. *Dissociation by Dissolution*

This Part examines the U.P.A.’s approach to partner dissociation in the light of the general definitions and considerations outlined in Part III.

Partner dissociation cannot be effected under the U.P.A. without dissolution of the partnership, since dissolution triggers the elements of dissociation, including termination of capital and credit contributions. Dissolution results from, among other things,²⁶ events that would be expected to be occasions for dissociation; voluntary withdrawal from participation in the firm;²⁷ the express will of a partner;²⁸ expulsion of a

24. The distinction between buyout and liquidation is analogous to the distinction between a Chapter 7 bankruptcy liquidation, in which the business may continue as a going concern with both outsiders and existing owners bidding for the business, and a Chapter 11 bankruptcy reorganization, in which the equity in the reorganized firm is sold to the creditors of the bankrupt business. *See* T. JACKSON, *THE LOGIC AND LIMITS OF BANKRUPTCY*, 211 (1986).

25. *See infra* § V(F).

26. Causes of dissolution not involving withdrawal from participation in partnership affairs are termination of the agreed term or undertaking (U.P.A. § 31(1)(a)); an event that makes it unlawful to continue the business or to continue it as a partnership (U.P.A. § 31(4)); bankruptcy of the partner or partnership; and decree of court (U.P.A. §§ 31(6) & 32). *See* U.P.A. § 31-32, 6 U.L.A. at 376-77, 394-95.

27. U.P.A. § 29 provides that “dissolution . . . is the change in the relation of the partners

partner in accordance with the partnership agreement;²⁹ and partner death.³⁰

B. Termination of Obligations to Co-Partners

Following dissolution,³¹ the partnership winds up and terminates. At that point, the partners have no further obligations to each other arising solely out of partner status, particularly including fiduciary duties.³²

C. Termination of Obligations as to Post-Dissociation Debts

Dissolution largely terminates the partners' credit contributions as to post-dissolution transactions. U.P.A. § 35 provides that the partnership is bound after dissolution only by (1) acts by non-bankrupt partners that are appropriate for winding up; and (2) by other transactions with creditors who had no knowledge or notice of the dissolution (unless the partnership was dissolved because its business was unlawful).

Dissolution terminates partners' mutual agency authority whether or not the partnership business continues after dissolution. If the dissolved

caused by any partner ceasing to be associated in the carrying on as distinguished from the winding up of the business." This inartfully drafted provision hopelessly entangles *cause*—a partner's "ceasing to be associated"—and *effect*—a "change in the relation of the partners." The latter seems to refer to U.P.A. § 30 which, like the end of U.P.A. § 29, provides that after dissolution the partnership enters the winding up phase. The problem is that "ceasing to be associated" is tied in § 29 to the entry into the winding up phase, which is the effect of dissolution. Thus, § 29 can be read as providing that dissolution is caused by its effect. It obviously makes more sense to separate the Section into its two components of (1) causation of dissolution by withdrawal of a partner, and (2) the effect of entry into the winding up phase. Even this interpretation does not remove all difficulty because there are causes of dissolution that do not involve partner withdrawal. *See supra* note 23. It is, in all events, clear under the case law that partner withdrawal causes dissolution. *See Berenter v. Stagers*, 362 F.2d 971 (D.C. Cir. 1966); *Ramseyer v. Ramseyer*, 98 Idaho 47, 558 P.2d 76 (1976); *Cox v. Jones*, 412 S.W.2d 143 (Mo. 1967); *Stein v. Jung*, 492 S.W.2d 139 (Mo. App. 1973); *Schoeller v. Schoeller*, 465 S.W.2d 648 (Mo. App. 1971); *Cave v. Cave*, 81 N.M. 797, 474 P.2d 480 (1970); *Lonning v. Kurtz*, 291 N.W.2d 438 (N.D. 1980); *Williams v. Terbinskii*, 23 Ohio Misc. 53, 261 N.W.2d 920 (Ohio Com. Pleas, 1970); *Timmermann v. Timmermann*, 272 Or. 613, 538 P.2d 1254 (1975); *Meuret v. Meuret*, 48 Or. App. 701, 617 P.2d 918 (1980); *Parker v. Donald*, 477 S.W.2d 947 (Tex. Civ. App.), *rev'd on other grounds*, 482 S.W.2d 846 (Tex. 1972); *Kelly v. Kelly*, 411 S.W.2d 953 (Tex. Civ. App. 1967); *Ashley v. Lance*, 80 Wash. 2d 274, 493 P.2d 1242, (1972).

28. U.P.A. § 31(1)(b), 6 U.L.A. at 376 (express will where no definite term or undertaking); U.P.A. § 31(2), 6 U.L.A. at 376 (express will in contravention of the partnership agreement).

29. U.P.A. § 31(1)(d), 6 U.L.A. at 376.

30. U.P.A. § 31(4), 6 U.L.A. at 376.

31. *See supra* § IV(A).

32. The partners' fiduciary duties continue through "liquidation" of the partnership. U.P.A. § 21(1), 6 U.L.A. at 258.

partnership is actually going out of business, it makes sense that the partners can no longer bind the partnership to transactions that are "for apparently carrying on in the usual way the business of the partnership."³³ But if the business continues, dissolution should not have a drastic effect on liability. In fact, it does not because the continuing partnership is liable for any debts it incurs without regard to § 35. Therefore, the principal effect of dissolution where the partnership business continues is merely to cut off the liability and the power to bind of a withdrawn partner or estate. Accomplishing this result by destroying the partnership entity is like removing a door from a building by demolishing the building and then rebuilding it without the door. A partner's authority obviously can be terminated as effectively as under the U.P.A. without the costs resulting from dissolution of the partnership entity.³⁴

D. Termination of Obligations as to Pre-Dissolution Debts

Dissolution itself discharges neither the existing liabilities of the partners³⁵ nor those of the dissolved partnership (at least until the partnership terminates at the conclusion of winding up³⁶). In the event of a buyout, the continuing partners normally assume rather than obtain discharge of the liabilities. Liabilities are usually discharged by payment on liquidation of the partnership assets.³⁷

Dissolution may have a more significant effect on the partnership's executory contracts. Although dissolution does not necessarily terminate the partnership's executory agreements,³⁸ the contract may terminate by its own terms on dissolution,³⁹ even if the dissolution was only a technical one caused by a change in membership and the business was contin-

33. U.P.A. § 9(1), 6 U.L.A. at 132.

34. These costs are discussed *infra* § V(F)(2).

35. U.P.A. § 36(1), 6 U.L.A. at 436.

36. U.P.A. § 30, 6 U.L.A. at 367.

37. For further discussion of discharge on liquidation, see *infra* § V(E).

38. *City of North Kansas City v. Sharp*, 414 F.2d 359 (8th Cir. 1969); *Centeno v. Roseville Community Hospital*, 107 Cal. App. 3d 62, 167 Cal. Rptr. 183 (1979); *Rossetti v. City of New Britain*, 163 Conn. 283, 303 A.2d 714 (1972); *Boroughs, Dale & Griffin v. St. Elias Eastern Orthodox Church*, 120 Ga. App. 434, 170 S.E.2d 865 (1969); *Edco Properties v. Landry*, 371 So.2d 1367 (La. App. 1979), *writ denied*, 375 So. 2d 945 (1979). As to liability for goods contracted for before the dissolution and delivered to the continuing business after dissolution, see *Herring v. Mishawaka Rubber & Wollen Mg. Co.*, 192 Ark. 1055, 95 S.W.2d 1141 (1936) (incorporation of partnership); *Henry v. Seiberling Rubber Co.*, 265 Ky. 241, 96 S.W.2d 590 (1936); *Goldman v. General Supply Co.*, 6 So.2d 778 (La. App. 1942); *Clinchfield Fuel Co. v. W.M. Lundy & Son*, 130 Tenn. 135, 169 S.W. 563 (1914).

39. See *Frederick C. Smith Clinic v. Lastrapes*, 111 Ohio App. 42, 170 N.E.2d 497 (1959) (non-

ued. Also, a contract might bind a particular entity and therefore terminate on dissolution of the entity, again even if the dissolution was only a technical one.⁴⁰ Finally, the third party might terminate a contract on dissolution caused by departure of a person who was important to performance of the contract.⁴¹

Dissolution may also affect the creditors' ability to obtain payment of partnership liabilities. If the partnership business is terminated and the assets are sold, U.P.A. § 40 entitles the pre-dissolution creditors to priority payment out of the proceeds of sale. Dissolution may, however, cause problems for pre-dissolution creditors if the partnership is continued after dissolution. U.P.A. § 41 provides that in the absence of fraud the successor firm assumes liabilities of the old firm only in certain situations: when it agrees to do so or the firm is rightfully continued by one or more of the partners in the dissolved partnership. Thus, the successor firm is not generally liable if the partnership is continued without assumption or consent by some of the former partners,⁴² or if the partnership is incorporated, so that the party carrying on the business is technically the corporation rather than one or more of the original partners.⁴³ If the liabilities of the old partnership do not carry over to the new one, the creditors

competition covenant of employee unenforceable after change in firm membership's contract provided for automatic termination on dissolution of firm).

40. See *Fairway Development Co. v. Title Insurance Co. of Minn.*, 621 F. Supp. 120 (N.D. Ohio 1985) (successor partnership not entitled to sue under policy guaranteeing title of original partnership).

41. This is particularly true where the contract called for the professional services of the departing member. *Rosner v. Modern Maid Packers, Inc.*, 274 F. Supp. 685 (D. Conn. 1967) (withdrawal of one of two members of food brokerage partnership terminated obligations of food process to partnership); *Little v. Caldwell*, 101 Cal. 553, 36 P.107 (1894) (client may discharge law firm); *Felt v. Mitchell*, 44 Ind. App. 96, 88 N.E. 723 (1909); *Schlau v. Enzenbacher*, 265 Ill. 626, 107 N.E. 107 (1914) (dissolution of real estate broker partnership terminated their power to sell client's land); *Wheaton v. Cadillac Automobile Co.*, 143 Mich. 21, 106 N.W. 399 (1906) (manufacturer may terminate sales agency after dissolution of partnership of automobile sales agents); *Egner v. States Realty Co.*, 223 Minn. 305, 26 N.W.2d 464, (1947) (dissolution of real estate brokerage firm terminates power to sell client's land); *Clifton v. Clark, Hood & Co.*, 83 Miss. 446, 36 So. 251, (1904) (client may discharge law firm); *Puffer v. Merton*, 168 Wis. 366, 170 N.W. 368, (1919). But see *Rossetti v. City of New Britain*, 163 Conn. 283, 303 A.2d 714 (1972) (city could not terminate contract for architectural services after withdrawal of partner where duties under the contract were not personal to the withdrawing partner). Note that in these situations it is really the departure of the partner and not the dissolution of the partnership that gives rise to the right to terminate.

42. Pursuant to U.P.A. § 38(1), 6 U.L.A. at 456, the innocent partner would have the right to application of partnership property. See *supra* § IV(F)(2). However, the partnership business could be continued without a sale of the partnership property if an innocent partner merely acquiesced in continuation without either consenting to continuation or insisting on liquidation.

43. For further discussion of § 41 see *infra* text accompanying notes 149-50.

cannot levy execution on its property to enforce the claim, but rather must resort to the more limited charging order against the former partners under U.P.A. § 28.⁴⁴

Thus, although dissolution itself does not cut off pre-dissolution claims and contracts, it sufficiently affects pre-dissolution dealings that both the partnership and its creditors must engage in costly planning against the eventuality of dissolution.

E. Termination of Capital Contribution

The dissociating partner terminates his or her capital contribution by receiving the cash value of his or her interest either through liquidation under U.P.A. § 38(1) or through buyout under U.P.A. §§ 38(2) and 42. These alternatives will be discussed in the next Section.

F. Alternative Methods of Achieving Dissociation under the U.P.A.: Transfer, Buyout and Liquidation

1. Transfer

This Section discusses the extent to which the U.P.A. adopts the various dissociation methods discussed in Section III(B).

Consistently with the considerations outlined in Section III(B)(1), the U.P.A. does not allow full transferability of partnership interests. U.P.A. § 24 clearly distinguishes a partner's "interest in the partnership" from "his right to participate in the management." A partner's interest in the partnership includes only his financial rights (U.P.A. § 26) and is freely transferable (U.P.A. § 27(1)). U.P.A. § 18(g) provides that, subject to contrary agreement, "[n]o person can become a member of a partnership without the consent of all the partners." Because a partner's interest in the partnership includes only "profits and surplus," an assignee does not assume debts of the firm. Even one who is admitted as a full-fledged partner does not automatically assume personal liability for pre-admission liabilities of the firm.⁴⁵

44. See U.P.A. § 25(2)(c), 6 U.L.A. at 326.

45. See U.P.A. § 17, 6 U.L.A. at 207 (the incoming partner assumes such obligations, but "this liability shall be satisfied only out of partnership property"); U.P.A. § 41(7), 6 U.L.A. at 510 (liability of third person becoming partner after dissolution "shall be satisfied out of partnership property only").

2. Liquidation

As discussed in Section IV(A), dissolution is basic to dissociation under the U.P.A. In the vast majority of circumstances, dissolution triggers a right by any partner pursuant to U.P.A. § 38(1) to compel liquidation of the firm—specifically, to “have the partnership property applied to discharge its liabilities, and the surplus applied to pay in cash the net amount owing to the respective partners.” This right exists unless (1) the partners have agreed to vary the rights under § 38(1); (2) dissolution is caused in contravention of the partnership agreement, as by express will of a partner prior to the expiration of an agreed term or undertaking;⁴⁶ or (3) dissolution is caused by expulsion of a partner. Even if the dissolution is “in contravention,” any innocent partner has a liquidation right pursuant to U.P.A. § 38(2)(a).

A partner’s right to application of assets involves a right to insist on a judicial sale of the partnership assets as distinguished from a one-on-one buyout⁴⁷ or distribution of the assets in kind.⁴⁸ This may mean that the business is sold as a going concern at the liquidation sale. The purchasers on a going concern basis are typically some of the partners in the

46. This exception to the liquidation right has been held to apply to dissolution by judicial decree based on partner misconduct rather than by express will (see U.P.A. § 32(1)(c)-(d), 6 U.L.A. at 394). *Zieback v. Nasser*, 12 Cal. 2d 1, 82 P.2d 375 (1938); *Ohlendorf v. Feinstein*, 636 S.W.2d 687 (Mo. App. 1982); *Dow v. Beals*, 149 Misc. 631, 268 N.Y.S. 425 (1933); *Drashner v. Sorenson*, 75 S.D. 247, 63 N.W.2d 255 (1954). See Hillman, *Misconduct as a Basis for Excluding or Expelling a Partner: Effecting Commercial Divorce and Securing Custody of the Business*, 78 NW.U.L. REV. 527, 537-38, 551-52 (1983). This point is clarified in GA. CODE ANN. § 14-8-38 (1986), which refers to dissolution “wrongfully either in contravention of the partnership agreement or as a result of the wrongful conduct of a partner.” See Ribstein, *An Analysis of Georgia’s New Partnership Law*, 36 MERCER L. REV. 443, 503-04 (1985). One court has held that dissolution was wrongful even if the partnership was at will, so that the “wrongful” partner could have rightfully dissolved the partnership by express will. *Monteleone v. Monteleone*, 147 Ill. App. 3d 265, 100 Ill. Dec. 859, 497 N.E.2d 1221 (1986).

47. See *Mahan v. Mahan*, 107 Ariz. 517, 489 P.2d 1197 (1971) (relying in part on an Arizona decedent’s statute); *Davis v. Davis*, 149 Colo. 1, 366 P.2d 857 (1961); *Polikoff v. Levy*, 132 Ill. App. 2d 492, 270 N.E.2d 540 (1971); *Detroit Bank & Trust v. Dickson*, 78 Mich. App. 12, 259 N.W.2d 228 (1977); *Gorger v. Gorger*, 276 Or. 267, 555 P.2d 1 (1976) (remand for determination of partners’ rights under statute, but strongly indicating that there was a right to liquidation); *Young v. Cooper*, 203 S.W.2d 376 (Tenn. App. 1947).

48. See *Bateh v. Brown*, 289 Ala. 699, 271 So.2d 833 (1973), 331 So.2d 671 (Ala. 1976) (opinion after remand); *Heard v. Carter*, 159 Ga. App. 801, 285 S.E.2d 246 (1981) (applying partnership agreement, which required expelling partners to “liquidate” the business); *Taylor v. Bryan*, 664 S.W.2d 52 (Mo. App. 1984); *Nupetco Assocs. v. Jenkins*, 669 P.2d 877 (Utah 1983) (court indicated that if property could not be sold in depressed market trial court could consider alternative of partition); *Dreifuerst v. Dreifuerst*, 90 Wis. 2d 566, 280 N.W.2d 335 (1979).

dissolved partnership, either alone or with third parties. The courts have sustained fairly conducted sales to the partners.⁴⁹

The liquidation right means that a partner can terminate his investment by receiving a "market" valuation at the judicial sale. A partner fully terminates his or her contribution of credit insofar as pre-dissociation creditors are concerned by reason of the duty under § 38(1) to apply partnership assets to discharge liabilities.⁵⁰

The courts have qualified the statutory right to application of partnership assets to some extent where recognition of the liquidation right would inflict particularly heavy costs on the other partners. They have held that a partner may be able to buy out a co-partner and continue the business if dissolution was caused by death of a partner⁵¹ and so was likely to have been unanticipated, forced sale of assets would result in a loss of value because of the nature of the asset,⁵² or because of current market conditions,⁵³ or if other circumstances justify a buyout right.⁵⁴ Also, partners must exercise the power to dissolve consistently with their fiduciary duties;⁵⁵ and they may be liable for appropriating partnership

49. See *Prentiss v. Sheffel*, 20 Ariz. App. 411, 513 P.2d 949 (1973); *Mandell v. Centrum Frontier Corp.* 86 Ill. App. 3d 437, 41 Ill. Dec. 323, 407 N.E.2d 821, (1980); *Cude v. Couch*, 588 S.W.2d 554 (Tenn. 1979) (partner bid through secret agent).

50. The partners may, however, have to contribute personal funds to the payment of liabilities under U.P.A. § 40 if other partnership assets are insufficient.

51. *Chapman v. Dunnegan*, 665 S.W.2d 643 (Mo. App. 1984); *Balaban v. Bank of Nevada*, 86 Nev. 862, 477 P.2d 860 (1970); *Fortungno v. Hudson Manure Co.*, 51 N.J. Super. 482, 144 A.2d 207 (1958); *Georgen v. Nebrich*, 12 Misc. 2d 1011, 174 N.Y.S.2d 366 (1958). This is consistent with the fact that the U.P.A. § 38(1) liquidation right is available only to "each partner" and not explicitly to legal representatives of deceased partners or assignees. However, some U.P.A. provisions cut the other way. See U.P.A. § 38, 6 U.L.A. at 456-7 (right to continue only in the event of wrongful dissolution, expulsion or agreement); § 41(3), 6 U.L.A. at 510 (consent of legal representative implicitly required for continuation); § 37, 6 U.L.A. at 444 (deceased's representative may obtain winding up by the court).

52. *Gregg v. Bernardi*, 250 Or. 458, 443 P.2d 166 (1968) (race horse).

53. *Dow v. Beals*, 149 Misc. 631, 268 N.Y.S. 425 (1933). See also *Nupetco Assocs. v. Jenkins*, 669 P.2d 877 (Utah 1983) (sale ordered, but court said trial court also had discretion to order partition in light of depressed economy).

54. See, e.g., *Nicholes v. Hunt*, 273 Or. 255, 541 P.2d 820 (1975). In *Nicholes*, the court permitted a buyout rather than compelling liquidation where the business involved a technical process that required the owners to have specific expertise. The process had been developed by the purchasing partners who had invited the other partner into the business, and the selling partner had brought on the break-up of the relationship partly through his own misconduct.

55. *Howell v. Harvey*, 5 Ark. 270, 39 Am Dec. 376 (1843); *Beller v. Murphy*, 139 Mo. App. 663, 123 S.W. 1029 (1910); *Trigg v. Shelton*, 249 S.W. 209 (Tex. Com. App. 1923); *McMahon v. McClernan*, 10 W.Va. 410 (1877). See U.P.A. § 21(1), 6 U.L.A. at 258, which explicitly applies to transactions connected with the "liquidation" of the partnership.

property, including goodwill and partnership opportunities.⁵⁶

3. *Buyout*

When the partnership business is continued, U.P.A. § 38(2), in the event of wrongful dissolution, or § 42 determines the rights of the outgoing partner or estate. Section 42 provides that the ongoing partner or estate is entitled to “the value of his interest” and interest on this amount or, at the outgoing partner’s election, “the profits attributable to the use of his right in the property of the dissolved partnership.”

As discussed above,⁵⁷ because the right to application of assets can lead to auction of the partnership business as a going concern, the difference between the liquidation and buyout rights is not necessarily one between continuation and termination of the partnership business, but a more subtle one that rests on the rights of the partners in each situation. The partners are entitled on liquidation to be paid in cash and to be discharged from partnership liabilities, so that the winning bidder is the partner or partners who can muster sufficient resources to cover the full net cash value of the partnership. If the dissociating partner is entitled only to be bought out, however, the nondissociating partners have the advantage in any contest for control of the firm because they have “first option” to buy at a price that is either agreed on or fixed by the court. The terms of the option, and therefore the extent of the non-dissociating partners’ advantage, depend on whether the dissociating partner wrongfully dissolved, was expelled or withdrew voluntarily and rightfully.

In a buyout governed by U.P.A. § 38(2)(b), the wrongful partner is entitled only to the “value of his interest” less the goodwill component of this value, and to termination of his credit contribution as to pre-dissolution liabilities to the extent of assumption of the liabilities by the continu-

56. *Leff v. Gunter*, 33 Cal. 3d 508, 189 Cal. Rptr. 377, 658 P.2d 740 (1983) (partner may not begin work on bid for lease while associated with partnership and then withdraw and make competing bid); *Page v. Page*, 55 Cal. 2d 192, 10 Cal. Rptr. 643, 359 P.2d 41 (1961) (dictum: partner may not appropriate business after dissolution without adequate compensation to copartner); *Rosenfeld, Meyer & Susman v. Cohen*, 146 Cal. App. 3d 200, 194 Cal. Rptr. 180 (1983) (law partners may not appropriate major antitrust case simply by withdrawing from firm); *Lavin v. Ehrlich*, 80 Misc. 2d 247, 363 N.Y.S.2d 50 (1974) (partner may not dissolve, buy building in which partnership operated and refuse to negotiate lease with former partners); *Howell v. Bowden*, 368 S.W. 2d 842 (Tex. Civ. App. 1963) (pre-U.P.A. damages for wrongful appropriation of partnership business by one partner in partnership at will); *Trigg v. Shelton*, 249 S.W. 209 (Tex. Com. App. 1923); *Featherstonhaugh v. Fenwick*, 17 Ves. 298, 34 Eng. Rep. 115 (1810). *See also* J. STORY, COMMENTARIES ON THE LAW OF PARTNERSHIP 392 (1841).

57. *See* text accompanying note 24.

ing partners⁵⁸ rather than to discharge. Moreover, the price is not immediately payable in cash but rather need only be secured by court-approved bond, at least until the expiration of the term of the partnership.⁵⁹ Therefore, rather than throwing the business up for grabs in a bidding war between partners which will be won by the strongest partner, the U.P.A. loads the scales in the wrongful dissolution situation on the side of the innocent partners who wish to continue the business.

An expelled partner is treated somewhat more favorably than a wrongful partner because expulsion does not have to be based on wrongful conduct.⁶⁰ Thus, the expelled partner is entitled to immediate payment in cash and to discharge from partnership liabilities. But there is no auction and the expelled partner receives only "the net amount due him"—i.e., the value of his or her interest pursuant to U.P.A. § 42.

If the partnership is continued with the consent of the innocent partners or estate, U.P.A. § 42 entitles these partners only to the value of their interests. Although § 42 does not explicitly entitle them to any protection from partnership liabilities, the innocent partners can exact a high price and adequate protection from partnership liabilities as a condition of giving their consent to continuation. The right to application of property therefore serves as the backdrop against which the terms of continuation are fixed.

G. Summary

In general, the U.P.A. approaches partner dissociation by blowing

58. U.P.A. § 38(2)(b), 6 U.L.A. at 456 provides that continuing partners must "indemnify" a wrongfully dissolving partner, while § 38(2)(c) provides, somewhat inconsistently, that the wrongful partner must be "released." For a discussion of the rights of wrongfully dissolving partners with regard to protection from liabilities, see Hillman, *supra* note 46, at 555-7. U.P.A. § 36 governs discharge of the former partner where the liabilities have been assumed. Section 36 provides for discharge only upon express or implied agreement of the creditor or upon material alteration of the debt with consent of a knowing creditor.

59. This is explicitly provided for in the Georgia version of U.P.A. § 38(2). The Georgia Code omits the "agreed term" limitation while at the same time requiring that the wrongful partner be paid, rather than permitting the mere securing of payment. GA. CODE ANN. § 14-8-38(b). The parties could, of course, agree to limit the term of the continuation in exchange for delaying payment for the interest after dissolution. If there is no such agreement, the partnership would dissolve at the end of the agreed term, subject to the ability of the nonwrongful partners to continue the partnership thereafter pursuant to U.P.A. § 23.

60. Under the U.P.A. § 31(1)(d), 6 U.L.A. at 376, expulsion need only be "bona fide in accordance with such power conferred by the agreement between the partners." The grounds of expulsion are discussed in Comment, *The Expulsion Clause in a Partnership Contract: A Pre-Planned Dissolution*, 13 U. CAL. DAVIS L. REV. 868 (1980).

apart the partnership through mandatory dissolution and by giving each partner a right in most instances to compel liquidation, reserving the more limited buyout right to a few specific situations. Mandatory dissolution is costly because it may disrupt relationships with and rights of those who are dealing with the firm at the time of dissolution. The liquidation right also may impose costs, as has been recognized by courts that have qualified the liquidation right where the costs are particularly high. The question raised by the above discussion is whether the costs associated with the U.P.A. "dynamite" approach are optimal in light of the benefits of this approach in effecting partner dissociation. The next Section addresses this question.

V. EVALUATION OF ALTERNATIVE METHODS OF ACHIEVING DISSOCIATION

A. *In General*

This Part evaluates the buyout, liquidation and dissolution methods of partner dissociation.⁶¹ I will begin with the considerations relevant to whether a partner should have at least a right to buyout. I will use this as a "baseline" method of dissociation to be compared with a statutory standard form that does not permit partner dissociation. I will then consider under what circumstances a partner should be entitled to the more drastic liquidation right, and under what circumstances the partnership should be dissolved.

The discussion in this Section will assume that the partners have made no agreement concerning dissociation. In Part VI, I will consider the extent to which it should matter if dissociation occurs prior to the end of an agreed term or undertaking. In Part VII, I will discuss the enforceability of agreements specifically governing dissociation.

B. *Buyout: Traditional Bases of the Buyout Right*

The partners' right to obtain at least buyout of their interests at any time has been said to rest on the view that partnership is a mutual agency that can exist only as long as the partners consent,⁶² and that partnership

61. As was discussed in § III(B)(2), the transfer method is not feasible in light of partners' personal liability for the debts of the business. Accordingly, this method of dissociation will not be discussed further.

62. *Karrick v. Hannaman*, 168 U.S. 328 (1897); *Lapenta v. Lettieri*, 72 Conn. 377, 44 A. 730 (1890); *Solomon v. Kirkwood*, 55 Mich. 256, 21 N.W. 336 (1884); *Napoli v. Dominitch*, 226 N.Y.S.2d 908 (N.Y. Sup. Ct. 1962); *Cahill v. Haff*, 248 N.Y. 377, 162 N.E. 288 (1928); *Lonning v.*

is a kind of personal service contract and therefore not specifically enforceable.⁶³

As to the agency law ground of dissociation at will, it has been pointed out that partnership could just as easily have been treated as a "power given as a security"⁶⁴ because the partners holding the power have a proprietary interest in the subject matter of the agency.⁶⁵ Thus, the absolute right of dissociation from the partnership is not compelled by agency law.

From the standpoint of whether partnership *ought* to be treated like a revocable-at-will agency rather than an irrevocable power given as a security, a partner arguably should be able at any time to terminate the heavy risks involved in being subject to another person's power to bind. But while escape from continued exposure to risk is a benefit of the dissociation right, exercise of that right may impose costs on the other owners. The question is whether, in light of *both* the benefits and costs of the withdrawal right, the parties would be sufficiently likely to agree to dissociation that the right should be incorporated in the standard form.

The simple response to the specific enforcement basis of dissociation at will is that merely precluding dissociation does not itself compel any further acts by the partner-promisor who wishes to dissociate. The supervision problems involved in specific enforcement are raised only if the court mandates performance of services the partner was contractually obligated to perform.

*Infusaid Corp. v. Intermedics Infusaid, Inc.*⁶⁶ illustrates the distinction between specifically enforcing personal services and prohibiting with-

Kurtz, 291 N.W.2d 438 (N.D. 1980); McCollum v. McCollum, 67 S.W.2d 1055 (Tex. Civ. App. 1934) (injunctive relief against dissolution refused); Logan v. Logan, 36 Wash. App. 411, 675 P.2d 1242 (1984); Crossman v. Gibney, 164 Wis. 395, 160 N.W. 172 (1916). See Lewis, *The Uniform Partnership Act*, 24 YALE L.J. 617, 628 (1915). As to the revocability of agency, see RESTATEMENT (SECOND) OF AGENCY § 118 (1957).

63. Engebrecht v. McCollough, 80 Ariz. 77, 292 P.2d 845 (1956); see also Jeebles v. Costellos, 391 So.2d 1024, *appeal after remand*, 406 So.2d 393 (Ala. 1980) (trial court erred in ordering an accounting and that defendant was to continue as sole active partner without ordering dissolution of partnership, thereby imposing a new agreement on the parties); Wolf v. Baltimore, 250 Pa. Super. 230, 378 A.2d 911 (1977) (refusal to enjoin dissolution of partnership because damages are an adequate remedy). But see *Infusaid Corp. v. Intermedics Infusaid, Inc.*, 739 F.2d 661 (1st Cir. 1984), discussed *infra* notes 63-66. As to personal service contracts, see Sarokhan v. Fair Lawn Memorial Hosp., Inc., 83 N.J. Super. 127, 199 A.2d 52 (1964). For a statement of this dual basis of the power to dissolve, see Hillman, *Indissoluble Partnerships*, 37 U. FLA. L. REV. 691, 699 (1985).

64. See RESTATEMENT (SECOND) OF AGENCY § 139 (1957).

65. See Hillman, *supra* note 63, at 703-07.

66. 739 F.2d 661 (1st Cir. 1984).

drawal. The court held, contrary to the U.P.A., that a joint venturer could not withdraw if the venture “can be maintained as an ongoing, profitmaking concern without obliging any officer or director of the corporation that per se dissolved the relationship ‘to continue in such a partnership against his will.’”⁶⁷ The court said that a finding that the joint venture was an “ongoing, assembly line process” would “bode well for the appropriateness of an equitable remedy.”⁶⁸ The court concluded that if the appropriate findings were made, the venturers could be compelled “to continue the business together *according to the terms of the joint venture agreement.*”⁶⁹ The personal service element therefore related not to whether the joint venturer could dissociate from the venture, but to whether it must continue performing the agreement.

Enforcing continuation of the partnership relationship does raise a problem that is similar to specific enforcement: The partner who wishes to dissociate is compelled to continue at least monitoring partnership affairs because of his or her continued investment and personal liability for partnership debts. While this involves a continuation of personal services, it is not like specific enforcement of a personal service agreement because it is the partner, and not the court, who determines how much monitoring to do. The problem is the same as that which underlies the analogy to revocable agency—the compelled continuation of risk-taking.

The traditional bases of the power to dissociate at will are unsatisfactory: Neither the specific performance nor agency analogies compel a buyout right. The buyout right may be justified only by weighing both the costs and benefits associated with buyout.

C. Evaluation of Buyout Right

1. In General

This Section considers whether the statutory standard form should give a partner at least the limited dissociation right involved in buyout. This Section assumes for purposes of discussion that there is no agreement that might be inconsistent with such a right. The specific question is whether the partners would be likely in the absence of transaction costs

67. *Id.* at 669, quoting 3 KENT'S COMMENTARIES 56.

68. *Id.*

69. *Id.* (emphasis in original). The emphasis was added because the court noted that the district court may have gone beyond the terms of the agreement. The court went on to hold that the venture had been wrongfully dissolved, so that the nonwrongful partner had a right to carry on the venture alone if it chose to do so. For further discussion of *Infusaid*, see *supra* note 94.

to agree to at least a buyout right. The answer to that question depends on a comparison of the benefits to the partners of having that buyout right and the costs that the exercise of that right might inflict on the non-dissociating partners.⁷⁰

2. *Benefits of Buyout Right*

a. Control of Agency and Coordination Costs

The buyout right serves as a counter to the exploitive conduct of co-partners. Some exploitive conduct results from the delegation of power to managers in order to utilize the managers' skills. Managers may exercise their discretion so as to benefit themselves at the expense of the business by consuming excess personal time and therefore making decisions carelessly, or by deliberately engaging in transactions on behalf of the firm for personal benefit. This is the problem of agency costs—i.e., the costs of delegating authority to agents.⁷¹ Another form of exploitation involves “coordination costs”—the costs of exploitation by *owners* and of devices to control such exploitation.⁷² These costs are distinguishable from agency costs in that they arise from the allocation of control among the owners—either to the majority, or to the minority in the form of a veto—rather than from the need to utilize the skills of professional managers.

The risk of exploitation may seem to be less in partnerships than in corporations because partners have greater input into business decisions than do corporate shareholders. In a partnership, each partner has an equal vote on partnership matters⁷³ and can veto important decisions.⁷⁴ Thus, while corporate directors typically determine such matters involving a risk of exploitation as manager compensation and dividends, in the

70. It has been suggested that analysis of the availability of a withdrawal right involves “three potentially conflicting objectives”—“stability,” “liquidity” and “risk-aversion.” Hillman, *supra* note 63, at 696. “Liquidity” appears to be one way of averting further exposure to the risks of the enterprise, and “stability” appears to comprise the costs of achieving liquidity. The cost-benefit analysis employed in this article therefore is arguably an articulation of these objectives.

71. See generally Anderson, *Conflicts of Interest: Efficiency, Fairness and Corporate Structure*, 25 U.C.L.A. L. REV. 738 (1978); Jensen & Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976).

72. See Carney, *The Theory of the Firm: Investor Coordination Costs, Control Premiums and Capital Structure*, 65 WASH. U.L.Q. 1 (1987).

73. U.P.A. § 18(e), 6 U.L.A. at 213.

74. U.P.A. § 18(h), 6 U.L.A. at 213-14. For a discussion distinguishing majority exploitation in partnerships and in corporations from the standpoint of partners' participation in control, see Hetherington & Dooley, *supra* note 6, at 42-43.

partnership these decisions would normally be made by unanimous vote of the partners.⁷⁵ But to the extent that this control structure shifts power from managers to owners, it only shifts exploitation from agency problems to coordination problems. The shifting of power from the majority to the minority through a veto power only changes the identity of the potentially exploited group rather than the total amount of coordination costs. Moreover, the partners can vary the U.P.A. standard form by agreement: Partnership agreements often provide for management authority to be exercised by one or more managing partners,⁷⁶ and for important decisions to be made by a majority vote.⁷⁷ Although there is some authority that "fundamental" changes in the partnership cannot be made by majority vote,⁷⁸ any such limitations on explicit delegations of power are questionable and unpredictable. Thus, in some partnerships the nature of exploitation may be closely similar to that in corporations.

Fiduciary duties protect partners, like shareholders, from exploita-

75. U.P.A. § 18(a) provides for equal profit sharing among the partners, and U.P.A. § 18(f) prohibits compensation of partners for acting in the partnership business. Both sections are subject to contrary provision in the partnership agreement, but making and altering the agreement would be by unanimous vote under U.P.A. § 18(h). See U.P.A. §§ 18(a),(f),(h), 6 U.L.A. at 213-14.

76. See *Day v. Avery*, 548 F.2d 1018 (D.C. Cir. 1976), *cert. denied*, 431 U.S. 908 (1977) (law firm executive committee controlled Washington office under partnership agreement); *Detrio v. Boylan*, 169 F.2d 77 (5th Cir. 1948) (power to fix salaries); *Bernstein, Bernstein, Wile & Gordon v. Ross*, 22 Mich. App. 117, 177 N.W. 2d 193 (1970) (exclusive management in senior partners); *McAlpine v. Millen*, 104 Minn. 289, 116 N.W. 583 (1908); *McCallum v. Asbury*, 238 Ore. 257, 393 P.2d 774 (1964) (executive committee of medical partnership given general management authority subject to other partners' power to alter or cancel action taken by majority vote); *Trigg v. Shelton*, 249 S.W. 209 (Tex. Com. App. 1923). Cf. *Michele Amoruco & Figli v. Fisheries Development Corp.*, 499 F. Supp. 1074 (S.D.N.Y. 1980) (partnership managed by American partner not unenforceable on theory that American company controlled by foreign partner in violation of statute); *Frank v. R.A. Pickens & Son Co.*, 264 Ark. 307, 572 S.W.2d 133 (1978) (managing power could terminate plaintiff's interest in partnership); *Texas Unemployment Comm'n. v. Bass*, 137 Tex. 1, 151 S.W. 2d 567 (1947) (because partnerships with some common members were controlled by different partners there was no business under common control that employed more than minimum number of employees for purposes of unemployment compensation contributions).

77. For a case upholding a partnership merger over a partner's objection pursuant to a majority-vote provision in the partnership agreement, see *Day v. Sidley & Austin*, 394 F. Supp. 986 (D.D.C. 1975), *aff'd sub nom*, *Day v. Avery*, 548 F.2d 1018 (D.C. Cir. 1976), *cert. denied*, 431 U.S. 908 (1977).

78. See *McCallum v. Asbury*, 238 Ore. 257, 393 P.2d 774 (1964) (upholding amendment creating management committee only because power of committee limited). For commentary advocating this approach, see Comment, *U.P.A. Section 18(h): Majority Control, Dissenting Partners and the Need for Reform*, 13 U.CAL. DAV. L. REV. 902 (1980). Professor Hillman has also argued that managers have a duty to consult non-managing partners. Hillman, *Power Shared and Power Denied: A Look at Participatory Rights in the Management of General Partnerships*, 1984 U.ILL. L. REV. 865, 884-86.

tion.⁷⁹ But this remedy is not wholly effective because it involves difficult questions concerning the extent of the majority or managing partners' duty and the damages resulting from breach of the duty, therefore necessitating lengthy and costly litigation.⁸⁰

In a publicly held firm, the efficient stock market provides an effective antidote to agency and coordination cost problems in addition to that provided by fiduciary duties. Since owners can transfer out of the company at little cost, shareholders can effectively contain damage from exploitation of their interests (provided they know of it).⁸¹ The efficient market also gives management an incentive to refrain from exploitation because it is relatively easy for someone who can offer superior management to buy control at a premium over market and replace the incumbents.⁸²

Partnership interests, unlike corporate stock, are not normally freely transferable.⁸³ Giving each partner a right to sell his interest back to the firm, depending on how the buyout price is determined and the transaction costs of exercising the put, serves as a substitute for the efficient market for corporate stock in containing exploitation.⁸⁴ In fact, a buyout price that represents the partner's pro rata share of the partnership is a better counter to exploitation than an efficient market price because the

79. U.P.A. § 21 provides that every partner must account to the partnership for unauthorized benefits. U.P.A. § 21, 6 U.L.A. at 258. Pursuant to U.P.A. § 22(c), this right may be enforced in an accounting action. The classic statement of partners' fiduciary duties is that of Judge Cardozo in *Meinhard v. Salmon*, 249 N.Y. 458, 463-64, 164 N.E. 545, 546 (1928): "not honesty alone, but the punctilio of an honor the most sensitive, is . . . the standard of behavior."

80. The principal method of enforcement of fiduciary duties apart from dissolution (the availability of which is at issue here) is by an action for accounting under U.P.A. § 22(a). A formal accounting would involve a complete review of partnership affairs since the last accounting. Note that a partner does have an advantage over corporate shareholders in respect of remedies: since an accounting imposes substantial burdens on those who are responsible for partnership accounts—i.e., the managers—it can therefore be used by the wronged partner as a lever to force concessions.

81. However, the power to transfer shares does not reduce the cost of exploitation that has already occurred. See Carney, *supra* note 72, at 19. Compare the effect of a buyout right in controlling coordination costs, see *infra* note 85 and accompanying text.

82. See Easterbrook and Fischel, *The Proper Role of A Target's Management in Responding to a Tender Offer*, 94 HARV. L. REV. 1161 (1982).

83. See *supra* §§ III(B)(2) & IV(F)(1).

84. Many writers have recognized this point. See, e.g., Carney, *supra* note 72, at 65; Epstein, *In Defense of the Contract at Will*, 51 U. CHI. L. REV. 947, 959 (1984); Goetz & Scott, *Principles of Relational Contracts*, 67 VA. L. REV. 1089, 1144 (1981); Hetherington & Dooley, *supra* note 6 at 39-41; Klein, *The Modern Business Organization: Bargaining under Constraints*, 91 YALE L.J. 1521, 1546 (1982). See also *Donahue v. Rodd Electrotype Co.*, 367 Mass. 578, 328 N.E.2d 505 (1975) (right of buyout necessary in light of illiquidity of close corporation interests).

pro rata price prevents the controlling faction from taking advantage of its own exploitive conduct by purchasing the minority's interest at a discount.⁸⁵ Moreover, like the efficient stock market, the buyout right can deter exploitation because it can act as a mechanism for replacement of dishonest or lazy managers of the partnership by dissociating partners who are able to purchase the assets of the business.

b. Other Benefits

Apart from the risk of misconduct by copartners, a wholly illiquid investment may be forced to earn returns that are lower than those that could be earned in a different business as a result of a change in circumstances from the time of the partner's initial investment in the firm.⁸⁶ If the change in circumstances adversely affects the business as a whole rather than an individual partner, presumably the partners would agree to terminate the business. An individual partner's right to be bought out is particularly important where a change in circumstances affects his or her human capital, as where the partner gains additional knowledge or expertise that is best used in a more specialized firm.⁸⁷

Even a partner whose services are most efficiently utilized within the firm may, because of a change in circumstances since the partner joined the firm, seek to leave because his or her contributions are being compensated at below-market rates. For example, the compensation of a law partner may not adequately reflect the increase of the partner's professional or business-getting skills since the partner's profit share was fixed.

85. It is not clear that the U.P.A. mandates a pro rata share. In *Seattle-First National Bank v. Marshall*, 31 Wash. App. 339, 641 P.2d 1194 (1982) the court held that a deceased partner's share was to be determined without a minority discount where the partnership agreement specifically provided that the value of the interest was "deemed to be the value determined by multiplying the net worth of the partnership by the interest of the deceased or selling partner," stating that a discount might be appropriate if the partnership agreement had not specifically provided for pro rata treatment. U.P.A. § 42, which governs the payment to a partner on continuation after non-wrongful dissolution, provides for payment to the existing partner of the "value of his interest." Nevertheless, in light of each partner's substantial participation in management under U.P.A. § 18(e) and (h), a strong argument can be made that the "default" valuation under the U.P.A. should be pro rata.

86. See W. KLEIN & J. COFFEE, *supra* note 6, at 56 (right to sell interest reduces risk of loss); *Hetherington & Dooley*, *supra* note 6, at 44.

87. Although service obligations are not specifically enforceable (*see supra* note 20), the partners' human capital is committed to the firm in the affirmative sense that the partner must continue to monitor the firm's business as long as his or her capital and credit are tied up in the firm, and in the negative sense that a partner is not permitted in the absence of contrary agreement to earn gains related to the firm without sharing these gains with the other partners. See U.P.A. § 21, 6 U.L.A. at 258.

3. *The Costs of the Buyout Right*

a. The Risk of Takeover

Are the benefits of a buyout right outweighed by the costs of such a right? In other words, would a partner have more to fear from giving his or her co-partners a buyout right than he or she would stand to gain from having such a right?

One problem with the buyout right is that it may permit a takeover of the firm by the "dissociating" partner.⁸⁸ This can occur in a number of circumstances where the non-dissociating partners cannot practicably replace the resources removed from the firm by the dissociating partner, and so are unable to buy out the dissociating partner and continue the firm. Specifically, the remaining partners may be unable to pay for the dissociating partner's interest without selling the firm's assets, to replace unique assets that were owned by the partner, to restore the creditworthiness attributable to the personal wealth of the dissociating partner, or to replace the dissociating partner's managerial skills.⁸⁹ A single partner's contributions are most likely irreplaceable in a firm with relatively few owners, the model for the statutory standard form.⁹⁰

*Page v. Page*⁹¹ illustrates this situation. In *Page*, the court permitted dissolution as of right by a managing partner who held a substantial demand note of the partnership, a linen supply firm, with the probable result that his brother and co-partner would be forced out of the business and unable to share in the burgeoning business from a new military base. In another case, a dissolving partner could appropriate the partnership's laundromat because he owned the premises in which the business was operated and he refused to lease them to his partner or any other successor.⁹²

Although the takeovers discussed in the preceding paragraph resulted from exercise of the U.P.A. liquidation right, a takeover clearly can oc-

88. "Dissociating" is used here in the technical sense of a partner who exercises a right to dissociate from the firm although the result may be the exclusion of the "non-dissociating" partners from the business.

89. A survey of close corporation dissolution cases revealed that dissolution was "rarely used as a takeover tactic" by the plaintiff. See Hetherington & Dooley, *supra* note 6, at 36. However, the surveyed cases arose under statutes that required a showing of oppression or other misconduct for dissolution, and so invited suits mainly by frozen-out holders whose need to take legal action was probably attributable to the fact that they did not hold significant resources.

90. See *supra* § II(B).

91. 55 Cal. 2d 192, 359 P.2d 41, 10 Cal. Rptr. 643 (1961).

92. *Cude v. Couch*, 588 S.W.2d 554 (Tenn. 1977).

cur on buyout even if the dissociating partner does not have a liquidation right. In *Pav-Saver Corp. v. Vasso Corp.*,⁹³ the terminating partner owned the patents of the machines manufactured by the partnership. The partnership agreement provided that the “partnership shall be permanent, and same shall not be terminated or dissolved by either party except upon mutual approval of both parties[.]” Since the terminating partner breached the agreement, the court ordered a buyout under U.P.A. § 38(2)(b). But this provision was little help to the non-breaching partner, who could not continue the business without the patents. The partner was rescued from the effects of dissolution at will only by the court’s decision to permit the partnership to retain the patents despite the parties’ agreement to return the patents to their owner on termination. The court reasoned that the U.P.A. specifically provides for continuation in this situation and that the partnership could not be continued without the patents. Moreover, the court held that the continuing partner did not have to pay for the patents because this was “good will” which could be excluded from valuation under U.P.A. § 38(2)(c)(II).⁹⁴

Although the takeover-by-buyout appears to involve exploitation by the dissociating partner of the other partners who are forced out of the business, it is not always clear how the forced-out partners are hurt. Why could they not borrow or hire the financial, managerial or other resources removed by the withdrawing partner, as by taking on a replacement partner? Specifically, why could not the *Page* defendant borrow enough to cover his partner’s demand note and hire a new manager? One possible answer is that the squeezed-out partner *could* have raised the necessary resources, but did not *want* to because he had a more pessimistic view than the partner insisting on buyout of the worth of the business. Under this view, the partner who ultimately takes over the business can do so because he can extract higher returns than can the losing partner, so that takeover-by-buyout may be an efficient result.

There is, however, an alternative explanation for the takeover that casts doubt on the desirability of facilitating the takeover: The losing partner was squeezed out not because he was unable to put the business

93. 143 Ill. App. 3d 1013, 493 N.E.2d 423 (1986).

94. 143 Ill. App. 3d at 10, 493 N.E.2d at 427. For another case in which the court prevented withdrawal of crucial property by stretching the U.P.A. see *Infusaid Corp. v. Intermedics Infusaid, Inc.*, 739 F. 2d 66 (1st Cir. 1984), discussed at *supra* notes 66-69. In that case, the court held that a licensor-venturer could not necessarily withdraw from a joint venture despite technical dissolution of the partnership.

to a better use than the winning partner, but because of the latter's inherent advantages in taking over the business. This will be the case if only the winning partner has sufficient personal wealth—including a large stake in the partnership—to make the purchase. The other partner or partners may attempt to borrow money or raise additional equity by offering an interest in the partnership, but they must persuade the person supplying the capital to their optimistic view of the prospects of the business. That may be difficult because of the unavailability of reliable information about the value of a very closely held business. The partner who lacks personal resources therefore may be unable to match the wealthy partner's bid, or may be able to do so only by accepting a very small share of the profits of the business. The inherent advantages of the dissociating partner are enhanced by the fact that by controlling the time of the buyout the dissociating partner may capitalize on temporary problems of the other partners.⁹⁵

Even a partner who lacks substantial personal wealth may have a significant advantage in competing for control if he or she has important managerial skills. The non-manager is faced with problems similar to those of the partner who lacks personal wealth in persuading a third party to commit valuable human capital to the partnership. Moreover, the non-manager may not even be able to accurately determine the value of the business without the services of the manager-partner.⁹⁶

Even if the dissociating partner can take over the business, it is still not clear why the remaining partners are hurt. If the losers will receive their shares of the market value of the firm's assets on sale of the business, do they have reason to complain?

The initial response is that sale of the firm may not be conducted so as to yield the highest possible price.⁹⁷ Possible defects in the method of sale could be mitigated by judicial supervision of the sale.⁹⁸ But judicial over-

95. See Carney, *supra* note 72, at 45.

96. See Hetherington & Dooley, *supra* note 6, at 28-29.

97. This is particularly true if the assets are sold in a judicial sale. For a discussion of the problems involved in execution sales, see LoPucki, *A General Theory of the Dynamics of the State Remedies/Bankruptcy System*, 1982 Wis. L. REV. 311, 317-18.

98. See the cases dealing with fiduciary duties of dissolving partners cited *supra* note 55. See also Weiss v. Gordon, 32 A.D. 2d 279, 301 N.Y.S.2d 839 (1969). In Weiss, the court permitted dissolution for deadlock of a close corporation, the court noting "[w]hatever respondent's share of the business is, he will get it. Instead of forcing respondent to accept an inadequate consideration for his share of the business, petitioner now applies to the court to make the distribution." 32 A.D.2d at 280, 301 N.Y.S.2d at 841.

sight cannot be a complete solution because of the difficulty of accurately valuing a partnership interest. There is no efficient market for interests in general partnerships. A court might look for comparable businesses, but the value of a partnership is likely to depend on characteristics that are specific to the firm, such as the nature of services rendered, location and the extent to which value depends on the human capital of the partners. In the absence of benchmarks of going concern value, the courts have been notably conservative in defining going concern value of a partnership,⁹⁹ or even in determining that the partnership has going concern value.¹⁰⁰ Even a court that is willing to recognize all elements of good will may rely on historical earnings and ignore the potential effect of real, but unproven, prospects.¹⁰¹ This is particularly troublesome because, again, the partner exercising the buyout right controls the timing of the valuation.¹⁰²

Valuation problems are not wholly alleviated even if a court is willing to give the non-dissociating partner the value of the business prospects of the partnership by characterizing these prospects as opportunities that were appropriated by the dissociating partner. The court in *Page* suggested that the plaintiff may be liable if he “violated his fiduciary duties by attempting to appropriate to his own use the new prosperity of the

99. Goodwill has been defined in the partnership context as “nothing more than the probability that the old customers will resort to the old place.” *Cruttwell v. Lye*, 17 Ves. 335, 346, 34 Eng. Rep. 129, 124 (1810). The “chief elements” of goodwill were characterized in a leading case as “continuity of place” and “continuity of name.” *In re Brown*, 242 N.Y. 1, 150 N.E. 581 (1926). This ignores the factors that relate to other aspects of the firm’s ability to deliver its product at a competitive price, including business organization, credit rating, volume and stability of demand. Thus, goodwill, perhaps interpreted in the narrow sense of expectation of future business, has been distinguished from the broader “going value” of a business. *Marso v. Graie*, 226 Minn. 540, 33 N.W.2d 717 (1948).

100. Courts have traditionally denied the existence of goodwill in professional partnerships. See *Jackson v. Caldwell*, 18 Utah 2d 81, 415 P.2d 667 (1966); Laube, *Good Will in Professional Partnerships*, 12 CORNELL L.Q. 303 (1927); Crane, *Partnership Goodwill*, 18 VA. L. REV. 651 (1932). This ignores the fact that such partnerships may have goodwill associated with such features as organization and place. See *In re Brown*, 242 N.Y. 1, 150 N.E. 581 (1926). Also, perhaps the reputations of the partners should be considered an element of the firm’s value. Some, particularly more recent, cases have recognized goodwill in professional partnerships. As to compensation of outgoing law partners for goodwill, see *Spayd v. Turner, Granzow & Hollerkamp*, 19 Ohio St. 3d 55, 482 N.W.2d 1232 (1985), noted in 20 AKRON L. REV. 157 (1986); Comment, *Dissolution of a Law Partnership—Goodwill, Winding-Up Profits and Additional Compensation*, 6 J. LEG. PROF. 277 (1981).

101. For an example of reliance on historical earnings in the corporate appraisal rights context, see *Universal City Studios, Inc. v. Francis I DuPont & Co.*, 224 A.2d 216 (Del. 1975).

102. See *Carney*, *supra* note 72, at 45. This may have been a particular problem in the *Page* case where the dissolution occurred just as an Air Force base opened up near the partnership’s linen supply business.

partnership without adequate compensation to his co-partner.”¹⁰³ It is difficult, however, to determine the potential profits of nascent business opportunities.¹⁰⁴

Even if the squeezed-out partners received the full value of their interests, there is some question whether this would be adequate. The ousted partners will lose the value of their firm-specific human capital—i.e., skills they can use only in their former firm.¹⁰⁵ An example would be any skills of the non-breaching partner in *Pav-Saver*¹⁰⁶ related specifically to manufacture of the machines covered by the breaching partner’s patents.

b. Other Costs

The buyout right may be costly to the other partners even if it does not aid a takeover of the firm by the dissociating partner. Particularly in our “model” small firm, the partners who wish to continue might have to sell important assets in order to pay off the leaving partner. If this happens prior to completion of a project, the start-up costs might have to be written off at salvage value. The threat of full or partial liquidation at any time might prevent a firm from undertaking projects that require a substantial investment with only long-range benefits.

A second problem with the buyout right focuses on use of the right to force changes in the partners’ agreement. A partner whose resources are vital to the firm can use a threat to withdraw to obtain a rate of compensation that reflects the current market value of these resources rather than the agreement’s lower value.¹⁰⁷ The partner can also use the threat to withdraw to exercise a de facto veto, thus changing the agreement’s governance structure.¹⁰⁸

103. 55 Cal.2d at 197, 359 P.2d at 45, 10 Cal. Rptr. at 647.

104. See Hillman, *supra* note 63, at 716. Thus, the courts have permitted only reliance damages where a partnership was wrongfully dissolved in its early stages, before potential profits could be determined. *Geczy v. La Chappelle*, 636 P.2d 604 (Alas. 1981); *Brand v. Elledge*, 101 Ariz. 352, 419 P.2d 531 (1966); *Kolb v. Dietz*, 454 S.W.2d 632 (Mo. App. 1970); *69th Street Apartments, Inc. v. Lauricella*, 142 N.J. Super. 546, 362 A.2d 78 (1976), *aff’d*, 150 N.J. Super. 47, 374 A.2d 1222 (1977) (corporation case applying partnership principles); *Webster v. Beau*, 137 P. 1013 (Wash. 1914).

105. As to firm-specific human capital see generally G. BECKER, *HUMAN CAPITAL* (1964). For a discussion of the problem in the context of takeovers of publicly held firms, see Haddock, Macey & McChesney, *Property Rights in Assets and Resistance to Tender Offers*, 73 Va. L. Rev. 701 (1987).

106. See *supra* text accompanying notes 93-94.

107. The use of the power to dissolve to force changes in the agreement is discussed in Hillman, *supra* note 5, at 443-44, 470.

108. See *id.* at 452 n. 101.

The effect of the buyout right on the partnership agreement is the dark side of the point discussed earlier that dissociation permits partners to react to changes in circumstances.¹⁰⁹ The question is whether, viewing the matter from the perspective of the making of the bargain, the partners would wish to enforce it although circumstances might later make some of them losers. The potential benefits of an agreement that cannot be unraveled are illustrated by the law firm setting; as discussed by Gilson and Mnookin,¹¹⁰ the law partners may wish to share firm profits on a strict seniority basis in order to diversify away any risks to the value of their human capital. If the partners can dissociate without penalty at any time,¹¹¹ they can force the firm to compensate them on the basis of their current marginal product at the expense of partners who are producing less than at the time of the agreement. This obviously defeats the point of diversification. The partners may prefer a rule that preserves the substantial benefits of diversification even if they risk losing the full value of their marginal product, assuming the potential benefits offset the potential costs.

The buyout right may also make it possible for the dissociating partner to withdraw resources he appears to own, but which he developed at firm expense. This is particularly clear as to the leaving partner's human capital, since the partner's work in the firm may result in development of expertise or a client base he can utilize outside the firm.¹¹² Similarly, firm-paid advertising may have increased the value of the premises used by the partnership but owned by the dissociating partner.

4. *Balancing Costs and Benefits*

The above discussion reveals that, while permitting dissociation at will

109. See text *supra* accompanying notes 87-88.

110. See Gilson and Mnookin, *Sharing Among the Human Capitalists: An Economic Inquiry into the Corporate Law Firm and How Partners Split Profits*, 37 STAN. L. REV. 313 (1985).

111. Gilson and Mnookin point out that ethical rules make it impossible to wholly restrict a lawyer's withdrawal from the firm. See *id.* at 337 n. 41. The authors then demonstrate how withdrawal can be deterred in a law partnership by the development of firm-specific capital, which exists by reason of such factors as the firm's client base and reputation. See *id.* at 353-71. The authors understate the effectiveness of a no-withdrawal rule even in the law firm setting because withdrawal would be effectively deterred if the withdrawing lawyer had no right to be paid the value of his or her interest in the firm or to be protected from exposure to past or future firm liabilities.

112. See Carney, *supra* note 72 at 45 giving as an example of this problem *In Re Radom & Neidorff, Inc.*, 307 N.Y. 1, 119 N.E.2d 563 (1954). This problem justifies enforcement of covenants not to compete. See Rubin & Shedd, *Human Capital and Covenants Not to Compete*, 10 J. LEG. STUD. 93 (1981). See also *infra* note 117.

involves substantial benefits for dissociating partners, these benefits come at a potentially great cost to the partners who wish to continue. In light of the costs and benefits of the dissociation right and the *ex ante* uncertainty, would the parties to a general partnership—and particularly our “model” small firm¹¹³—be likely in the absence of transaction costs to agree to dissociation at will? Several considerations suggest an affirmative answer to this question.

To begin with, it is important to consider the distribution and not merely the total amount of the costs of each alternative. For example, an individual partner who is locked into a partnership after circumstances cause the relationship to become onerous may suffer substantial losses in the value of his financial and human capital over an extended period. A partner's abusive exercise of the dissociation right may cause all of the non-dissociating partners to give up partnership assets without adequate compensation or to lose the benefit of firm specific human capital. But even if the non-dissociating partners as a group might suffer a greater loss in the event of abusive dissociation than a single locked-in partner might suffer without a dissociation right, each partner is more likely *ex ante* to focus on his risk than on the aggregate. Assuming the partners cannot predict *ex ante* whether they will belong to the dissociating or the non-dissociating group, they would want an agreement that minimized the graver costs borne by locked-in partners. Moreover, on a more objective basis, a loss that is spread among individuals has less impact than the same loss borne by one individual.¹¹⁴

The argument in the preceding paragraph assumes that the partners cannot and do not know *ex ante* whether they would want to dissociate. That will not always be the case. For example, if, as in the *Pav-Saver* case,¹¹⁵ one partner contributes vital and unique resources to the partnership and others contribute cash, it is likely that the former will at some point in the relationship want to use the threat of dissociation to force renegotiation of the bargain.¹¹⁶ But it does not necessarily follow that the parties will draft around dissociation at will. Even if the capital contributors outnumber the vital resource contributor, the resource contributor will have considerable leverage in negotiating the initial agreement.

113. See *supra* § II(E).

114. For a discussion of the benefits of risk spreading, see G. CALABRESI, *THE COSTS OF ACCIDENTS*, 20-21 (1970).

115. See *supra* text accompanying notes 93-94.

116. This problem is discussed *supra* notes 107-111.

The other partners might agree to dissociation at will in order to induce the resource contributor to join the firm. Although the other partners will expose themselves to the risk of a squeezeout, the agreement is not necessarily one-sided in this respect because there is some possibility that they will want to escape the partnership.¹¹⁷ Thus, if the dissociation scenario is foreseeable at the outset it is more likely that the parties will draft for dissociation than that they will draft around it.

A third consideration is that it is less costly to draft around dissociation at will than to draft for it. If the statute failed to provide a right of exit, the partners could provide one only by settling such details as when the right could be exercised, the terms of payment, and liabilities to creditors. It will usually be easier for the partners to limit dissociation.¹¹⁸

A related point favoring dissociation at will is the availability of cost-efficient contractual devices to protect against costly dissociation. If the statute provides for dissociation at will, the partnership can discourage dissociation and protect against withdrawal of human capital and other resources by developing firm-specific capital the partners would lose by leaving,¹¹⁹ by limiting the compensation to be paid to the dissociating partner,¹²⁰ by providing for payment of liquidated damages,¹²¹ or by limiting post-dissociation competition.¹²² On the other hand, there are

117. In *Pav-Saver*, the parties did not agree to dissociation at will, perhaps because withdrawal of the patent-owner would certainly destroy the firm. Thus, dissolution at will would have been one-sided under the particular circumstances of this case.

118. I am not suggesting that the statute should provide for dissociation at will regardless of its likely costs and benefits, but only that drafting considerations might tip the balance toward dissociation at will given that costs and benefits are both substantial.

119. See *supra* note 111.

120. See *Osborne v. Workman*, 273 Ark. 538, 621 S.W.2d 478 (1981) (departing partner denied interest in accounts receivable); or, the provisions limit the buyout price to book value, *Hagan v. Dundore*, 185 Md. 86, 43 A.2d 181 (1945) (buyout price limited to book value). As to possible non-enforcement of provisions providing for payment of less than fair market value, see *supra* note 14. For an argument that the U.P.A. provision providing for no compensation for post-dissolution services discourages dissolution for the purpose of "grabbing" uncompleted business in law firms, see Comment, *Winding Up Dissolved Law Partnerships: The No-Compensation Rule and Client Choice*, 73 CAL. L. REV. 1597, 1606 (1985).

121. For an example of a partnership dissolution case in which a liquidated damages provision was enforced, see *Pav-Saver Corp. v. Vasso Corp.*, 143 Ill. App. 3d 1013, 493 N.E.2d 423 (1986).

122. As to the use of non-competition agreements in controlling taking of human capital developed at firm expense, see *Rubin & Shedd*, *supra* note 112. Enforceability of non-competes may be less of a problem in the partnership than in other contexts because it is likely that the agreement was the product of fair and equal bargaining. See *Foti v. Cook*, 263 S.E.2d 430 (Va. 1980); RESTATEMENT (SECOND) CONTRACTS § 188, Illus. 11-13; Closius and Schaffer, *Involuntary Nonservitude: The Current Judicial Enforcement of Employee Covenants Not to Compete—A Proposal for Reform*, 57 S. CAL. L. REV. 531, 554-56 (1984).

fewer cost-effective devices for protecting against the costs of illiquidity. The most effective protection is fiduciary duties, but these are vague, unpredictable and costly to enforce and do not address costs resulting from changes in circumstances that do not involve partner misconduct.

5. *Suggested Approach*

It follows from the foregoing that the statute should, at a minimum, permit each partner to dissociate at will by terminating his investment and obligations to co-partners and creditors. Accordingly, Section 1.01 of my proposed statute (set forth in Part VIII) provides for dissociation in circumstances similar to those in which the partnership is dissolved under U.P.A. §§ 29, 31 and 32, including withdrawal by voluntary act (Section 1.01(a)(1)). The lead-in to Section 1.01, by specifying that the dissociating partner “ceases to be a partner” on occurrence of an event of dissociation, effects termination of the partner’s obligations to co-partners.¹²³ Section 1.02 sets forth the rights of the dissociating partner to be paid by the partnership—i.e., to terminate his investment in the partnership. Section 1.02 provides for payment of the fair value of the partner’s interest, but facilitates continuation of the firm by the other partners by permitting deferred payments.¹²⁴ The dissociating partner terminates his credit contribution as to post-dissociation debts pursuant to Section 1.03, which is drawn from U.P.A. § 35.

D. *Liquidation Right*

1. *The Benefits of Liquidation*

The liquidation right as used here refers to a partner’s right to exit the partnership through a sale of the assets of the partnership and not merely a buyout by the other partners at a price fixed by the court. Although an asset sale can result from the buyout right where the non-dissociating partners are unable to arrange a buyout, there is a separate question whether the dissociating partner should have a right to insist on sale and thereby override the preference of the other partners.

This Section discusses the liquidation right distinct from the dissociating partner’s right to have the liabilities discharged. U.P.A. § 38(1) links

123. U.P.A. §§ 20 and 21 should be amended in light of the provision in Section 1.01 for cessation of partner status to protect former partners prior to settlement of their interests under Section 1.02.

124. I base Section 1.02(d), which provides for deferred payments, on the Hetherington and Dooley proposal for close corporation buyouts, Hetherington and Dooley, *supra* note 6, at 56-58.

liquidation and discharge by requiring application of assets to the payment of liabilities. However, as I discuss in Section V(D), whether liabilities are discharged involves issues separate from those involved in liquidation without discharge.

One justification for the liquidation right is that a sale of the assets is a better way of determining the value of the partnership than relying on a judicially supervised guess.¹²⁵ Ensuring full valuation of partnership interests lowers the costs of dissociation and commensurately increases the effectiveness of dissociation as a counter to exploitation and changes in circumstances. Also, a market test of valuation may conserve judicial resources that would otherwise be committed to the difficult task of valuation.

A second benefit of the liquidation right is its even-handedness among the partners. Because no partner has a legal advantage in acquiring the business, as is the case when a partner exercises a right to be bought out by the other partners, the market alone determines the identity of the buyer.¹²⁶ This helps to ensure that the partner who can best use the partnership assets (because that partner is willing to pay a higher price for them) acquires them.

2. *The Costs of the Liquidation Right*

It has been said that a negative aspect of the liquidation right is that it destroys the going concern value of the firm.¹²⁷ In fact, if, and only if, the partnership business is worth more alive than dead, someone—either a partner or a third party—will purchase it as a going concern.¹²⁸ That is particularly so if, as is assumed in this Section, the liquidation right is not coupled with a right to have the liabilities discharged.

The more important problem with the liquidation right is that, as compared with buyout, the liquidation right makes it easier for the stronger

125. See STORY, *supra* note 56, at 496-7 note 4, 500-01. Similarly, some have argued that a market auction under Chapter 7 of the Bankruptcy Code (11 U.S.C. §§ 701, et. seq.) is preferable to giving the existing claimants the right to take the firm at a valuation under Chapter 11 of the Bankruptcy Code (11 U.S.C. §§ 1101 et. seq.). T. JACKSON, *supra* note 23, at 222-23; Roe, *Bankruptcy and Debt: A New Model for Corporate Reorganization*, 83 COLUM. L. REV. 527 (1983).

126. See STORY, *supra* note 56, at 502-03.

127. See Bromberg, *Partnership Dissolution—Causes, Consequences, and Cures*, 43 TEX. L. REV. 631, 647 (1965).

128. See Hetherington & Dooley, *supra* note 6, at 26, 33 and 50 (survey of close corporation dissolution cases demonstrated that dissolution rarely, if ever, results in loss of going concern value).

partner to take over the business. For example, in *Prentiss v. Sheffel*,¹²⁹ two partners owning an aggregate 85% interest in the partnership dissolved the firm and then purchased its assets at a judicial sale; this accomplished the expulsion of the remaining 15% partner. The excluded partner (defendant) complained that plaintiffs could bid “paper” dollars due to their 85% interest—i.e., could acquire the firm by purchasing only the small fraction they did not own—and that the plaintiffs’ attorney chilled the sale to a third party by announcing that his clients were prepared to go to three million dollars (the sale price was a little over two million). The court, finding no misconduct, confirmed the sale.¹³⁰

If the “dissociating” partners in *Prentiss* had had only a right to be bought out, the defendant would have had an opportunity to buy at a judicially set price. In a liquidation, on the other hand, the “dissociating” partners could use their investment in the firm to bid even higher than the actual value of the firm, and certainly higher than the value a court would have fixed in light of judicial conservatism concerning “goodwill.”¹³¹ Even if the defendant had borrowed against the “hard” assets of the business, he might not have been able to outbid the plaintiffs’ “paper dollars.” Although the plaintiffs’ position in this case was so strong that it is unlikely defendant could have acquired the firm even in a buyout, the case illustrates how liquidation can strengthen a dissociating partner’s position.

In *Prentiss*, the auction process may have resulted in payment to defendant of a price that fairly reflected the market value of the firm’s assets and was actually higher than the price defendant would have received if the plaintiffs had not participated in the bidding. But this is significant only if defendant wanted to leave the partnership. If the sale facilitated a squeeze-out of defendant, defendant may have incurred substantial costs as a result of the takeover even if he was paid a “fair” price.¹³²

129. 20 Ariz. App. 411, 513 P.2d 949 (1973).

130. For other cases dealing with the fairness of judicial sales of the partnership see *supra* note 49.

131. See *supra* text accompanying notes 99-102.

132. See *supra* discussion at notes 105-106. Moreover, the auction approach does not ensure that the partner who is best able to use the assets in fact acquires them because the high bidder may have an inherent bidding advantage rather than simply being willing to pay a higher price. See *supra* text accompanying notes 95-96.

3. *Balancing Costs and Benefits*

Would the partners be likely to conclude that the increased risk of squeeze-out from the right to liquidate at will outweighs its benefits in terms of lowering the cost of exit? To answer this question, it is helpful to look more closely at the most likely scenarios involving exercise of the liquidation right. The liquidation right is likely to yield its principal benefit of facilitating payment of full value when the partnership business has substantial going concern value—i.e., is not merely holding assets. The good will component of value is the most difficult to measure because it is determined by unique characteristics of businesses and because exact comparables are impossible to find.

Whether the liquidation right will lead to an adequate going concern value depends largely on whether there is an active auction for the partnership business as a going concern. That auction is unlikely to happen unless the partners participate in the auction. The partners usually will be the highest bidders for a going business because they have an information cost advantage over outsiders and because they may include in their bid elements of value that are irrelevant to third parties, particularly including the value of the partners' own firm-specific human capital that they will lose if they leave the business.¹³³

An inter-partner auction for the business probably will not occur without the participation of the electing partner. Although more than one of the continuing partners probably will wish to take over the business, it is unlikely that they will suddenly decide to *compete* with each other for control simply because a partner has decided to leave. Thus, the competition for the firm that is essential for full valuation usually will occur on liquidation at will only if the partner who exercises the liquidation right also seeks control. In other words, liquidation at the will of a partner is likely to yield its greatest benefit in terms of accurate valuation of the partnership precisely when the liquidation right is most likely to be used as a mechanism to take over the business.

In light of the above discussion, the parties to a partnership relationship would not be likely to give each partner the right to liquidate at will. Because liquidation at will is ordinarily beneficial in terms of valuation of the partnership assets only if accompanied by a costly squeezeout, liquidation at will offers the partners only the opportunity to be on the winning side of a zero-sum reallocation of values among the partners. If the

133. See *supra* text accompanying notes 105-106.

partners do not know *ex ante* whether they will be winners or losers, they have little to gain by gambling in this way. If the partners can predict who will benefit from a liquidation right, it is unlikely the potential losers will agree unless they are offered strong inducements under a customized agreement. By comparison, the buyout right is desirable because it offers all of the partners, including those who are unlikely to be able to use the buyout as a squeeze-out device, a cost-efficient way to reduce the substantial risks associated with illiquidity.

4. *When Liquidation is Appropriate*

Although the partners would be unlikely to agree that a single partner should have the right to compel liquidation of the partnership at any time, situations exist where liquidation is appropriate.

First, the firm should be liquidated if the partners unanimously so decide. By extension, liquidation is also appropriate on the termination date set in the agreement because this is, in effect, a unanimous vote to liquidate taken at the outset of the partnership.¹³⁴

The serious question as to consensual liquidation is whether liquidation should be permitted on the basis of a sub-unanimous vote. Although this might facilitate a squeeze-out of the dissenting partner or partners, the majority could probably effect a squeeze-out in all events by exercising their buyout right because it is unlikely the minority could muster the resources for a buyout.¹³⁵ However, the disparity in financial interests between the majority and the minority is not necessarily determinative. The majority's liquidation right is meaningful if the minority has a bidding advantage because of its management position. Thus, a sub-unanimous liquidation right might be useful in some cases to protect against exploitive conduct by a managing partner. This situation will most likely exist in our "model" small firm¹³⁶ where the abilities of a single partner may loom relatively large.

A single partner should be able to compel liquidation, as opposed to merely obtaining buyout, upon a judicial determination that the business of the partnership is no longer viable. A business is no longer viable if

134. It is important to distinguish the effect of termination of an agreed term or undertaking under an agreement that the partnership shall terminate at this time from the problem of premature dissociation. See *infra* text accompanying notes 167-171.

135. This is illustrated by the *Prentiss* case, where the owners of 85% of the firm dissociated the firm. See *supra* text accompanying notes 129-131.

136. See *supra* § II (B).

the business is unlawful¹³⁷ or a losing proposition with no prospects of success.¹³⁸ Liquidation of such a business cannot facilitate takeover of a going concern and will minimize the partners' costs of exit where exit is particularly desirable.

Judicial liquidation upon request of a single partner is also appropriate in the event of partner exploitation.¹³⁹ In this situation, the added benefit of the liquidation right in deterring misconduct serves to counterbalance its costs. Moreover, since liquidation on this ground is likely to be sought by the weaker partner, it probably will not facilitate a squeeze-out.

A single partner also should be able to have judicial liquidation on the basis of partner deadlock. Because deadlock is more likely where there is disagreement among active managers rather than between managing and non-managing partners, liquidation on a showing of deadlock presents a relatively low risk of facilitating takeover by a strong partner. Also, the "evenhandedness" of liquidation¹⁴⁰ is of primary importance in this situation: Liquidation may be the only fair way of determining which partner or faction should have the business when they cannot run it together. Although granting a liquidation right upon deadlock might perversely encourage a partner who wishes to liquidate to force a deadlock, characterizing such conduct as a breach of fiduciary duty can minimize this risk.

Finally, liquidation is appropriate if the partnership fails to buy out the interest of a partner who exercises his buyout right. This "back-up" liquidation is necessary in order to effectuate the partners' basic dissociation right. Although liquidation in this situation may be costly, as where it facilitates squeeze-out, the benefits of dissociation at will outweigh these costs.

137. U.P.A. § 31(3) provides for dissolution when it becomes unlawful to carry on the business "or for the members to carry it on in partnership." 6 U.L.A. at 376. In the latter situation, a more appropriate remedy might be the severing of the "unlawful" partner. Although no judicial determination is necessary under U.P.A. § 31(3), this issue is sufficiently likely to be disputed that judicial determination should be required.

138. U.P.A. § 32(1)(e) provides for judicial dissolution when "[t]he business of the partnership can only be carried on at a loss" 6 U.L.A. at 394.

139. The appropriate standard of misconduct is discussed *infra* in § VII(C) in connection with whether dissociation should be permitted in this situation even in the face of a contrary agreement. As discussed *infra* text accompanying note 192, misconduct might be a basis of expulsion of the wrongdoing partner rather than liquidation.

140. See *supra* text accompanying note 126.

Sections 1.04 and 1.05 of the proposed statute provide for liquidation and winding up in the situations discussed in this subsection.

E. Liquidation with Discharge

Should the liquidating partner be entitled to discharge of liabilities as distinguished from merely assumption of liabilities by the continuing partners? Liquidation clearly need not involve discharge. The business, together with its liabilities, could simply be transferred to new owners, subject to limitations on assignment of contractual obligations.

The obvious benefit of the discharge right is that the dissociating partners can sever their connection from the firm more completely than if the liabilities are merely assumed by the continuing partners, and so they can reinvest capital and credit in other ventures. The position of the dissociating partners is particularly sympathetic in that, if they cannot obtain discharge, they will continue as uncompensated financial backers of the partnership.¹⁴¹

Discharge does, however, entail two types of costs. First, discharge makes it more difficult to carry on the business as a going concern. The right to compel discharge does not necessarily prevent continuation of the business. The debts may be small in relation to assets, or the dissociating partner may be an unimportant credit source (i.e., judgment proof) so that the partnership's creditors will readily agree to discharge. The partners who wish to continue also may be able to avoid discharge by compensating the dissociating partner for his guarantee. In other situations, discharge may have a significant effect on whether the business can be continued. If the debts are high in relation to assets or if the dissociating partner is an important source of the partnership's credit, as will likely be the case in our relatively small "model" firm, the creditors may insist on payment as a condition of granting discharge. Because the risk is greatest in these situations, the price of the dissociating partner's guarantee is likely to be high.

Second, even if the discharge right does not result in loss of going concern value, exercise of the right may facilitate takeover by the faction of partners best able to put up the additional ante, therefore entailing the costs discussed in Section V(C)(3).

Although discharge adds both costs and benefits to liquidation, the

141. By comparison, as I discuss in the following paragraph, partners who can insist on discharge can sell this right for an amount sufficient to cover the risk of guaranteeing partnership debts.

situations that call for the liquidation right also justify liquidation with discharge. In the majority vote situation, whether the dissenting partner or partners must cover the partnership debts as a cost of continuing the partnership will probably not affect their ability to win a bidding contest with the liquidating majority. Moreover, if the majority concludes that termination of the business is appropriate, there is little reason to fear loss of substantial going concern value because the interests of the majority are likely to be aligned with those of the partnership as a whole. If the partnership is no longer viable, the discharge right obviously will not result in takeover or in loss of going concern value.

When the firm is liquidated because of the misconduct of a partner, the fact that the plaintiff will not usually be the controlling partner means that the right to obtain discharge probably will not facilitate a takeover by the plaintiff or threaten the viability of the firm. If there are costs in this situation because of discontinuity of the firm, the most appropriate remedy is expulsion of the misbehaving partner rather than liquidation.¹⁴² If liquidation with discharge in response to partner misconduct is both necessary and costly, the deterrent value of the discharge right counterbalances the extra costs. Dissociation is cheaper and therefore more effective in curbing partner misconduct if an exploited partner can dissociate without guaranteeing pre-dissociation debts.

The discharge right is not excessively costly in the deadlock situation. Although discharge may threaten the viability of the firm, if the deadlock is sufficiently serious that a partner is willing to press for liquidation despite the potential loss of going concern value, this may signal that the business should be discontinued. If, as will often be the case in the event of deadlock, the parties are co-managers, the added burden of discharge may be enough to facilitate a squeeze-out that might not have occurred without the discharge right. But the benefit of the discharge right in resolving costly disharmony counterbalances this cost. If neither partner can dissociate without guaranteeing future liabilities, the deadlock is likely to continue. But if either partner can make a clean break, he will do so or the partners will resolve their differences to reap the greater benefits of preserving the firm.

Consistently with the foregoing, Section 1.04 of the suggested statute provides, as does U.P.A. § 38(1), that upon sale of the partnership assets, the proceeds must be applied to discharge of the partnership's liabilities.

142. See *infra* text accompanying note 192.

F. Dissolution

1. The Benefits of Dissolution

Despite the central role of dissolution under the U.P.A., it is not immediately clear why the partnership must dissolve in order to effectuate a partner's departure. The proposed statute terminates obligations among the partners by providing for the cessation of partner status (Section 1.01). The statute also terminates the dissociating partner's investment through buyout (Section 1.02) or sale of assets (Section 1.03) and terminates obligations to post-dissociation creditors (Section 1.04) all without dissolving the partnership entity.

Because dissolution operates with regard to the partnership entity, the need for dissolution relates to the function and existence of the partnership entity. The U.P.A. definition of partnership is neutral on whether a partnership is a legal entity or an aggregation of the partners,¹⁴³ and the Act itself includes both aggregate and entity-based features.¹⁴⁴ The U.P.A. appears to adopt the aggregate approach as to dissolution because although the firm dissolves, it does so upon dissociation of any member, and so has no life apart from the individuals associated with it.¹⁴⁵ But the partnership is a separate entity for many purposes outside the U.P.A. For example, a partnership can generally sue and be sued in its own name.¹⁴⁶ To the extent that a partnership is a separate entity, it is impor-

143. Under U.P.A. § 6(1), the partnership business is carried on not by a "legal person" but by an "association of two or more persons . . . as co-owners." The Commissioners' Notes state that the characterization of partners as co-owners is intended to clarify that they have the "power of ultimate control." 6 U.L.A. at 22-23. Thus, the statement that partners are co-owners is apparently not intended as a statement that the business is to be identified with the partners.

144. Aggregate characteristics include joint or joint and several liability of the partners (U.P.A. § 15, 6 U.L.A. at 174) and, at least nominally, ownership of partnership property by the partners rather than by the partnership (U.P.A. § 25, 6 U.L.A. at 326). Entity features include the ability of the firm to hold title to property (U.P.A. §§ 8(3), 10(1), 6 U.L.A. at 115, 155), characterization of the partner as agent of the partnership (U.P.A. § 9, 6 U.L.A. at 132-33), and internal financial relationships between the partner and the firm (U.P.A. § 18(a)-(d), 6 U.L.A. at 213).

145. See S. ROWLEY, *ROWLEY ON PARTNERSHIP* 605-06 (2d ed. 1960) (death of a partner dissolves the partnership because the "principal" is destroyed); Lewis, *The Uniform Partnership Act*, 24 *YALE L.J.* 617, 627 (1915) (dissolution constitutes the end of carrying on of the business in a particular partnership). The aggregate approach is, however, moderated in that the partnership business may survive dissolution under U.P.A. § 38(2) and 42, 6 U.L.A. at 456-57, 521, and the continuing business in some situations is deemed to automatically assume liabilities of the old business under U.P.A. § 41, 6 U.L.A. at 509-10.

146. See, e.g., *FED. R. CIV. P.* 17(b); *Decker Coal Co. v. Commonwealth Edison Co.*, 714 P.2d 155 (Mont. 1986) (partnership could sue in its own name even in the absence of explicit statutory authority). Consistently with the entity theory, a suit against the partners individually does not give

tant for both the partners and third parties to know the identity of the entity that is conducting the partnership business.

2. *The Costs of Dissolution*

Dissolution introduces uncertainty regarding relationships with third parties because it may operate to discharge contractual obligations.¹⁴⁷ The parties to these relationships would probably want them to change or terminate only if the identity of the business substantially changed and not if the dissolution was a merely technical one caused by the dissociation of a single partner. The parties can, of course, agree that technical dissolution will not affect their executory contracts, but a statute that anticipates such agreements can reduce transaction costs.

3. *Suggested Approach*

It follows from the above discussion that a partnership, like a corporation, should not dissolve merely as a result of changes in ownership because partners and third parties contracting with the partnership would not want or expect their agreements to change or terminate in this situation. An important difference between partnerships and corporations, however, is that while a corporate entity is created formally and can be dissolved only by a formal procedure, partnership is an informal relationship. Thus, just as the partnership statute must describe the elements of the relationship that signify partnership¹⁴⁸ so it must describe the changes in the business that the parties would expect to result in the creation of a new entity.

We can derive some guidance as to the parties' expectations regarding dissolution from U.P.A. § 41. This provision addresses the relevant issue of when partnership obligations should carry over to a successor firm. The partnership's¹⁴⁹ liability carries over to the successor if the business is continued by at least one of the partners in the old firm. Although a complete change in ownership does not alone dissolve a corporation,

the plaintiff a right to damages from the partnership. *Morse v. Mayberry*, 183 Neb. 89, 157 N.W.2d 881 (1968). Also, the absence of the sole general partner from the jurisdiction does not toll the statute of limitations against the partnership. *Epstein v. Frank*, 125 Cal. App. 2d 111, 177 Cal. Rptr. 831 (1981) (noting that the partnership is procedurally an entity and could be served through a designated agent).

147. See *supra* text accompanying notes 38-41.

148. See U.P.A. §§ 6 and 7, 6 U.L.A. at 22, 38-9.

149. The individual liability of the *partners* continues until discharged pursuant to U.P.A. § 36, 6 U.L.A. at 436.

such a change should result in a different partnership entity because the owners of a partnership actively manage the business and are liable for its debts under the U.P.A. and therefore are more identified with their business than are the passive shareholders of the standard form corporation.

U.P.A. § 41 should not, however, be used as a definition of continuity to the extent that the carryover to the successor firm depends on assignment of rights or consent to continuation by the withdrawing partner or estate.¹⁵⁰ The ex-partner's or executor's consent to continuation should not matter because the liability of the new firm helps the ex-partner by minimizing the effect of his continued personal liability. Also, the ex-partner's consent is irrelevant to the expectation of a third party as to whether a new firm has been created.

Perhaps the most difficult question with regard to the continuity of the entity concerns incorporation of the partnership. U.P.A. § 41(4) provides that there is no automatic assumption if the firm is continued exclusively by persons not partners of the dissolved partnership. This prevents carryover if the successor is a corporation, even if the corporation is owned by all of the partners in the old firm. If the business is continued on the same basis, the change wrought by incorporation appears merely technical. Although the change from individual liability of the partners to limited liability affects third parties, this change only affects post-incorporation creditors. Pre-incorporation creditors would undoubtedly prefer to have their liabilities assumed by the new firm, as long as the personal liability of the partners continued. On the other hand, excepting the corporation situation would present formidable drafting problems: What must the former partners' interest in the corporation be in order to prevent dissolution? What if the partnership was owned by two or more corporations that sold their interests to other corporations? On balance, it is preferable to require the partnership to deal explicitly with the incorporation situation by agreement.

The circumstances under which the partnership dissolves should to some extent be subject to control by the partnership agreement. Because dissolution may adversely affect the rights of third parties, the partners should not be able to provide by agreement solely among themselves for dissolution in circumstances *in addition* to those set forth in the statute. However, the partners should be able to *avoid* statutory causes, as by

150. See U.P.A. § 41(1)-(3), 6 U.L.A. 509-10.

agreeing that the partnership entity merges with a successor corporation rather than dissolving.

In summary, the theory of partnership dissolution should be changed from the U.P.A.'s extreme aggregate approach of wholly identifying the business entity with the individual owners, to the entity approach pursuant to which the business organization exists to some extent apart from the identity of its owners. Section 1.06 of the suggested statute reflects this change: the partnership dissolves only upon complete change of membership unless the agreement even further limits the circumstances in which the entity dissolves.

VI. AGREED TERM OR UNDERTAKING

A. *Penalizing Premature Dissociation*

The previous section considered statutory dissociation provisions that operate when the partners have made no relevant agreement. This Section considers whether the partner's buyout right should be limited by an uncompleted agreed term or undertaking. The fact that the partners have specified a duration implies that the partners intended dissociation prior to the expiration of the term to be on a different basis from dissociation that is not premature. If the partners have not specified how the prematurity affects the basis of dissociation, the statutory standard form must fill the blanks in the parties' agreement.

Because the U.P.A. fully develops the consequences of an agreed term or undertaking, I use the U.P.A. provisions as the starting point for analysis. The U.P.A. makes a substantial distinction between dissolution "without violation of the agreement between the partners" under Section 31(1) and "in contravention of the agreement" under Section 31(2). In the latter situation, U.P.A. Section 38(2) provides that the contravening partner has no right to application of assets and must not only pay damages for breach but forego compensation for goodwill of the partnership.

The fact that there is an uncompleted agreed term or undertaking may say something about the costs of the exercise of a buyout or liquidation right. Such an agreement may indicate that the parties intended to invest toward completion of a long-term project like publication of a book¹⁵¹ as distinguished from incurring expenditures (such as for inventory) that will yield near term returns. These investments may be in tangible assets

151. See *Shawn v. England*, 570 P.2d 628 (Okla. App. 1977) (squeezeout of a partner from such a project prior to publication).

such as equipment or in the development of skills that can only be used in connection with the agreed undertaking—i.e., in firm-specific human capital. A partner who dissociates prematurely may, by purchasing the assets of the business and using expertise he acquired in the partnership, appropriate the prospects of the business.¹⁵²

The above problems often cannot be fully redressed by assessing damages against the breaching partner because of the speculative nature of damages relating to future, hypothetical events.¹⁵³ U.P.A. § 38(2)(c)(II), in denying the wrongful partner a share in the partnership good will, attempting rough justice in light of the weakness of the damage remedy.¹⁵⁴ Moreover, the reduced purchase price, together with the innocent partners' rights under the U.P.A. to merely assume rather than discharge partnership debts and to secure payment by bond rather than pay the value of the dissolving partners' interest,¹⁵⁵ properly minimizes the chance that the wrongful partner will be able to appropriate the uncompleted undertaking.¹⁵⁶

B. Premature Dissociation Without Penalty

1. In General

U.P.A. § 31(2) provides that dissolution is caused "in contravention of the agreement between the partners" only if it is "by the express will of any partner," and not "where the circumstances . . . permit a dissolution under any other provision of this section." Therefore, dissolution is not in contravention even if there is an unexpired term or undertaking if the dissolution was caused by unlawfulness of the partnership, death or bankruptcy of a partner or partner incapacity or incompetence, the fact that the business can only be carried on at a loss, or other equitable circumstances. In these situations, any partner can have the firm liquidated under U.P.A. § 38(1). Moreover, even if dissolution is in contravention under U.P.A. § 31(2), any *innocent* partner has a right to liquidate the

152. See *supra* § V(C)(3)(a).

153. See *supra* note 104.

154. See Hillman, *supra* note 5, at 552-53.

155. See *supra* text accompanying notes 58-59.

156. For an example of a case in which the court facilitated continuation of the firm by not requiring the continuing partner to pay a wrongfully terminating partner for "goodwill" in the form of patents used by the partnership, see *Pav-Saver Corp. v. Vasso Corp.*, 143 Ill. App. 3d 1013, 493 N.E.2d 423 (1986), discussed *supra*, text accompanying notes 93-94.

firm under U.P.A. § 38(2). Should premature dissociation be penalized in these situations as well?

2. *Disabled and Bankrupt Partners*

Disabled partners or the estate of a deceased should have a right of unpenalized withdrawal because, unlike able partners who may merely suffer increased costs from continued association with the partnership,¹⁵⁷ the disabled partner or estate undergoes a transformation in the type of risk undertaken. The partner initially agreed to be subjected to the risks of partnership in return for the ability to monitor and control the activities of the other partners. The disabled partner or estate must remain exposed to risk while losing control. Allowing the partner's representative or estate to substitute for the disabled or deceased partner as a solution to this problem is inconsistent with the principle of *delectus personarum*.¹⁵⁸ Even if the able partners are willing to admit the representative or executor, this sort of proxy monitoring changes the initial deal of direct participation by the partner. Consequently, the partners would be likely to agree that, despite an agreed term or undertaking, disabled partners or estates can escape the partnership without penalty.

The same result should follow as to bankrupt partners, but for different reasons. Bankruptcy of a partner does not, like disability, prevent the partner from participating in the partnership. A bankrupt partner's partnership interest does become property of the bankruptcy estate¹⁵⁹ and so may be assigned to a trustee. But this interest is financial only and does not include the partner's right to participate in management.¹⁶⁰ Bankruptcy is significant because it may terminate the partner's credit contribution as to pre-bankruptcy debts¹⁶¹ and usually signals the partner's inability to pay debts in the near future. This withdrawal of credit significantly changes the basis of the partner's deal with the other partners.

157. See *supra* § V(C)(2).

158. See J. STORY, *supra* note 52, at 445-46 (1841).

159. See Bankruptcy Code § 541(a)(1), 11 U.S.C. § 541(a)(1) (1982) (property of the estate includes "all legal or equitable interests of the debtor in property as of the commencement of the case").

160. For authority favoring partner bankruptcy as a cause of dissolution because it may result in assignment of the partner's interest to a trustee, see *Marquand v. New York Mfg. Co.*, 17 Johns 525, 528-29 (Ct. Errors, 1820).

161. Completion of a Chapter 7 liquidation under Bankruptcy Code Section 727, 11 U.S.C. § 727 or a Chapter 11 reorganization, Bankruptcy Code § 1141, 11 U.S.C. § 1141 may discharge a partner from pre-bankruptcy debts. The debtor is not discharged until completion of payments under the plan in a Chapter 13 reorganization, Bankruptcy Code § 1328, 11 U.S.C. § 1328.

Also, to the extent that the partner is unable to share in the burden of partnership debts, the partner's incentives are not aligned with those of the other partners, and so he should not have the power to bind the partnership in transactions with third parties.¹⁶² Because dissociation in the event of partner bankruptcy is in the interests of the partnership as a whole rather than of the bankrupt partner, and because the bankruptcy is not likely to have been intentionally manipulated in order to obtain relief from a partnership for a term or to effect a squeeze-out of the other partners, the dissociation should not be penalized even if it is premature.

It does not follow from the above that bankruptcy of the *partnership* should permit premature dissociation. U.P.A. § 31(5) provides for dissolution in this situation whether or not there is an unexpired agreed term or undertaking. The partnership statute should not, however, discourage the partners from reorganizing the business under Chapter 11 of the Bankruptcy Code. Thus, the statute should not permit premature dissociation unless the partnership voluntarily or involuntarily liquidates under Chapter 7 of the Code.¹⁶³

3. Other Partners

As discussed at the beginning of this Section, the U.P.A. permits unpenalized departure not only by estates and disabled partners, but also by nondissolving partners whether or not they are disabled or insolvent. Under what circumstances should a nondisabled solvent partner be permitted to escape the partnership without penalty despite an unexpired agreed term or undertaking?

The response to this question distinguishes between events that involve a single partner—i.e., death, disability or partner bankruptcy—and those that affect the entire partnership. The only justification for disregarding the unexpired term in the first type of situation is that the dissociation of any partner materially changes the basis of the partnership.¹⁶⁴ But the existence of a definite term or undertaking implies that the partners have

162. Thus, U.P.A. § 35(3)(b) provides that a bankrupt partner has no authority to represent the firm after dissolution even as to winding up transactions. 6 U.L.A. at 43.

163. See *In Re Safren* 65 B.R. 566 (C.D. Cal. 1986) (no dissolution upon Chapter 11 bankruptcy of partner or partnership). As discussed in subsection VI(B)(3) *infra*, liquidation of the firm by consent or because the firm is no longer viable (which would be the case if it cannot be reorganized in bankruptcy) would justify dissociation without penalty.

164. See III KENT'S COMMENTARIES 56 (14th ed. 1896): The "abilities and skill, or characteristics and credit, of the deceased were the inducements to the formation of the connection." See also *id.* at 58 and 62 concerning dissolution by partner insanity and incapacity.

invested substantial resources toward the realization of a long-term goal. Under these circumstances, the partners would probably prefer to maximize the possibility of continuation until completion and minimize the chance that one partner could, by leaving, appropriate the benefit of the object of the partnership. Moreover, contrary to the U.P.A. assumption that *every* partner induced the partnership relationship, it is much more likely that the partnership consists both of entrepreneurs (who contributed unique managerial skills) and of capital contributors (who are more fungible). Since the standard form cannot practicably differentiate among contributors, it would be best to leave it to the partners themselves to agree to liquidate in the event of dissociation of a crucial partner. Therefore, the departure of one partner should not change the consequences of premature termination for the others.

Despite the existence of an unexpired term, a partner should have a right to dissociate by compelling liquidation in the situations identified in Section V(D)(4), including nonviability, unanimous or majority vote, partner misconduct and deadlock. In all of these situations, the results expected from the agreed duration are unlikely to be achieved, and relatively little danger exists that dissociation will cause loss or appropriation of going concern value. The existence of an unexpired agreed term or undertaking and the likely attendant costs of premature dissociation do, however, justify use of remedies less drastic than liquidation if possible. Hence, if the partners cannot practicably carry on the partnership because of the presence of a particular partner whose participation is unlawful or whose conduct is dishonest or obstreperous, the appropriate remedy may be expulsion of the illegal or misbehaving partner.¹⁶⁵ If partner misconduct does not prevent the carrying on of the partnership business,¹⁶⁶ the appropriate remedy may be assessment of damages against the misbehaving partner for breach of fiduciary duty.

165. This can be effected under the current version of the U.P.A. by obtaining a judicial dissolution based on the misconduct of a partner. The misbehaving partner then would probably be characterized as having wrongfully caused dissolution and therefore would be subject to a buyout at fair value less goodwill and less damages.

166. U.P.A. § 32(1)(c) permits judicial dissolution where a partner's conduct merely "affect[s] prejudicially the carrying on of the business." 6 U.L.A. at 394. U.P.A. § 32(1)(d) permits dissolution where a partner "wilfully or persistently commits a breach of the partnership agreement, or otherwise so conducts himself in matters relating to the partnership business that it is not reasonably practicable to carry on the business in partnership with him." 6 U.L.A. at 394. It is not clear whether the "not reasonably practicable" clause qualifies dissolution in the event of persistent breach.

C. *What is an Agreed Term or Undertaking?*

An agreed term or undertaking that has the consequences outlined in the preceding two subsections is one that indicates an intent that the partnership last *at least until* expiration or completion. For example, in *69th Street Apartments, Inc. v. Lauricella*,¹⁶⁷ the court, applying partnership principles in a corporation case, held that, in light of the money, time, and effort required, the shareholders intended that the corporation would continue until completion of the building the partnership was formed to construct. This should be distinguished from a term that merely *limits* duration, which is significant only in causing the partnership to terminate when the limit is reached.¹⁶⁸ Consistent with this reasoning, dissolution was held not in contravention when the partnership was to terminate on death of a partner.¹⁶⁹ On the other hand, some courts have held that a partnership could not be rightfully dissolved prior to the expiration of a lease or franchise under which the partnership operated,¹⁷⁰ or where the partnership term extended into the next century.¹⁷¹ If it is unclear whether the parties intended a maximum or minimum term, perhaps a term specified in an apparently comprehensive agreement without provision for the consequences of premature dissociation should be presumed only to limit duration.

A more difficult question concerns agreements that arguably imply a duration by, for example, providing for payment of initial financing out of operating income. Such an agreement may represent no more than a hope that things will work out rather than an intent to penalize withdrawal prior to repayment of the financing.¹⁷²

167. 142 N.J. Super. 546, 362 A.2d 78 (1976), *aff'd* 150 N.J. Super. 47, 374 A.2d 1222 (1977).

168. It is not clear whether the U.P.A. supports limiting the effect of an agreed term in this way. § 31(1)(b) provides that dissolution by express will of a single partner is "without violation" of the agreement *if* there is no definite term or undertaking. On the other hand, it is difficult to see how dissolution by express will or withdrawal can be "in contravention" of the partnership agreement under U.P.A. Section 31(2) if the agreement sets only a limit on duration. As to the appropriateness of liquidating the firm when the limit is reached see *supra* note 134.

169. *Stone v. Stone*, 292 So.2d 686 (La. 1974).

170. *Zeibak v. Nasser*, 12 Cal. 2d 1, 82 P.2d 375 (1938) (lease); *Bates v. McTammany*, 10 Cal. 2d 697, 76 P.2d 513 (1938) (government license of radio station). *Cf.* *Campbell v. Miller*, 274 N.C. 1430, 161 S.E.2d 546 (1968) (partnership formed by lease of property was at will where lease was at will).

171. *Infusaid Corp. v. Intermedics Infusaid, Inc.*, 739 F.2d 661 (1st Cir. 1984) (agreement provided for continuation until 2030). *See Stanton v. Tarantino*, 637 F. Supp. 1051 (E.D. Pa. 1986) (provision for continuation until 2020 constituted partnership for a term). *See also Hillman, supra* note 59, at 708 n.93.

172. *See Page v. Page*, 55 Cal. 2d 192, 359 P.2d 41, 10 Cal. Rptr. 643 (1961). *But see Owen v.*

D. Summary

If the partners have clearly agreed that the partnership shall last at least for a specific term or undertaking, a prematurely dissociating partner should, as under the U.P.A., be liable for damages and should not be able to recover the goodwill component of the value of his or her partnership interest. A disabled or bankrupt partner should be able to dissociate prematurely without penalty. Also, the partners should be able to compel liquidation in the situations identified in Section V(D)(4) without penalty for premature dissociation. However, there should be no right to dissociate prematurely without penalty merely because another partner has exercised such a right.

Consistent with the foregoing, Sections 1.01(c), 1.02(b) and 1.04(b) of the suggested statute penalize partners whose conduct causes premature dissociation. A partner who withdraws or is expelled from a going partnership is subject not only to damages but also to loss of his share of the going concern value of the firm.¹⁷³ Although these provisions do not penalize partners, such as disabled partners, whose premature dissociation is not wrongful, they do not permit a partner to prematurely dissociate merely because another partner has withdrawn or been expelled for wrongful conduct. Note that dissociating partners lose going concern value only if the dissociation is prior to the end of an agreed term, even if the dissociation is otherwise wrongful. The goodwill penalty is a response to the specific situation of the agreed term and not to wrongful conduct generally.

Cohen, 19 Cal. 2d 147, 119 P.2d 713 (1941); Vangel v. Vangel, 116 Cal. App. 2d 615, 254 P.2d 919 (1953); Drashner v. Sorenson, 75 S.D. 247, 63 N.W.2d 255 (1954). For an argument favoring implication of a term only from specific evidence see Hillman, *supra* note 6, at 25-26. It may be that findings of agreed terms on the basis of scant evidence are motivated by a desire to avoid the high costs associated with the U.P.A. liquidation right. See the cases cited *supra* notes 170-71. If so, such findings will be unnecessary under statutory provisions like those suggested in this article that permit liquidation in more limited circumstances than under the U.P.A.

173. There may be a serious question as to the components of going concern value or goodwill as distinguished from other aspects of the value of the firm. See *supra* note 99. See also Pav-Saver Corp. v Vasso Corp., 143 Ill. App. 3d 1013, 493 N.E.2d 423 (1986), discussed *supra* notes 93-94 (good will under U.P.A. § 38(2)(c)(II) includes value of patents wrongful partner contributed to firm). Nevertheless, this provision is useful in that it gives a court discretion to use valuation to compensate for the difficulty of assessing appropriate damages against the dissociating partner. See text accompanying note 153. It is doubtful that a more exact standard accomplishing this purpose could be devised.

VII. CONTRACTING AROUND THE STANDARD FORM: PROHIBITING DISSOCIATION

A. *Defining the Issues*

The preceding two Parts described the appropriate features of the statutory standard form as to partner dissociation. Those Parts conclude that the partners should have the power to dissociate, except that dissociation should be penalized if departure occurs prior to the termination of an agreed minimum term or undertaking. Under the U.P.A., the power to dissociate by dissolving the partnership is absolute.¹⁷⁴ In this Part, I consider whether the partners ought to be able to contract around the power to dissociate at will.

It is important to clarify at the outset precisely what type of agreement is at issue. The partners clearly should be able to *vary* statutory dissociation rights that affect only the partners themselves by provisions in the partnership agreement.¹⁷⁵ The issue here is whether the parties should be able by their agreement to wholly supplant the statutory power to dissociate.¹⁷⁶ In light of the high costs of illiquidity,¹⁷⁷ the parties pre-

174. Several states have qualified the power to dissolve the partnership in the event of withdrawal or death. As to non-dissolution on partner withdrawal, see ARK. CODE ANN. § 4-42-601 (1987) (adding to the official version of U.P.A. § 29 that dissociation "shall not effect a dissolution of the partnership in contravention or violation of the agreement between the partners") and § 65-131 (omitting U.P.A. § 31(2)); CAL. CORP. CODE § 15031 (West 1977) (adding to the official version of U.P.A. § 31 a subsection (7) that provides that a written partnership agreement signed by all the partners may prevent dissolution upon the "withdrawal of a partner or admission of a new partner"); LA. STAT. ANN. §§ 2821 and 2826 (Supp. 1987) (partner may withdraw prematurely only for just cause, and such withdrawal does not dissolve the partnership); see also Osborne v. Workman, 273 Ark. 538, 621 S.W.2d 478 (1981); Cagnolatti v. Guinn, 140 Cal. App. 3d 42, 189 Cal. Rptr. 151 (1983); Bunch v. Quin-L Baton Rouge Partnership, 424 So.2d 1210 (La. Ct. App.), writ denied, 429 So.2d 131 (La. 1983). Note that the California statute preserves U.P.A. § 31(2), providing for dissolution by express will in contravention of the agreement. As to nondissolution on death of a partner, see ALA. CODE § 10-8-91(4) (1980); CAL. CORP. CODE § 15031(4) (West 1977); GA. CODE ANN. § 14-8-31 (a)(5) (1986); IOWA CODE § 544.31(4) (West Supp. 1984); KAN. STAT. ANN. § 56-331(d) (1983); MISS. CODE ANN. § 79-12-61(4) (Supp. 1983); N.C. GEN. STAT. § 59-61(4) (1982); OKLA. STAT. tit. 54, § 231(4) (1969); TEX. REV. CIV. STAT. ANN. art. 6132b, § 31(4) (Vernon 1970).

175. The partners' rights under U.P.A. §§ 38 and 42, the principal sections controlling rights among the partners, are subject to contrary agreement. Note, however, that variations restricting payment to the partners have been strictly construed. See *supra* text accompanying note 14.

176. There may be a question in some cases whether the agreement wholly prevents withdrawal or only restricts it. For analogous discussions in the corporate area compare *Allen v. Biltmore Tissue Corp.*, 2 N.Y.2d 534, 161 N.Y.S.2d 418, 141 N.E.2d 812 (1957) (disparity between option exercise price and market value of corporate stock did not invalidate transfer restriction because transfer not prohibited) with *Rafe v. Hindin*, 29 A.D.2d 481, 288 N.Y.S.2d 662, *aff'd mem.*, 23 N.Y.2d 759, 244 N.E.2d 469, 296 N.Y.S.2d 955 (1968) (consent restriction on transfer invalid as restriction on alienation of stock). In light of the conclusion in this Part that even total prohibition

sumably have not, in fact, made such an agreement. The presumption is overcome if the parties have entered into an apparently comprehensive agreement that provides for dissociation only in specific circumstances or an agreement that expressly precludes dissociation in some circumstances. A sketchy agreement that does not provide for dissociation should not be interpreted as supplanting the statutory provisions. Most importantly, the fact that the partners agreed to an unexpired minimum term or undertaking does not necessarily mean that they intended wholly to prohibit dissociation, as distinguished from merely penalizing it.¹⁷⁸

The question whether the partners should be able to dissociate notwithstanding their agreement to the contrary is separate from whether the partners should have continuing obligations under their agreement to furnish capital or services. Traditional contract rules regarding discharge should be applied to such agreements. Even if these rules justify discharge or prohibit specific performance of service obligations, however, that does not mean that the parties should be able to demand, in effect as promisees, repayment of investments they have already made and release from responsibility for partnership debts.¹⁷⁹

B. Evaluation of Reasons for Non-Enforcement of Prohibitions on Withdrawal

This Section evaluates some of the reasons that have been and might be given for refusing to enforce the parties' express agreement not to permit dissociation at will.

1. Distinctions Between Corporation and Partnership

The corporate standard form, unlike the partnership standard form,

on the right of dissociation should be permitted in most situations, I will not explore where the line between variation and elimination of the dissociation right should be drawn in the partnership area.

177. See discussion *supra* § V(C)(3).

178. One commentator argues against this position. See Hillman, *supra* note 63, at 731: "An agreement concerning duration, in short, should effectively deny a partner the power to unilaterally cause a premature dissolution through an expression of will." While Professor Hillman notes immediately prior to this statement that "[s]everal possibilities may be addressed in bargaining" including giving partners the power but not the right to dissolve, *id.* at 731 n.201, he says that partners unaware of the fact that the partnership necessarily dissolves under the U.P.A. would assume that the partnership would last for the full term. However, I believe that it is more likely, in light of the high costs of illiquidity, that the partners, even in ignorance of the U.P.A., would assume that they were not completely locked into the partnership for the full term.

179. As to the relationship between specific performance and the power to dissociate, see *supra* text accompanying notes 66-69.

does not provide for a power to dissociate. Thus, a shareholder may be able to escape, in the absence of contrary agreement, only by selling his or her shares to a third party. Do the differences between the corporation and the partnership justify permitting illiquidity in the former but mandating an escape route in the other?

Without a buyout right, partnership interests, unlike corporate shares, are wholly illiquid.¹⁸⁰ But this alone is not a major distinction between a partnership and a closely-held corporation because interests in the latter normally cannot be transferred apart from a sale of the entire business.

Perhaps more importantly, without statutory withdrawal provisions, partners, unlike corporate shareholders, are personally at risk for business debts. Although close corporation shareholders frequently guarantee particular corporate obligations, these guarantees are more limited than partners' open-ended exposure to corporate debts. Also, although corporate shareholders may be personally liable for business debts under a veil-piercing theory, this liability normally extends only to active shareholders¹⁸¹ who can avoid the liability prospectively merely by withdrawing personal services from the business even in the absence of a power to dissociate.

Although there are differences between the plight of partners and shareholders related to the need for a power to dissociate, these differences go only to the degree to which the owners are exposed to risk *in the usual case*. A corporate shareholder may invest his entire assets in the business while a partner may make a relatively small investment in a passive enterprise that is unlikely to incur substantial liabilities.¹⁸² The differences between corporations and partnerships are therefore more relevant in determining the appropriate statutory standard form than to the enforceability of a specific agreement. They do not justify refusing to honor partners' deliberate choice of a corporate-type business structure.

2. *Providing for Unanticipated Costs of Illiquidity*

As discussed earlier,¹⁸³ the costs of illiquidity may be high. Partners

180. See *supra* §§ III(B)(2) and IV(F)(1).

181. See *Krivo Industrial Supply Co. v. National Distillers & Chemical Corp.*, 483 F.2d 1098 (5th Cir. 1973), *modified*, 490 F.2d 916 (5th Cir. 1974); *Fisser v. Int'l Bank*, 282 F.2d 231 (2d Cir. 1960).

182. This observation has been made in noting the similarity between veil-piercing as to individual and corporate shareholders in the close corporation setting. See R. POSNER, *ECONOMIC ANALYSIS OF LAW* 381 (3d ed. 1986).

183. See *supra* § V(C)(2).

who agree to prohibit dissociation would seem to have taken these costs into account, but this is not necessarily the case. A partnership, like any business association, is normally a long-term relationship. Changing circumstances might greatly increase the costs of illiquidity. The partners do not have perfect foresight. Even if they did, contracting for every eventuality is prohibitively expensive, and the cost of detailed dissociation provisions¹⁸⁴ normally outweigh the benefits perceived in the light of the harmonious atmosphere at formation. Thus, the failure to plan for a particular contingency does not necessarily mean that the parties intended not to provide for it, but may mean only that the costs of planning for the contingency outweighed the expected benefits of such planning. The power to dissociate thus serves as a kind of escape valve that accommodates imperfections in planning.

The problem with this line of reasoning is that it gives insufficient weight to the parties' agreement. While the partners *may* not have anticipated a particular event or intended that a partner be locked in whatever the cost, they may also have intended and planned for this result after taking into account the costs of illiquidity. For example, a partnership engaged in the business of buying raw land for investment purposes may require little or no commitment of human capital by non-managing, capital-contributing partners. Hence, illiquidity may impose relatively small costs on these partners, while dissociation may be quite costly because it may facilitate a squeezeout or necessitate sale of the partnership assets under poor market conditions. Even when illiquidity is costly, the partners may have concluded that the potential cost of liquidity was even higher, as where the partners have committed substantial capital to an enterprise with a long-term payoff so that the damages from premature termination may be particularly difficult to measure.¹⁸⁵

For the foregoing reasons, enforcement of a non-dissociation agreement is not necessarily inappropriate. Moreover, viewing the situation *ex ante*, prohibiting the partners from entering into a binding agreement that precludes dissociation may deter otherwise efficient arrangements or necessitate the use of cumbersome and inadequate protective devices

184. The costs of entering into customized agreements are discussed *supra* notes 5-9.

185. See J. STORY, *supra* note 56, at 397 (opposing power to dissolve in part because damages may be inadequate); Hillman, *supra* note 63, at 719 (specific enforcement of partnership may be preferable to dissolution at will because promisees are in a position to know about the adequacy of damages). Hillman relies on Schwartz, *The Case for Specific Performance*, 89 YALE L.J. 213 (1979) which makes a similar point about specific enforcement of contracts generally.

(such as bonding) where the costs of the power to dissociate at will are likely to be high.

A good illustration of the problems involved in not permitting the parties to draft around dissociation is provided by *Pav-Saver Corp. v. Vasso Corp.*¹⁸⁶ In *Pav-Saver*, the partnership agreement included a liquidated damages clause to deter unilateral termination by a partner that contributed essential patents and the services of its shareholder. The partners intended this provision to protect the shareholder of the other partner, who had made a heavy personal commitment to the venture. When the patent-contributing partner terminated, the court, in an effort to effectuate the U.P.A. scheme of buyout and continuation on wrongful dissolution, not only enforced the liquidated damages clause, but refused to apply a provision in the partnership agreement that the patents be returned on termination. The court further characterized the value of the patents as goodwill that need not be included in the buyout price. However, the court would not go so far as to set off the damages against the value of the terminating partner's interest rather than permitting payment of damages by installments over a ten-year period as provided in the agreement. The nonterminating partner was therefore forced to bear the risk that the terminating partner might become insolvent and fail to pay the damages. Thus, even elaborate drafting and a willing court were not enough to protect against harm from premature dissociation.

3. *The Incorporation Option*

One can argue that if the parties really want to be locked into a business relationship they could simply incorporate and adopt the standard corporate form. The problem with this reasoning is that incorporation may involve substantial costs. The parties may have to sacrifice the flow-through features of partnership taxation, draft elaborately for partnership-type management and share transfer restrictions, and enter into customized guarantees with creditors in order to secure credit at reasonable cost. These costs should not be forced on the partners unless permitting non-dissociation agreements in the partnership involves greater costs.

C. *The Judicial "Escape Valve"*

Although the partners should not necessarily be able to avoid a non-dissociation agreement, it is sometimes appropriate to permit a partner to

186. 143 Ill. App. 3d 1013, 493 N.E.2d 423 (1986). This case is also discussed *supra* notes 93-94.

dissociate despite an apparently inconsistent agreement. These situations should be dealt with through limited judicial dissociation.¹⁸⁷

Perhaps some guidance as to the standards that should be applied by the courts can be drawn from the corporate context. The courts generally can order corporate dissolution or other relief in the event of deadlock¹⁸⁸ or manager misconduct.¹⁸⁹ Unless the partners have some right of exit in these situations, the exploitation of their co-partners or the prolonged foundering of the business may expose the partners to particularly high costs of illiquidity. Moreover, the partners probably did not anticipate these situations at the harmonious outset of their relationship.

Courts should order liquidation of the partnership notwithstanding the partnership agreement if the partnership business is no longer viable because it has become unlawful or a losing proposition. The partners obviously could not have intended to carry on in these circumstances. Liquidation in these situations is similar to discharge of contractual obligations by reason of the impossibility of further performance.¹⁹⁰

In decreeing a right of exit in the above situations, the courts must take adequate account of the partners' explicit rejection of a power to dissociate by focusing on the expectations of the partners.¹⁹¹ Also, the court should tailor the remedy to the particular circumstances, and not order liquidation if this can be avoided by expelling or assessing damages against the misbehaving partner.¹⁹² The mere fact that the partnership

187. Note that judicial determination is necessary as to other events that trigger dissociation, such as partner incapacity. Unlike the situations discussed in this Section, those determinations operate only in the absence of contrary agreement.

188. Deadlock is a particular risk in the partnership in view of the small number of members and the fact that the partners generally have a veto power as to extraordinary matters under U.P.A. § 18(h).

189. See, e.g., REV. MODEL BUS. CORP. ACT § 14.30 (dissolution on shareholder petition on the grounds of deadlock, controlling persons have acted in "illegal, oppressive or fraudulent" manner, or "corporate assets are being misapplied or wasted").

190. See RESTATEMENT (SECOND) CONTRACTS § 262 (1981).

191. For recent cases considering shareholder expectations in the context of close corporation dissolution see *Gardstein v. Kemp & Beatley*, 64 N.Y.2d 63, 484 N.Y.S. 2d 799, 473 N.E.2d 1173 (1984); *Meiselman v. Meiselman*, 309 N.C. 279, 307 S.E.2d 551 (1983).

192. A "last-resort" approach has also been applied to close corporation dissolution. The MODEL BUS. CORP. CLOSE CORP. SUPP. includes somewhat broader grounds for dissolution or other relief than the general statute, but permits dissolution only as a last resort. *Close Corporation Supplement Section 16(b)(9)-(10)*, 37 BUS. LAW. 269, 301 (1981). N.Y. BUS. CORP. LAW § 1104-(a) (b) (1986) requires the court, before ordering dissolution, to consider whether "liquidation of the corporation is the only feasible means" of protecting the shareholder. See *Gardstein v. Kemp & Beatley*, 64 N.Y. 2d 63, 73, 484 N.Y.S. 2d 799, 805, 473 N.E. 2d 1173, 1179 (1984): "Implicit in this direction [in Section 1104-(a)(b)] is that once oppressive conduct is found, consideration must be

business has been losing money should not compel liquidation where it is evident that the partners anticipated losses, as in a tax shelter situation.

A possible objection to judicial resolution of dissociation issues is that, as compared with dissociation at will, this remedy involves an expenditure of scarce judicial resources.¹⁹³ It is not at all clear, however, that the goal of conservation of judicial resources is achieved through a rule permitting dissociation at will. In the first place, buyout or liquidation often will require judicial determination of the value of the outgoing interest. Moreover, there are numerous qualifications on the power to dissolve that require judicial oversight, including the good faith of the dissolving partner and whether market conditions render liquidation of assets inappropriate.¹⁹⁴

Consistently with the foregoing, Section 1.01 of the suggested statute provides that dissociation is subject to contrary agreement *except* with respect to expulsion of a wrongful partner (Section 1.01(a)(ii)(2)). Also, the power to compel liquidation of the partnership under Section 1.04 is subject to contrary agreement *except* as to the court's power to liquidate if the partnership has become unlawful (1.04(a)(3)), the business cannot be carried on profitably (1.04(a)(4)), or it is not practicable to carry on the partnership because the partners are deadlocked or because of partner misconduct (1.04(a)(5)). Pursuant to Section 1.04(c), the court, in determining whether to order liquidation, must "have due regard for the agreement and reasonable expectations of the parties."

VIII. SUGGESTED DISSOCIATION PROVISIONS

The following dissociation provisions, intended for inclusion in a revised Uniform Partnership Act, give specific form to the ideas expressed in this Article.

given to the totality of circumstances . . . to determine whether some remedy short of or other than dissolution constitutes a feasible means of satisfying both the petitioner's expectations and the rights and interests of any other substantial group of shareholders."

193. See Comment, *Winding Up Dissolved Law Partnerships: The No-Compensation Rule and Client Choice*, 73 CAL. L. REV. 1597, 1637 (1985) (rule compensating partners of dissolved law partnership who complete pending cases on pre-dissolution basis preserves judicial resources by making it unnecessary for courts to become involved in allocating fees on case-by-case basis).

194. See *supra* text accompanying notes 51-56.

Section 1.01: Events of Dissociation

(a) A person ceases to be a partner upon the occurrence of one or more of the following events:

- (1) Except as provided in the partnership agreement, the partner withdraws by voluntary act from the partnership as provided in subsection (b) of this Section;
- (2) The partner is expelled (i) in accordance with the partnership agreement; or (ii) pursuant to the entry of an order by a court of competent jurisdiction on the ground that he has wilfully or persistently committed a breach of the partnership agreement or otherwise breached his duty to the other partners or the partnership such that it is not reasonably practicable to carry on the business in partnership with him, or that it is unlawful to carry on the partnership with him;
- (3) Except as provided in the partnership agreement, the partner: (i) makes an assignment for the benefit of creditors; (ii) files a voluntary petition in bankruptcy; (iii) is the subject of an order for relief under Section 303(h) of the Bankruptcy Code (11 U.S.C. § 303(h)) or the filing of a petition for voluntary bankruptcy under Section 301 of the Bankruptcy Code (11 U.S.C. § 301) as these provisions may be now or hereafter amended, or an equivalent order or petition under any successor statute or code of general application, or an equivalent order or petition under any state insolvency act; (iv) files a petition or answer seeking for himself any reorganization, arrangement, composition, readjustment, liquidation, dissolution, or similar relief under any statute, law, or regulation; (v) files an answer or other pleading admitting or failing to contest the material allegations of a petition filed against him in any proceeding of this nature; or (vi) seeks, consents to, or acquiesces in the appointment of a trustee, receiver, or liquidator of the partner or of all or any substantial part of his properties;
- (4) Except as provided in the partnership agreement, 120 days after the commencement of any proceeding against the partner seeking reorganization, arrangement, composition, readjustment, liquidation, dissolution, or similar relief under any statute, law, or regulation, the proceeding has

not been dismissed, or if within 90 days after the appointment without his consent or acquiescence of a trustee, receiver, or liquidator of the general partner or of all or any substantial part of his properties, the appointment is not vacated or stayed or within 90 days after the expiration of any stay, the appointment is not vacated;

- (5) Except as provided in the partnership agreement, in the case of a partner who is an individual; (i) his death; or (ii) the entry of an order by a court of competent jurisdiction adjudicating him incompetent to manage his person or his estate;
- (6) Except as provided in the partnership agreement, in the case of a partner who is a trust or is acting as a partner by virtue of being a trustee of a trust, the termination of the trust, but not merely the substitution of a new trustee;
- (7) Except as provided in the partnership agreement, in the case of a partner that is a separate partnership, the dissolution and commencement of winding up of the separate partnership;
- (8) Except as provided in the partnership agreement, in the case of a partner that is a corporation, the filing of a certificate of its dissolution or the equivalent for the corporation or the revocation of its charter and the lapse of 90 days after notice to the corporation of revocation without a reinstatement of its charter;
- (9) Except as provided in the partnership agreement, in the case of an estate, the distribution by the fiduciary of the estate's entire interest in the partnership;
- (10) Any event specified in the partnership agreement as resulting in a person ceasing to be a partner;
- (11) Except as provided in the partnership agreement or an agreement between the purchaser and the partner, pursuant to the entry of an order by a court of competent jurisdiction on the application of the purchaser of a partner's interest under Sections 27 or 28 (i) after the termination of the specified term or particular undertaking; or (ii) at any time if the partnership was a partnership at will when the interest was assigned or when the charging order was issued.

(b) A partner may dissociate from a partnership by voluntary act at any time by giving 90 days' written notice to the other partners, or by such other notice as is specified in writing in the partnership agreement.

(c) Except as provided in the partnership agreement, if an event of dissociation violates the partnership agreement or occurs as a result of otherwise wrongful conduct of the partner, the partnership may recover from the dissociating partner damages for such wrongful conduct or breach, including the reasonable cost of obtaining replacement of the services the withdrawn partner was obligated to perform, and may offset the damages against the amount otherwise distributable to him, in addition to pursuing any remedies provided for in the partnership agreement or otherwise available under applicable law. Except as provided in the partnership agreement, in the case of a partnership for a definite term or particular undertaking, a partner's dissociation by voluntary act pursuant to subsection (b) of this Section before the expiration of that term or undertaking is a breach of the partnership agreement.

Comments

This section is based on Section 402 of the Uniform Limited Partnership Act (1985). Note that "dissociation" is used instead of "withdrawal" to clarify the statute's concern with the legal consequences of termination of the partner's association with the firm rather than with the partner's voluntary conduct. Section 1.04, below, specifies events that justify sale of the partnership business; and Section 1.06 discusses the circumstances under which the partnership dissolves. The consequences of events of dissociation are specified in Sections 1.02 and 1.03.

If the partnership is for an agreed term or undertaking, dissociation by voluntary act pursuant to subsection (b) prior to expiration of the term is penalized under subsection (c) even if another partner has a right to dissociate without penalty. However, there is no penalty if the partner dissociates under other provisions of this Section or if the partner has a right to compel sale of assets under Section 1.04.¹⁹⁵

As is discussed in Part VII, the statutory events of dissociation other than expulsion are subject to contrary provision in the partnership agreement.

Expulsion of a partner is permitted not only pursuant to agreement,

195. The circumstances under which premature dissociation should be permitted without penalty are discussed *supra* § VI(B).

but also by court order under Section 1.01(a)(2).¹⁹⁶ A similar result may be reached under the current version of the Uniform Partnership Act if Section 38(2) is deemed to be triggered by misconduct other than premature withdrawal,¹⁹⁷ because the partners would be able to buy out the misbehaving partner at book value (i.e., not including goodwill) less damages caused by the misconduct. Section 1.01 states the grounds of expulsion for misconduct in terms similar to those for dissolution under current U.P.A. Section 32 (1)(c) and (d), and so invokes the standards currently applied under those U.P.A. subsections, except that the proposed statute makes clear that expulsion is justified only when it is impracticable to continue the business with the expellee. Misconduct may also justify liquidation by judicial decree under Section 1.04(f), below.

An assignee of a partner's interest can force the assignor's dissociation and thereby obtain any funds to which the assignee is entitled upon buyout of the assignor. This approach is less drastic than current U.P.A. § 32 (2) which permits the assignee to obtain dissolution and liquidation of the partnership.

The notice of dissociation minimizes disruption caused by the need to secure a replacement for the services, credit and capital of the exiting partner and adds certainty as to whether a partner who ceases participation in the business remains a partner. The ninety-day period specifies the time as of which the dissociation is effective, so premature dissociation is not possible by reason of violation of the notice provision. If the partner dissociates in the sense of ceasing to act in the partnership business without providing the requisite notice, this may constitute a breach of a service obligation that exists under the partnership agreement.

Section 1.02: Rights of Dissociated Partner to Value of Interest and Indemnification

(a) Subject to subsections (b) and (d) of this Section and to Section 1.04, a person who ceases to be a partner pursuant to Section 1.01 shall have the right to demand payment for the fair value of his partnership interest, with interest on such fair value from the date of the demand, or such other amount, if any, as shall be determined in accordance with the provisions of the partnership agreement. If no agreement is reached for the purchase of the interest within ninety days of the demand, the demanding partner may commence an action in the court for the determi-

196. Expulsion for misconduct is not subject to contrary agreement of the partners for the reasons discussed following note 189, *supra*.

197. *See supra* note 46.

nation of the amount due for his interest. The court shall thereupon proceed to determine the amount due in a manner which it finds to be appropriate under the circumstances. Upon the determination of the amount due, the court shall issue a decree providing that the partnership shall within ninety days purchase the interest of the demanding partner for such amount, and further providing that if the partnership shall not have purchased the demanding partner's interest within such period, the court shall order a sale of the assets of the partnership pursuant to Section 1.04.

(b) A partner who has been expelled pursuant to Section 1.01(a)(2)(ii), or has dissociated by voluntary act pursuant to Section 1.01(b), (i) shall be liable for damages caused by his wrongful conduct and for his breach of the partnership agreement as provided in Section 1.01(c); and (ii) if the dissociation is prior to the termination of an agreed term or undertaking shall not be entitled to be paid any amount representing the goodwill of the business.

(c) Except as provided in the partnership agreement, the demanding partner shall be entitled to be indemnified by the partnership against all liabilities for which the partner is held liable by reason of having been a partner in the partnership.

(d) Except as provided in the partnership agreement, the court may for good cause shown permit all or part of the purchase price for any or all shares purchased to be paid over a period of time not exceeding five years, provided that (i) as to any portion of the purchase price for which payment is deferred as herein provided, interest shall be awarded at the legal rate; and (ii) that the partnership secure the payment by such bond, if any, as the court may determine. A partner who has dissociated by voluntary act pursuant to Section 1.01(b) prior to the expiration of an agreed term or undertaking need not be paid any portion of the value of his interest until the expiration of the term or undertaking, provided the partnership secures payment by such bond, if any, as the court may determine.

Comment

This provision is designed to achieve the optimal balance between facilitating continuation of the business and fairness to the dissociating partner. The basic measure of the buyout price ("fair value"), the provision for deferred payments, and the procedure for determination of the price are drawn from the Hetherington and Dooley proposal for close

corporation buyouts.¹⁹⁸ The penalties against wrongful partners and the provision for deferred payment to partners who dissociate prematurely are drawn from current U.P.A. § 38(2).¹⁹⁹

Section 1.03: Dissociating Partner's Power to Bind the Partnership and Liability to Third Persons after Dissociation

A person who ceases to be a partner under Section 1.01 shall not be personally liable as a partner for any partnership debt incurred, and shall not have the power to bind the partnership, after one of the events specified in subsections (a) and (b) of Section 1.01, provided the other party to the transaction:

(a) was a creditor of the partnership at the time of such event or had extended credit to the partnership within two years prior to such time and, in either case, had no knowledge or notice of the person's ceasing to be a partner; or

(b) though he had not so extended credit, had nevertheless known, prior to such event that the person was a partner and, having no knowledge or notice of the occurrence of such event, the event had not been advertised in a newspaper of general circulation in the place (or in each place if more than one) at which the partnership business was regularly carried on.

Comment

This section, which is drawn from current U.P.A. § 35, provides a method of escaping liability for post-dissociation partnership debts without dissolution of the partnership.²⁰⁰ It reaches the same basic result as under current law where the partnership is continued after a partner dissociation.²⁰¹

Section 1.04: Sale of Assets

(a) The assets of the partnership shall be sold, the proceeds applied to discharge its liabilities, and the surplus applied to pay in cash the net amount owing to the respective partners, upon the occurrence of any of the following circumstances:

- (1) Except as provided in the partnership agreement, by the express will of a majority in number of the partners who have

198. See Hetherington and Dooley, *supra* note 6, at 56-58.

199. This Section clarifies that the bond is required to secure nonpayment of the value of the departing partner's interest during the remainder of the agreed term. See *supra* note 59.

200. The provision therefore fills a gap in current statutes that permit dissociation without dissolution (see *supra* note 174) but provide for termination of agency only in the event of dissolution.

201. See text accompanying notes 33-34.

not assigned their interests or suffered them to be charged for their separate debts;

- (2) Except as provided in the partnership agreement, the partnership fails to perform its obligations to the dissociating partner pursuant to Section 1.02;
- (3) An event has occurred that makes it unlawful for the business of the partnership to be carried on;
- (4) The business of the partnership can no longer be carried on profitably for the foreseeable future;
- (5) The termination of the definite term or particular undertaking specified in the agreement unless, upon such termination, the partners continue the partnership business pursuant to [U.P.A.] Section 23;
- (6) Pursuant to a decree of court on the grounds that it is not reasonably practicable to carry on the partnership because the partners are deadlocked or because a partner has wilfully and persistently breached the partnership agreement or otherwise breached his duties to the partnership or the other partners.

(b) If the assets of the partnership are sold pursuant to subsection (a)(6) of this Section, the partnership may recover from any partner whose breach of duty causes such sale damages resulting from such breach, and may offset the damages against the amount otherwise distributable to him, in addition to pursuing any remedies provided for in the partnership agreement or otherwise available under applicable law.

(c) In entering a decree under this Section, the court shall have due regard for the agreement and reasonable expectations of the parties.

Comments

The events specified in this section are those that cannot be resolved merely through partner dissociation, and therefore necessitate liquidation of the partnership business. Consistent with the discussion in Section VI(B)(3), sale in these circumstances does not trigger the penalties for premature dissociation. Also, consistent with the discussion in Section VII(C), the right to compel sale pursuant to subsections (a)(3) through (a)(6) is not subject to contrary provision in the partnership agreement. However, subsection (c) requires the court, in ordering sale, to take into account provisions of the partnership agreement, including those that provide for a term or that do not allow dissociation. The remedy against

a partner whose breach of duty results in sale of the partnership parallels that against a wrongfully dissociating partner under Section 1.01(c).

Section 1.05: Winding Up

(a) Except as provided in the partnership agreement, upon the occurrence of an event specified in Section 1.04 the partners shall cease to be associated in the carrying on of the partnership. The partnership shall continue until the winding up of the partnership affairs is completed, at which time the partnership shall terminate. Until termination the partners shall be associated in the winding up of the partnership.

(b) Except as provided in the partnership agreement, the partners who have not wrongfully caused an event under Section 1.04 have the right to wind up the partnership affairs, including the right to convey any real property of the partnership; provided, however, that any partner, his legal representative or his assignee, upon cause shown, may obtain winding up by the court.

Comment

Whether the partnership is engaged in winding up is particularly important with regard to the partners' power to bind the partnership during the winding up period. This section clarifies that the partnership enters the winding up period not upon any partner dissociation, as under current U.P.A. §§ 29 and 30, but only upon occurrence of one of the events that justifies sale of the partnership business. This is, in effect, consistent with current law. Although the U.P.A. now provides for winding up even if there is only a technical dissolution and the partnership business continues as before, in fact the winding up affects only the "old" partnership—i.e., the one that included the dissociated partner—while the remaining partners are engaged in "carrying on" the new, post-dissolution partnership. Providing for winding up only when the partnership is, in fact, to be sold, eliminates this confusing state of affairs.

It is true that the business of the partnership might, in fact, continue after a sale of assets under this Section. But because it will not usually be possible to predict with certainty the future of a business that is about to be sold in the absence of an agreement providing for this situation, it is appropriate to regard the "carrying on" of the business as suspended during the presale period.

The language concerning who may wind up and the extent of their powers is drawn from current U.P.A. § 37, and therefore invokes the substantial body of case law under that Section.

Section 1.06: Dissolution of the Partnership

Subject to provisions of the partnership agreement limiting the circumstances under which the partnership entity dissolves, the partnership entity shall dissolve when, following dissociation of one or more partners pursuant to Section 1.01 or sale of the assets of the business pursuant to Section 1.04, the business of the partnership is either not carried on or is carried on solely by one or more persons not partners in the dissolved partnership.

Comments

This section relegates dissolution of the partnership entity to a residual role, in stark contrast to its fundamental role under current law. As is discussed in Section V(F), dissolution is necessary only to indicate the situations in which the continuity of the business has been disrupted to the extent that the parties would not expect rights and obligations of the old firm to carry over to the new one. For the reasons discussed in Section V(F)(3), the partnership agreement may limit, but may not expand, the circumstances under which the partnership dissolves.

This provision may affect whether a general partnership is an “association” and therefore treated as a corporation for tax purposes.²⁰² Current Treasury Regulations provide that an association is a business organization that includes three or more of four corporate characteristics: continuity of life, centralized management, limited liability, and free transferability of interests.²⁰³ Because proposed Section 1.06 gives a general partnership corporate-type continuity of life, a general partnership organized under this statute would be taxed as a corporation *if* it also had two other “association” characteristics. Although the risk that a general partnership would have these other characteristics is slight, this problem should be taken into account in considering the appropriateness of this provision. In light of the advantages of this provision discussed in Section V(F)(3) and the artificiality of the dissolution concept under the U.P.A., the optimal approach would be reconsideration of the tax definition of a corporation. In all events, the parties can draft around this provision in specific circumstances where the partnership has other “association” characteristics.

202. Internal Revenue Code § 7701(a)(3) defines a “corporation” for tax purposes to include any “association”, and § 7701(a)(2) defines a “partnership” so as to exclude “corporation.”

203. See Treasury Regulations §§ 301.7701-2; *Zuckman v. United States*, 524 F.2d 729 (Ct. Cl. 1975).

Comments on Other U.P.A. Dissolution Provisions

A complete revision of the U.P.A. dissolution provisions is beyond the scope of this Article. However, a few changes that follow from the above sections should be noted.

(1) Current U.P.A. §§ 33, 34 and 35 should be revised to provide that the scope of a nondissociating partner's authority to bind the partnership is limited only after an event specified in proposed Section 1.04.

(2) Current § 36 should be revised to apply to any dissociated partner, and not merely after dissolution of the partnership.

(3) Current §§ 40 and 43 should be revised to apply to distribution upon sale of the assets of the partnership under proposed Section 1.04.

IX. CONCLUSION

I have considered in this Article two broad questions concerning partner dissociation: First, what should the statutory standard form provide? And, second, what should be the effect of complete and incomplete partnership agreements? In light of the high costs associated with illiquidity of partnership interests, a partner's power to dissociate from the firm at will is desirable in many situations. It is also necessary, however, to take into account the costs that can be inflicted on the partners who do not wish to dissociate. Fashioning an approach that appropriately balances costs and benefits in particular situations requires precise thinking about the elements of and various approaches to partner dissociation. This "scalpel" approach contrasts with the U.P.A.'s "dynamite" approach of blasting the partnership apart, whatever the cost to the partners as a whole, in order to achieve the dissociation of a single partner.

I have designed the statutory standard form dissociation provisions outlined in this article specifically for the partnership. They are consistent with other aspects of the partnership standard form, particularly including the personal liability of the partners for partnership debts. Thus, my conclusions do not necessarily apply to corporations, whether closely or publicly held. An analysis of the costs and benefits of dissociation in the corporate context may well support a standard form that does not include dissociation at will even for closely held corporations.²⁰⁴

204. For the opposite conclusion see Hetherington and Dooley, *supra* note 6 (proposing statutory withdrawal provisions for closely held corporations).

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