Loss Sharing, Settling Accounts in a General Partnership:
Addressing UPA (2013)'s Error and UPA (1997)'s Imperfection
February 15, 2021

reporter's memorandum to the Uniform Unincorporated Organization Acts Amendment Committee

Introductory Concepts

1. The right to share profits and losses: The right to share profits has always been the hallmark of any partnership, and partnership law has always provided a corresponding obligation among partners to share losses. Under all the uniform general partnership acts, rules for profit and losing sharing have always been default rules – i.e., subject to be changed by the partnership.[1] The default rule for profit sharing has always been per capita. The default rule for loss sharing has always been in proportion to each partner's share of profits. (Thus, if the default rule for profits remains in place, loss sharing is per capita. However, if (for example) two partners agree to share profits 60/40 but do not specifically address loss sharing, losses are allocated 60/40.)

2. The dual functions of loss sharing:
   The third-party function – In a traditional (i.e., non-LLP) general partnership, each partner is personally liable for the debts of the partnership. If the partnership lacks funds to pay its creditors the partners are obligated to contribute funds to the partnership to make up the deficit. These contributions reflect one aspect of loss sharing among the partners.
   The inter se function – In a traditional (i.e., non-LLP) general partnership, loss sharing rules determine how partners "true up" their respective capital losses in the event the partnership loses money. If the truing up occurs during winding up, some partners may be required to contribute additional funds to the partnership, so that the partnership can distribute the funds to partners who otherwise would have lost capital beyond the partners' respective share.

3. The distinction between profits and distributions: Partnership law distinguishes profits and distributions. The former means an allocation (for various purposes) of profits on the books of the company. The latter refers to the actual transfer of money or other property to a person on account of the person's status as a partner.[2]

4. The timing issue – when are profits (or losses) allocated and when are distributions made: Although partnership statutes do not specify when profits or losses are to be allocated, except in unusual circumstances, profits/losses are allocated annually. Tax law so requires, as do accounting principles. Partnership law has never had a default rule

[1] In contrast, to be a partner under partnership law a person must have a right to share profits. This rule, which also affects the rights of third parties, is not a default rule.
[2] For reasons beyond the scope of this memo, neither ULPA (2013) nor ULLCA (2013) provide for allocation of profits.

providing for distributions before dissolution and winding up.[3] Partnership agreements (whether verbal or implied-in-fact) almost always provide for interim distributions.

5. The loss sharing rules change dramatically for a partnership that is an LLP: An LLP is a general partnership with an LLC-like liability shield for the partners. The shield does not protect against a partner's own misconduct or personal commitments (e.g., a guaranty of a partnership debts) but does eliminate each partner's automatic liability for the partnership's obligations. As a result, partners of an LLP do not share losses to the benefit of the partnership's creditors. Also (in part to protect the liability shield from indirect damage),[4] LLP partners do not contribute to "true up" their respective capital losses. Thus, capital losses (among partners) in an LLP lay where they fall.

The Fly in the Ointment – Status Changes
During the Life of a General Partnership

Loss sharing in a traditional general partnership requires some bookkeeping but the default rules are quite straightforward. In an LLP, the default rule is even clearer – there is no loss sharing. The complexity arises –to an almost daunting extent – if a partnership has been a non-LLP for some period of time and an LLP for another period of time.[5]

As originally developed, RUPA contemplated only the first situation. RUPA did not provide for LLPs until 1996.[6] The 1996 LLP amendments provided some rules governing the impact of the LLP shield on a partner's contribution obligations. However, as discussed below, the approach was imperfect.

Unfortunately, in this area UPA (2013) made progress backwards – put another way: the harmonization project got this area fundamentally wrong, in large part by conflating profit allocation and share of distributions.[7]

Thus, the Unincorporated Organization Acts Committee should not seek to fix the 2013 version but instead should (i) identify the key questions; (2) decide the answers; (3) assess the UPA

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[3] In brief, the semi-default rule for winding up is: (i) marshal assets (including loss sharing contributions owed by partners); (ii) pay creditors (including partners in the capacity of creditor); (iii) return to each partner the value of any contribution not previously returned (if necessary, obtaining and using loss sharing contributions from partners); and (iv) distribute any "left over" funds according to the profit allocation then in effect. (Paying creditors first is not a default rule. Nor is the obligation to share losses to the exent necessary to fund payments to creditors.)
[4] Anyone wishing further information on this somewhat recondite point is invited to contact the reporter, who is willing to discuss *ad nauseum*.
[5] This discussion contemplates two phases only (i.e., one period during which the partnership is not an LLP and one period when the partnership is an LLP status). If the Committee solves that "equation," it can then consider whether the solution works for a partnership that oscillates – i.e., has more than two phases.
[6] UPA (2013), Prefatory Note to Uniform Partnership Act (1997), Addendum Pertaining to 1997 Amendments.
[7] The author of this memo was one of the two co-reporters for the harmonization project.

(1997) approach in light of the answers; and (4) to the extent necessary, develop revisions to the UPA (1997) approach.[8]

The Key Questions

In the reporter's view, there are three key questions:

- Assuming a general partnership (GP) has never been an LLP, should UPA (2013) produce the same loss-sharing results as RUPA (1996) and UPA (1914)?
- Assuming a GP has been an LLP throughout its existence, should UPA (2013) produce the same results as ULLCA (2013)?
- Assuming a GP has been a non-LLP for some time and then an LLP until dissolution, what should the results be?

The reporter's analysis follows.[9]

Analysis

1. Assuming a general partnership (GP) was never an LLP, should UPA (2013) produce the same loss-sharing results as RUPA (1996) and UPA (1914)?
    a. Yes.
    b. To say no would reject a default rule embodied in UPA and RUPA prior to the 2013 version that, despite outliers (e.g *Kovacik v. Reed*)[10] has been settled law for hundreds of years.[11]

2. Assuming a GP has been an LLP throughout its existence, should UPA (2013) produce the same results as ULLCA (2013)?
    a. Yes.
    b. From the twin perspectives of liability to others and loss sharing inter se, the two entity types should be indistinguishable.
    c. Thus, as a matter of non-tax state law (and entirely independently of what tax law may prescribe), in an "always LLP" the partners owe no contributions – neither to fund the entity's debt to creditors nor to reallocate losses among the partners.
3. Assuming a GP has been a non-LLP for some time and then an LLP until dissolution, what should the results be?

[8] Devotees of The Princess Bride may recognize this approach as reflecting "The Vizzini Protocol." (Sometime after being defeated by the Man in Black, a very drunk Inigo Montoya says, "I am waiting for you, Vizzini. You told me to go back to the beginning."

[9] The Committee's chair provided valuable comments, as did Professor Don Widener, the reporter for RUPA. Remaining errors, omissions, obfuscations, etc. are the reporter's responsibility.

[10] Kovacik v. Reed, 49 Cal. 2d 166, 315 P.2d 314 (1957) (establishing a different loss sharing rule when one partner contributes the capital and the other contributes only "sweat equity."

[11] The reporter currently favors returning to UPA (1997)'s simple accounting rules to handle loss sharing.

a. *Contributions to fund debts to creditors for obligations incurred during the non-LLP phase* – should be required of those who were partners when obligation incurred

   i. with one important modification, this is the current approach under UPA (2013)

      - might be complex in application but conceptually straightforward
         - identifying who must contribute via "when incurred"; and
         - determining contribution ratio among those persons according to their respective then-applicable rights to share profits
      - UPA (2013) § 806

        (c) If a partnership's assets are insufficient to satisfy all its obligations under subsection (a), with respect to each unsatisfied obligation incurred when the partnership was not a limited liability partnership, the following rules apply:

          (1) Each person that was a partner when the obligation was incurred and that has not been released from the obligation under Section 703(c) and (d) shall contribute to the partnership for the purpose of enabling the partnership to satisfy the obligation. The contribution due from each of those persons is in proportion to the right to ~~receive distributions~~ share profits in the capacity of a partner in effect for each of those persons when the obligation was incurred.

          (2) If a person does not contribute the full amount required under paragraph (1) with respect to an unsatisfied obligation of the partnership, the other persons required to contribute by paragraph (1) on account of the obligation shall contribute the additional amount necessary to discharge the obligation. The additional contribution due from each of those other persons is in proportion to the right to ~~receive distributions~~ share profits in the capacity of a partner in effect for each of those other persons when the obligation was incurred.

          (3) If a person does not make the additional contribution required by paragraph (2), further additional contributions are determined and due in the same manner as provided in that paragraph.

   ii. two issues recommended not to be resolved

      - what does "incurred" mean?
         - the ULC has used "incurred" (with its marvelous ambiguity) since 1914 and contemporary drafting committees have repeatedly decided to:
            - use the term "incurred" without elaborating on the word's meeting in the statutory text; or
            - develop an entirely new approach.

        - The 2013 acts contain an extensive comment guiding the reader into the case law.[12]
    - partners (and former partners) who might be liable to contribute to fund payment for obligations incurred in the non-LLP phase will want the partnership to pay those obligations before paying any obligations incurred in the LLP phase
        - perhaps those managing winding up would have a fiduciary duty to do so?
        - however, doing so might raise bankruptcy issues; for example:
            - preferences
            - trustee or uncovered creditors might prefer to pay the LLP debts in preference to the non-LLP debts – to the extent partner vicarious personal liability brings additional assets into the estate.

b. *Contributions to allocate losses among partners for the period during which the GP was not an LLP* – should preserve the assumed "spirit" of UPA (1997)

[12] See Appendix A to this document.

§ 806(b) but make the mechanics clear.

i. UPA (1997) § 401(a)'s simplified provision for accounts should be reinstated for the sake of clarity – especially for non-experts; however, the provision should apply only when a GP is a non-LLP[13]
ii. Partners' obligations to share losses for a non-LLP period should be frozen as of the moment before the GP becomes an LLP. It is too difficult to sort things through as of the moment of dissolution. See Appendix B
iii. Tentative drafting suggestion:
    - one disposition of assets regime for pure non-LLP (i.e., non-LLP throughout its existence);
    - one disposition regime for pure LLP;
    - changeover rules[14] for changing from LLP to non-LLP and *vice versa*
        - from non-LLP to LLP
            - Section 401(a) (with its simplified accounting rules) has been maintained during non-LLP period
            - rights to receive and obligations to contribute for the purpose of loss sharing are determined as if dissolution had occurred;[15] but
            - settling up is deferred until:
                - ~ dissolution, except
                - ~ if a partner with a payment obligation dissociates before dissolution, in which case the obligation is a set off against the buyout price under Article 7.
        - from LLP to non-LLP –
            - Section 401(a) accounting begins
            - each partner is credited with the amount of the partner's initial contribution[16]
                - ~ for these purposes, each partner's initial contribution is intact

[13] As a matter of non-tax law, there is no loss sharing in an LLP.
[14] I chose "changeover" because "transition" or "conversion" would be confusing given the use of those terms in other contexts.
[15] Contribution obligations to pay creditors need not be calculated because UPA (2013) has a retrospective provision, applicable upon dissolution, that is more straightforward than the approach in UPA (1997) § 807(a). Section 807(a) implies that settling accounts among the partners inter se will produce the funds necessary to pay off any creditors: "In winding up a partnership's business, the assets of the partnership, including the contributions of the partners required by this section, must be applied to discharge its [i.e., the partnership's] obligations to creditors …." Subsections (b) and (c) so require and they pertain directly to working through partner accounts to determine distribution rights and contribution allocations necessary to fund those rights. Neither subsection states that the contributions are intended to go beyond inter se loss sharing to satisfy partnership debts to creditors. [I think the yellow highlighted phrase is confusing. Distributions and contributions are made. Profits and losses are allocated]
[16] To deal with oscillations (i.e., more than one phase of each status), this rule will necessarily become at least a bit more complicated.

~ there has been no interim distribution (default rule) and no allocated losses (no loss sharing in an LLP per non-tax state law)[17]

[Appendices A and B follow.]

[17] The tax accounting might be quite different. So it goes. *Cf.*, *e.g.*, ULLCA (2013) § 404, cmt. ("To the extent the tax law allows partners to make further tax elections or satisfy alternative safe harbors, the partners may look to the tax law for guidance and include necessary provisions in their agreements.")

Appendix A – "Incurred"

UPA (2013) 306[Partner's Liability](b), cmt.

With regard to when a partnership incurs a debt, obligation, or other liability, the case law is scant and concerns only contractual and similar obligations. The leading case is *Conklin Farm v. Leibowitz*, 658 A.2d 1257 (N.J. 1995), which holds that: (i) obligations on a loan, whether for interest or principal, are incurred when the loan is made, not when each particular payment is due; and (ii) obligations for lease payments are incurred when each rental payment is due, not when the lease is made.

Conklin concerned a partnership loan obligation that was: (i) entered into before a particular partner joined the partnership; but (ii) for the most part, was payable afterwards. The court held that "interest is part of the contractual debt, and the obligation to pay interest on a loan *arises,* if at all, at the time that the parties execute the note or other debt instrument. *Conklin*, 658 A.2d at 1261. The court indicated that the same analysis applies to the obligation to repay principal. *Id.* at 1263 (stating that "the decisive issue before this court . . . [is that] [p]ayment of interest, like repayment of advances, is an obligation that arises at the time the debt instrument is executed").

Conklin discussed the lease issue in response to the creditor's argument that "just as a rent obligation arises for current use of property, an interest obligation arises for current use of principal." *Id.* at 1261. Rejecting that argument, the court: (i) noted "the *common-law* obligation to pay rent based on current tenancy [which] . . . arises with each period of tenancy, and . . . arises even in the absence of a lease"; (ii) described "the common-law obligation to pay rent [as] entirely independent of the contractual obligation under the lease"; and (iii) held that, for purposes of partnership law, the rule for "incurring" a lease obligation rests on the common law duty in tenancy and not on the lease as a contract. *Id.* at 1262 (citing *Ellingson v. Walsh, O'Connor & Barneson*, 104 P.2d 507, 508 (Cal. 1940)).

As to when a partnership incurs a tort liability, the answer might be found by analogy to statute of limitation rules, another area of law concerned with when claims arise. "Although the courts have not been consistent . . . , the interpretation of [when] a . . . statute [of limitations begins to run] as applied to torts has been such that the statute does not usually begin to run until the tort is complete . . . . A tort is ordinarily not complete until there has been an invasion of a legally protected interest of the plaintiff." RESTATEMENT (SECOND) OF TORTS § 899, cmt c (1979); *see also Loehr v. Ventura Cnty. Cmty. Coll. Dist.*, 147 Cal. App. 3d 1071, 1078 (Cal. Ct. App. 1983). By analogy, a partnership would incur liability for a tort when the harm occurs. *See, e.g.*, *Jones v. Cox*, 828 P.2d 218, 224 (Colo. 1992) ("A cause of action has commonly been understood to 'accrue' when a suit may be maintained thereon.") (quoting BLACK'S LAW DICTIONARY 19 (5th ed. 1979)); *Loehr*, 147 Cal. App. 3d at 1078.

However, a policy argument exists to the contrary. Vicarious liability for a partnership's torts should be confined to persons who are partners when the wrongful conduct occurs. It is the conduct, not the consequences, that is wrongful; therefore, the occurrence of the wrongful conduct should determine which set of partners is liable for the conduct's consequences.

For further discussion of the "incurred" issue, see Subsection (c), comment (The Temporal Nexus—When Claim Incurred).

UPA (2013) 306(c), cmt.[18]

The Temporal Nexus—When Claim Incurred

The LLP shield functions only with respect to obligations incurred while the partnership is a limited liability partnership. The shield does not protect partners from vicarious liability for partnership obligations incurred before a partnership becomes an LLP or after the partnership cancels its LLP status. *See* Section 903(d). The same is true initially when LLP status has been administratively revoked, but reinstatement of LLP status resurrects the shield retroactively, except as to persons who relied on the revocation. Section 903(d).

For a preliminary discussion of when a partnership obligation is incurred, see Subsection (b), comment. It could well be argued that "incurred" under Subsection (c) has the same meaning as "incurred" under Subsection (b). *IBP, Inc. v. Alvarez*, 546 U.S. 21, 34 (2005) (referring to "the normal rule of statutory interpretation that identical words used in different parts of the same statute are generally presumed to have the same meaning"); *Timberline Air Serv., Inc. v. Bell Helicopter-Textron, Inc.*, 884 P.2d 920, 925 (1994) (stating that "[w]hen the same words are used in different parts of the same statute, it is presumed that the Legislature intended that the words have the same meaning").

However, the argument should yield if the subsections' different contexts raise different issues of policy. 1A SUTHERLAND STATUTES AND STATUTORY CONSTRUCTION § 45:12 (7th ed.) (stating that "departure from the literal construction of a statute is justified when such a construction would produce an absurd and unjust result and would clearly be inconsistent with the purposes and policies of the act in question"); *see, e.g.*, *S.V. v. R.V.*, 933 S.W.2d 1, 4 (Tex. 1996) ("[W]e have held that a cause of action accrues when a wrongful act causes some legal injury, even if the fact of injury is not discovered until later, and even if all resulting damages have not yet occurred. We have not applied this rule without exception, however, and have sometimes held that an action does not accrue until the plaintiff knew or in the exercise of reasonable diligence should have known of the wrongful act and resulting injury.") (citations omitted).

The case law concerning contractual obligations (incurred when the contract is made) applies appropriately in the context of the LLP shield. However, the lease case law is problematic. If an obligation is incurred each time rent is due, subsection (c) is a trap for the

[18] Section 306 generally deals with partner liability for partnership obligations. Subsection (c) deals with the LLP shield and its consequences.

unwary landlord.

> EXAMPLE: Ordinary general partnership enters into a lease with a commercial landlord. Knowing that each partner is automatically liable for the partnership's debt, the landlord does not obtain personal guarantees. Subsequently, the partnership becomes an LLP. If future rent payments are incurred when due, and not as of when the lease was made, the landlord loses a very important part of the bargain.

Thus, for the purposes of Subsection (c), lease obligations should be treated as contractual obligations, incurred when the contract is made.

A similar issue exists with regard to tort liability. Courts must look to when the conduct causing the injury takes place and not to when actual injury occurs. Otherwise, a partnership could: (i) engage in wrongful conduct that does not cause immediate injury; (ii) come to realize that the conduct has occurred; (iii) subsequently file a statement of qualification; (iv) thereby become an LLP; and (v) thereby eliminate the vicarious liability of its partners for all harm subsequently arising from the misconduct. *Cf. Savini v. Univ. of Haw.*, 153 P.3d 1144, 1150 (Haw. 2007) (addressing the question of when a statute of limitations begins to run for bodily injury, when another statute precludes bringing a claim until the amount of damages has reached a specified threshold).

In general, courts should determine the "incurred" question under Subsection (c) so that the LLP shield protects the partners of an LLP to the same extent that the corporate and LLC shields protect corporate shareholders and LLC members. From that perspective, LLP status obtained after a partnership commits a wrongful act should provide no greater protection for the partners than a sole proprietor obtains by forming an LLC after committing a wrongful act – *i.e.*, none. *See, e.g.*, *Foxchase, L.L.L.P. v. Cliatt*, 562 S.E.2d 221, 224 (Ga. Ct. App. 2002) (holding that a partnership's liability shield did not protect partners from claims of property damage caused by the construction of a golf course, where the jury could have found that the "damage . . . occurred when they, not the partnership, owned the course").

From the same perspective, *Evanston Ins. Co. v. Dillard Dept. Stores, Inc.*, 602 F.3d 610 (5th Cir. 2010) makes no sense. Interpreting the Texas LLP statute, the court held that a partner's liability for a partnership debit is incurred only when judgment is entered against the partnership. Although the decision itself benefitted creditors, the holding invites the type of gamesmanship shown in the leasing example, above. Moreover, the decision: (i) has been criticized by the Texas Court of Appeals, *Am. Star Energy & Minerals Corp. v. Stowers*, 405 S.W.3d 905, 907 (Tex. App. 2013); (ii) ignores the precedent discussed in Subsection (b), comment and Section 307(c), comment; and (iii) can be distinguished as depending on the particular (non-uniform) language of the Texas statute. *Evanston Ins. Co v. Dillard Dep't Stores, Inc.*, 602 F.3d 610, 615–16 (5th Cir. 2010) (contrasting "incurred" with "committed").

Appendix B – Worksheet on UPA (1997) § 806(b)

subsection (c) requires separate validation

This worksheet seeks to determine whether the underlined passage [below] in UPA (1997) § 807(b), and particularly the phrase highlighted in yellow, work if a partnership begins as a non-LLP and later becomes an LLP. The relevant sections of Section 807 are below. The relevant provisions for maintaining each partner's account, Section 401(a)-(b), are further below. Then follows a hypothetical and year by year calculations.

> SECTION 807. SETTLEMENT OF ACCOUNTS AND CONTRIBUTIONS AMONG PARTNERS.
>
> (a) In winding up a partnership's business, the assets of the partnership, including the contributions of the partners required by this section, must be applied to discharge its obligations to creditors, including, to the extent permitted by law, partners who are creditors. Any surplus must be applied to pay in cash the net amount distributable to partners in accordance with their right to distributions under subsection (b).
>
> (b) Each partner is entitled to a settlement of all partnership accounts upon winding up the partnership business. In settling accounts among the partners, profits and losses that result from the liquidation of the partnership assets must be credited and charged to the partners' accounts. The partnership shall make a distribution to a partner in an amount equal to any excess of the credits over the charges in the partner's account. A partner shall contribute to the partnership an amount equal to any excess of the charges over the credits in the partner's account but excluding from the calculation charges attributable to an obligation for which the partner is not personally liable under Section 306.
>
> (c) If a partner fails to contribute the full amount required under subsection (b), all of the other partners shall contribute, in the proportions in which those partners share partnership losses, the additional amount necessary to satisfy the partnership obligations for which they are personally liable under Section 306. A partner or partner's legal representative may recover from the other partners any contributions the partner makes to the extent the amount contributed exceeds that partner's share of the partnership obligations for which the partner is personally liable under Section 306.

> Section 401 provisions re: partner's account:
>
> (a) Each partner is deemed to have an account that is:
>
> (1) credited with an amount equal to the money plus the value of any other property, net of the amount of any liabilities, the partner contributes to the partnership and the partner's share of the partnership profits; and
>
> (2) charged with an amount equal to the money plus the value of any other property, net of the amount of any liabilities, distributed by the partnership to the partner and the partner's share of the partnership losses.

(b) Each partner is entitled to an equal share of the partnership profits and is chargeable with a share of the partnership losses in proportion to the partner's share of the profits.

Worksheet

L & S General Partnership
duration – three years
initial contributions L = 100 S = 50
per the statutory default rule:
no interim distributions;
distributions (and therefore losses) shared equally
year 1 – non-LLP; loss
year 2 – LLP and profit
year 3 – LLP and loss

<u>Beginning of Year 1 – Upon Formation</u>

L & S – partners' equity = 150
cash on hand = 150

Partners' Respective Accounts under Section 401(a)

L	S
100	50

<u>During Year 1 – Partnership Has Loss of 150</u>

L & S – partners' equity = 0
cash on hand = 0

Partners' Respective Accounts under Section 401(a)

L		S
100	initial amounts, per above	50
(75)	losses shared equally	(75)
25	account balance end of year 1	(25)

<u>During Year 2 – Partnership Has Profit of 200</u>

L & S – partners' equity = 200
cash on hand = 0

Partners' Respective Accounts under Section 401(a)

L		S
25	year 1 amounts, per above	(25)
100	profits shared equally	100
125	account balance end of year 2	75

During Year 3 – Partnership Has Loss of 200
and dissolves at end of year

L & S – partners' equity at dissolution = 0
cash on hand = 0

Partners' Respective Accounts under Section 401(a)

L		S
125	year 2 amounts, per above	75
100	losses shared equally	100
25	account balance end of year 2	(25)

Analysis: If the partnership had dissolved at the end of year 1, S would have had a contribution obligation of 25, and L would (via the partnership) receive 25. There would be no reason to "exclud[e] from the calculation charges attributable to an obligation for which the partner is not personally liable under Section 306." Section 807(b).

The situation is different by the end of year 3. Is S's negative balance attributable to year 1 obligations, even though:

- S had a positive balance at the end of year 2; and
- S's negative balances in year 3 results from obligations for which S was not personally liable?