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PARTNERSHIPS — CONTINUED LIABILITY OF A RETIRING PARTNER RECEIVING PAYMENTS

by James H. Wallenstein

I. INTRODUCTION[1]

A partner who retires usually seeks relief from his personal liability on partnership obligations. For economic or tax reasons, he may continue to receive payments from the firm rather than withdraw his entire interest.[2] This Comment explores the effect of such payments on his liability for future partnership obligations.

Payment to a retiring partner for his interest in the partnership is usually provided for in a retirement agreement.[3] The Internal Revenue Code has labelled the two basic types of arrangements as "sale" and "liquidation."[4] "Sale" involves transfer for consideration of the retiring partner's interest in the firm to one or more remaining partners, or to a third person. "Liquidation" involves transfer or surrender to and payment from the partnership itself. In either case the parties may ease the burden and improve terms of payment by delaying full payment. Moreover, continuing payments under either plan may reduce income taxes for the retiring partner or the continuing partners.[5]

No retirement agreement by itself can insulate the retiring partner from debts existing at the time of retirement. Section 36 of the Uniform Partnership Act in expressing this rule[6] merely restates past law.[7] On the other hand, complete withdrawal including a lump-sum payment for the retiring partner's interest should protect him from

[1] Analysis in this article will be based upon the UNIFORM PARTNERSHIP ACT, 7 UNIFORM LAWS ANN. §§ 1-45 (1949), hereafter referred to as "the act" and cited by section. The act was passed with few modifications by the 1961 Texas Legislature and is codified as TEX. REV. CIV. STAT. ANN. art. 6132b (Supp. 1965).

[2] See Bakst, *Payments to a Retiring Partner or to a Deceased Partner's Successor in Interest*, N.Y.U. 19th INST. ON FED. TAX. 319 (1961); and Dauber, *Partnership Reorganizations: A New Tax Frontier*, 64 DICK. L. REV. 95 (1959).

[3] Section 42 of the act allows a partner to retire without an agreement and later to receive his interest in the partnership plus either interest or profits attributable to that interest. For an analysis of liability problems in connection with section 42 see Note, *Profit Rights and Creditors' Priorities after a Partner's Death or Retirement: Section 42 of the UPA*, 63 YALE L.J. 709 (1954).

[4] See Treas. Reg. § 1.736 (1956), as amended, T.D. 6832, 1965 INT. REV. BULL. No. 33, at 22 and § 1.741 (1956), and note 2 *supra*.

[5] See note 2 *supra*.

[6] "The dissolution of the partnership does not of itself discharge the existing liability of any partner." § 36(1) of the act. Section 36(2) expressly approves a novation agreement among the retiring partner, the partnership, and the creditor.

[7] Shaw v. Green, 128 Tex. 596, 99 S.W.2d 889 (Tex. Comm. App. 1937); Reed v. Shaw, 274 S.W. 274 (Tex. Civ. App. 1925).

liability for future debts of the firm.[8] When the retiring partner accepts continuing payments, however, he may be held to have delayed complete withdrawal of his partnership interest. Thus, even though he withdraws personally from management, he may subject himself to continued partnership liability.

A quick glance at the rules of partnership is reassuring to a retiring partner but perhaps misleading. Most cases indicate that any valid retirement agreement among partners ends the partnership as to those partners.[9] Moreover, although such cases deal with suits between partners themselves, section 7(1) of the act provides that in cases not involving estoppel, "persons who are not partners as to each other are not partners as to third parties."[10] It might seem that courts would logically allow complete protection for retiring partners with an express agreement.

Unfortunately, courts are either quick to find estoppel or slow to give due respect to section 7(1)[11] and any indications of continuity of the former partnership may prove costly to the retiring partner. Signs of visible continuity include failure to give notice of retirement and failure to withdraw the retiring partner's name from the firm. These signs are common elements of estoppel to be avoided in any retirement.[12]

More subtle perhaps are the signs of economic continuity in the form of continuing payments from the firm. "Liquidation" agreements seem particularly vulnerable because the form of payment may be quite similar to that under the former partnership. Moreover, the retiring partner in a liquidation is considered for tax purposes *as a partner* until his interest has been fully liquidated.[13] The "sale" agreement, although ending economic continuity on the surface, may not be totally immune, especially when partnership property is used as security for payment.[14] Analysis in this Comment will

[8] This protection, however, can be shattered by estoppel. See specifically sections 16, 33, 34, and 35 of the act. See also Sher and Bromberg, *Texas Partnership Law in the 20th Century—Why Texas Should Adopt the Uniform Partnership Act*, 12 Sw. L.J. 263, 311 (1958).

[9] Sorokach v. Trusewich, 13 N.J. 363, 99 A.2d 790 (1953); Lanier v. Bowdoin, 282 N.Y. 32, 24 N.E.2d 732 (1939); Sechrest v. Sechrest, 248 Wis. 516, 22 N.W.2d 594 (1946). See also Annot., 55 A.L.R. 2d 1391, 1413 (1957); and Williams, *The Uniform Partnership Act Comes to Nebraska*, 22 NEB. L. REV. 215, 247 (1943). Note that the continuing partners may prevent by agreement problems associated with dissolution. Bromberg, *Partnership Dissolution—Causes, Consequences, and Cures*, 43 TEXAS L. REV. 631, 637-38 (1965).

[10] Section 7(1).

[11] Boone v. General Shoe Corp., 242 S.W.2d 138 (Ark. 1951); Mercer v. Vinson, 85 Ariz. 280, 336 P.2d 854 (1959); Gustafon v. Taber, 234 P.2d 471 (Mont. 1951).

[12] See note 8 *supra*.

[13] Treas. Reg. § 1.736-1(a)(ii) (1956), as amended, T.D. 6832, 1965 INT. REV. BULL. No. 33, at 22.

[14] For an example of how closely a "sale" can resemble a "liquidation," see David A. Foxman, 41 T.C. 535, 547-53 (1964), *aff'd*, 352 F.2d 466 (3d Cir. 1965).

assume circumstances under either a "liquidation" or border-line "sale."

II. The Perspective of Profit-Sharing

Profit-sharing is an essential element of partnership;[15] therefore, if the retiring partner does not share in profits, he should not fear future personal liability.[16] But the term "profit-sharing" is at least arguably applicable to all continuing payments from a prospering firm,[17] so the considerations in any retirement providing for continuing payments include not only the existence of profit-sharing but also the presumptions arising from profit-sharing.

A. *What Constitutes Profit-Sharing?*

Section 18(a) of the act indicates that standard profit-sharing involves equal allocation of profits among partners. But all profit-sharing is not necessarily equal,[18] and allocations of profits on any percentage basis easily fall under the classfication of profit-sharing.[19] Likewise, agreements for payments of fixed sums plus a percentage of the profits are considered profit-sharing.[20] The latter form of agreement arises frequently in retirements from professional and other personal service firms where each partner's interest in the partnership is small in relation to the continuing income value of the firm.[21]

Agreements often call for payments only of fixed sums but with some definite relation to the prosperity of the continuing firm. One popular form requires payment of the retiring partner's interest in the partnership plus fixed (although possibly diminishing) yearly payments calculated as a percentage of his distributive share of income at the time of retirement.[22] Assuming no drastic change in the income of the firm, these payments bear too close a resemblance

[15] Section 6(1): "A partnership is an association of two or more persons to carry on as co-owners for a profit." See also 1 Rowley, Partnership 163 (2d ed. 1960) indicating that profit-sharing is the only essential element of partnership.

[16] This feeling of security, of course, should be tempered by a healthy awareness for elements of estoppel. See note 8 and text accompanying note 10 *supra.*

[17] See text accompanying notes 18-29 *infra.*

[18] Section 18: "The rights and duties of the partners in relation to the partnership shall be determined, *subject to any agreement between them,* by the following rules. . . ." (Emphasis added.)

[19] Holst v. Butler, 379 Pa. 124, 108 A.2d 740 (1954) (24% - 24% - 24% - 15% - 8% division of profits); Blair v. Rindy, 358 S.W.2d 685 (Tex. Civ. App. 1962) *error ref. n.r.e.* (70% - 30% division of profits).

[20] Blumberg v. Palm, 238 Minn. 249, 56 N.W.2d 412 (1953). See also Annot., 137 A.L.R. 6, 85 (1942).

[21] 1 Rabkin and Johnson, Current Legal Forms with Tax Analysis 346-50 (1965).

[22] Bromberg, *supra* note 9, at 666-67.

to the agreements described above to prevent classification as profit-sharing. Moreover, any payments of fixed sums which are readily related to income are likely subject to the same classification.[23]

Even payments of fixed sums which are not readily related to income of the firm are vulnerable, especially when they exceed the retiring partner's interest in the assets of the partnership.[24] The Internal Revenue Code treats liquidation payments in excess of the retiring partner's interest in the assets of the partnership as ordinary income rather than as capital gains. Thus, tax authorities consider the excess to be a measure of future earnings—*per se* related to income of the firm—rather than an increase of capital.[25] To be sure, if the partners have agreed prior to retirement to establish a value for partnership good-will, payments allocated for that sum are allowed capital-gains treatment.[26] This point should be considered long before retirement, and it may prove to be a valuable safeguard in avoiding profit-sharing classification. However, at least one writer has summarily stated that all continuing payments above the retiring partner's interest in the assets of the partnership constitute profit-sharing.[27]

Fixed payments limited to the retiring partner's interest in the assets of the partnership best withstand profit-sharing classification. Of course, by definition these payments preclude realization of much gain on investment if the market value of the partnership assets has not risen greatly.[28] Moreover, these payments are not totally invulnerable. Because of the delay in payments, the partnership can reasonably use current profits to meet yearly installments, more so than if payment were in lump-sum. A liberal extension of profit-sharing might include any payments which are made from such current profits.

Perhaps the vital factor to consider in the latter examples is the

[23] See Annot., 137 A.L.R. 6, 31 (1942).

[24] A partner's interest in the partnership itself is the cost of his investment plus his share of undistributed profits. (Of course if a partner sells his interest the new partner's basis on purchase is the same as it was to the selling partner.) A partner's interest in the assets of the partnership is his share of the market value of the specific assets. For the nature of each interest during the existence of the partnership see §§ 25-26. See also note 54 *infra*. The Internal Revenue Service has allowed considerable leeway in valuing a partner's interest in partnership assets. See Treas. Reg. § 1.736-1(b)(1) (1956), as amended, T.D. 6832, 1965 INT. REV. BULL. No. 33, at 22.

[25] Treas. Reg. § 1.736 (1956), as amended, T.D. 6832, 1965 Int. Rev. Bull. No. 33, at 22, and Bakst, *supra* note 2. For a general statement of the concept of capital gains as opposed to ordinary income, see 3B MERTENS, FEDERAL INCOME TAXATION 4-10 (1958).

[26] Treas. Reg. § 1.736-1(b)(3) (1956), as amended, T.D. 6832, 1965 INT. REV. BULL. No. 33, at 22.

[27] "The payments may be a fixed sum, or they may be a percentage of past income or of future income. They all, however, involve one basic concept: the retiring partner is sharing in the current earnings of the partnership." RABKIN AND JOHNSON, *supra* note 21, at 346.

[28] Partners can raise the stated value of the partnership assets by a reasonable amount. See note 24, *supra*.

conditions of payment. If payments are limited by the firm's profits, they resemble profit-sharing, fixed or not. On the other hand, if payments are fixed and mandatory, they are likely to avoid the profit-sharing classification and to be classed instead as a sharing of gross returns.[29]

B. *The Consequence Of Profit-Sharing*

At early common law, the sharing of profits was equated with the existence of a partnership.[30] Under this view, a partner would certainly remain so after retirement regardless of intention if he continued to receive a share of the profits. This view, however, has been repudiated long since[31] and has been clearly rejected in Texas as in most jurisdictions.[32]

The act follows the modern trend, but it nevertheless includes profit-sharing as a basic element of partnership.[33] Moreover, section 7(4) lists profit-sharing as prima facie evidence of the existence of a partnership relation, evidence which can be avoided only by proof that the profits were received as payment for one of the six exceptions listed in section 7(4).[34]

1. *Debt*

Section 7(4)(a) perhaps implies that payments in the retirement agreement can escape any presumption of partnership continuity merely because they are payments of an amount owed to the retiring partner. However, the history behind section 7(4) (a) indicates that it was meant to protect creditors of debtors in financial difficulties,

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[29] Section 7 (3) "The sharing of *gross returns* does not of itself establish a partnership. . . ." (Emphasis added.)

[30] Waugh v. Carver, 2 Bl. H. 235 (1793); see also Cothran v. Marmaduke & Brown, 60 Tex. 370 (1883); Fouke v. Brengle, 51 S.W. 519 (Tex. Civ. App. 1899) *error ref.*; and Steger v. Greer, 228 S.W. 304 (Tex. Civ. App. 1921) *error dism.*, indicating acceptance in Texas.

[31] Cox v. Hickman, 8 H.L. 268, 11 Eng. Rep. 431 (1860).

[32] Meehan v. Valentine, 145 U.S. 611 (1892); Wild v. Davenport, 48 N.J. L. 129, 7 Atl. 295 (1886); Fink v. Brown, 215 S.W. 846 (Tex. Comm. App. 1919); Gardner v. Wesner, 55 S.W.2d 1104 (Tex. Civ. App. 1932) *error ref.* See also Sher and Bromberg, *supra* note 8, at 264-65.

[33] See note 15, *supra*.

[34] Section 7(4):

> The receipt by a person of a share of the profits of a business is prima facie evidence that he is a partner in the business, but no such inference shall be drawn if such profits were received in payment:
>
> (a) As a debt by installments or otherwise,
>
> (b) As wages of an employee or rent to a landlord,
>
> (c) As an annuity to a widow or representative of a deceased partner,
>
> (d) As interest on a loan, though the amount of payments vary with the profits of the business,
>
> (e) As the consideration for the sale of good-will of a business or other property by installments or otherwise.

where by permitting continuance of the business, the creditor would attempt to salvage his debt through profit-sharing.[35]

Modern courts, confronted with the act itself, may expand this narrow historical scope of debt profit-sharing. Section 42 of the act indicates that a retiring partner can be a creditor as to profits earned by the interest he leaves in the partnership.[36] Such express approval of the retiring partner's creditor status may expand the scope of section 7(4)(a) to cover retirement payments.[37]

2. *Interest on a Loan*

Section 7(4)(d) clearly excuses the lender who agrees to repayment of his principal plus a share in the profits of the borrower's business.[38] The connection with retirement agreements, however, is not clear. As suggested by both case law[39] and the existence of separate subdivisions in section 7(4), a debt is not always a loan. If the retirement agreement is to be considered a loan, what is being lent? Since payments to the retiring partner are usually in cash, money seems to be the only possible principal for the loan. Moreover, the retiring partner has not transferred money to the firm; he has transferred his interest. The transaction is basically then a sale of property

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[35] Cox v. Hickman, 8 H.L. 268, 11 Eng. Rep. 431 (1860). See also 1 ROWLEY, PARTNERSHIP 140-42 (1960), and CRANE, PARTNERSHIP 65-66 (1952).

[36] Section 42:

> When any partner retires or dies, and the business is continued under any of the conditions set forth in section 41 (1, 2, 3, 5, 6) or section 38(2b), without any settlement of accounts as between him or his estate and the person or partnership continuing the business, unless otherwise agreed, he or his legal representative as against such persons or partnership may have the value of his interest at the date of dissolution ascertained, and shall receive as an ordinary creditor an amount equal to the value of his interest in the dissolved partnership with interest, or, at his option or at the option of his legal representative, in lieu of interest, the profits attributable to the use of his right in the property of the dissolved partnership. . . .

[37] At least one writer has indicated that the term "ordinary creditor" may apply only to the receiving of "an amount equal to the value of his interest in the dissolved partnership with interest." Williams, *supra* note 9, at 247-48. Under this interpretation, the retiring partner in exercising the option to receive profits may fail to achieve creditor status. The language of the section itself, however, seems to imply the categorizing of both alternatives under "ordinary creditor." Probably the most grammatical and logical explanation of the use of the conjunction "or" is that it connects "interest" and "profits," both equally objects of the preposition "with." Nevertheless, courts would feel little restraint in ruling that the two clauses follow "shall receive" and that "ordinary creditor" modifies only "an amount."

[38] Meehan v. Valentine, 145 U.S. 611 (1892); Martin v. Peyton, 246 N.Y. 213, 158 N.E. 77 (1927). But compare the following: "Appellee is too preoccupied, we think, with its insistence that the relationship between [the alleged partners] was that of debtor and creditor. This is undoubtedly correct, but it is equally undoubtedly indecisive." Minute Maid Corp. v. United Foods, Inc., 291 F.2d 577, 583 (5th Cir. 1961). This case was argued before final enactment of the act in Texas, but its warning is still appropriate. See note 55 *infra* and accompanying text.

[39] Ketchum v. City of Buffalo, N.Y., 21 Barb. 294, 305 (1854). *Cf.* Heilos v. State Land Co., 113 N.J. Eq. 239, 116 Atl. 330, 331 involving forbearance of a previous loan.

for credit. A broad extension of "loan" to include credit is unlikely.[40]

Even if the broad interpretation of "loan" is accepted, the language of section 7(4)(d) inherently assumes that only the interest for the loan is paid through profit-sharing.[41] Unless the retirement agreement absolutely requires the return of the retiring partner's interest in the firm in fixed payments,[42] it might fall outside the section.

Defense of the retirement agreement solely under 7(4)(d) is then highly questionable. The retiring partner might well incorporate both section 7(4)(d) and section 7(4)(a), but some problems of each individual section (expansion of the scope of "debt" and existence of a "loan" to calculate interest) do not seem to be answered merely by combination.

3. *Wages of an Employee*

If a partner ends all activity in connection with the firm, section 7(4)(b) is irrelevant. Often, however, he will remain as consultant to the continuing partners and may then seek to show that his services were those of an employee. Profit-sharing as compensation to an employee is not presumptive of partnership liability,[43] but the division between employee and partner is not at all clear.[44] Under any test the retiring partner is at a disadvantage since he was a full partner and is now both performing services and receiving a share of the profits.[45]

4. *Rent to a Landlord*

One writer has stated that section 7(4)(b) is too narrowly worded and that profit-sharing as compensation for the use of any property should be covered.[46] Still, coverage of normal retirement agreements seems unlikely. The partner by his retirement gives up all interest in the assets of the firm,[47] and payments for his interest in the partnership take the form of sale. In short, the retiring partner has nothing to rent.

[40] Day v. Cohen, 165 Mass. 304, 43 N.E. 109 (1896), cited in Canadian Ace Brewing Co. v. Swiftsure Beer Service Co., 17 Ill. App. 2d 54, 149 N.E.2d 442, 450 (Ct. App. 1958), and Estate of Moore, 135 Cal. App. 2d 122, 286 P.2d 939, 945 (Dist. Ct. App. 1955).

[41] See discussion in Starer v. Milwaukee General Ins. Agency, Inc., 20 Wis. 2d 268, 121 N.W.2d 872, 874-75 (1963).

[42] As in agreements following the example in Bromberg, *Partnership Dissolution—Causes, Consequences, and Cures*, 43 TEXAS L. REV. 631, 666. See note 22 *supra* and accompanying text.

[43] Berne v. Keith, 361 S.W.2d 592 (Tex. Civ. App. 1962) *error ref. n.r.e.*

[44] See Provident Trust Co. of Philadelphia v. Rankin, 333 Pa. 412, 5 A.2d 214 (1939).

[45] See text accompanying notes 56-59 *infra*.

[46] ROWLEY, *supra* note 35, at 149.

[47] Section 41(3). See also Commissioners' Note, 7 UNIFORM LAWS ANN. 231 (1949).

The partners can alter the normal agreement to perhaps make use of section 7(4)(b). They can give the retiring partner land or equipment as payment for his interest in the partnership and then rent such property from him. Assuming no claims of "sham" transaction,[48] the retiring partner may share profits as rent.

5. Annuity to a Widow or Representative of a Deceased Partner

Section 7(4)(c) cannot possibly apply to profit-sharing by a living retiring partner and since the act specifically protects the estate of the deceased and is silent as to a retiring partner, it may even give rise to a negative inference of liability of the retiring partner receiving payments. The latter interpretation seems unfair since the purpose of the section is to protect the decedent's family and estate, when the widow or representative inadvertently allows the partnership to continue.[49] The section in connection with section 41(10)[50] not only allows the widow or representative to escape liability but also gives her express protection from harassing law suits. Such extra protection would not be needed by a living retiring partner and so omission of his situation in the act is perhaps explainable.[51]

6. Consideration for the Sale of Good-will of a Business or Other Property

Payments for the right to continue using the firm name have been held to be good-will payments,[52] but it is doubtful that an existing partner owns good-will in order to sell it.[53] Nevertheless, inclusion of "other property" in section 7(4)(e) probably offers a retiring partner his greatest opportunity to avoid any presumption of partnership liability.

The retiring partner receives payments for the sale of his interest

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[48] See note 55, *infra*. One specific problem is obvious. If the property transfered for the retiring partner's interest is to be equivalent to the value of that interest and if payments are to represent adequately the fair rental value of the property, the payments might be excessive.

[49] See Western Shoe Co. v. Neumeister, 258 Mich. 662, 242 N.W. 802 (1932), before the act but expressing the same opinion. The case was cited and analyzed favorably in Van Stee v. Ransford, 346 Mich. 116, 77 N.W.2d 346, 355 (1956).

[50] Section 41(10):

> The use by the person or partnership continuing the business of the partnership name, or the name of a deceased partner as part thereof, shall not of itself make the individual property of the deceased partner liable for any debts contracted by such person or partnership.

[51] See note 54 *infra* and accompanying text.

[52] Mitchell v. Gruener, 251 Mass. 113, 146 N.E. 252 (1925).

[53] Section 25 of the act states generally that partners hold specific partnership property (which includes good-will) as "tenant(s) in partnership." The provisions of section 25 indicate that no partner owns a part of any asset; the partnership itself owns all assets. Thus, on liquidation a partner could not sell an asset to the partnership unless he had special rights in it by prior agreement. For related tax concepts see note 24 *supra*.

in the partnership. Sections 26 and 27 declare this interest to be property owned by the partner and transferable by him. And since section 7(4)(e) expressly includes good-will, it is irrelevant for purposes of the section that the property being sold is intangible. No cases have applied the section to sales between partners, but one writer in his discussion of annuity payments to widows, indicates his belief that section 7(4)(e) gives similar protection to retiring partners.[54]

C. *Preliminary Conclusions On Profit-Sharing*

Despite seemingly favorable analysis in previous sections of this Comment courts have provided little precedent for categorizing the profit-sharing of retirement agreements under any exception of section 7(4). Moreover, courts are often inconsistent in finding partnership liability seemingly in the face of a section 7(4) exception and in turn denying liability without relying heavily on a section 7(4) exception.[55] The standard of "co-ownership"[56] often used to justify the decisions is certainly elusive. Probably the most helpful standard is that of control; that is, if the parties share profits under some form of mutual control, they are vulnerable to partnership classification.[57] However, the amount of control necessary to create a partnership cannot be stated definitively.[58] Each case carries new fact situations to be interpreted. The retiring partner should realize his precarious position and should establish grounds for a section 7(4) exception and for a showing of lack of control.[59]

III. The Perspective of Retirement

Payments from the partnership cause unique problems to a former partner merely because he is a former partner. The most serious danger is the possibility of estoppel.[60] As explained previously, visible continuity can perpetuate partnership liability despite the intentions

[54] "An annuity may also be paid to a retiring partner in consideration of his interest or a portion of his rights, and this is the subject of a later proviso." (Noting § 7(4)(e)) ROWLEY, *supra* note 35, at 155.

[55] *Compare* Berne v. Keith, 361 S.W.2d 592 (Tex. Civ. App. 1962) *error ref. n.r.e.*, *with* Provident Trust Co. of Philadelphia v. Rankin, 333 Pa. 412, 5 A.2d 214 (1939). Also *compare* Martin v. Peyton, 246 N.Y. 213, 158 N.E. 77 (1927) *with* Minute Maid Corp. v. United Foods, Inc., 291 F.2d 577, 583 (5th Cir. 1961).

[56] See ROWLEY, *supra* note 35, at 79. Similar in both intention and vagueness is the phrase "community of interest." ROWLEY, *supra* at 170.

[57] See Commissioners' Note, 7 UNIFORM LAWS ANN. 11-12 (1949).

[58] Especially uninviting to definite statements of classification is the comparison of Martin v. Peyton, 246 N.Y. 213, 158 N.E. 77 (1927) *with* Minute Maid Corp. v. United Foods, Inc., 291 F.2d 557 (5th Cir. 1961).

[59] See text accompanying notes 67-71 *infra*.

[60] See note 11 *supra* and accompanying text.

of the parties.[61] In addition, signs of economic continuity may also tend to show visible continuity; thus, where a third party can show reasonable reliance based on the retiring partner's former status and continued contact with the partnership through profit-sharing, prospects of partnership liability are imminent.[62]

The existence of an additional ground for liability was implied by the Supreme Court of New Jersey. The court denied an executrix of the estate of a deceased partner recovery of profits earned after the testator's death because the executrix had not consented to a continuation of the partnership. The opinion reasoned in part that under section 42[63] the quid pro quo of a share in profits is the subjection of the retired or deceased partner's interest to the risk of new creditors' claims.[64] To be sure the court's approach is singular[65] and has been criticized by writers.[66] Then, too, the language of the opinion dealt only with the retirement under section 42 and not retirement agreements. However, the existence of such an approach creates a slight possibility that it will be followed and extended to cover retirement agreements. At any rate, the retiring partner sharing profits should be aware of this line of thinking.

IV. Conclusions — An Ounce of Protection

Partners desiring a complete retirement program should recognize the possibility of continued liability and should plan accordingly. Many safeguards can be drafted into the retirement agreement.[67] The partner's retirement should be stated explicitly. He should release all rights in partnership assets[68] to the continuing partnership and should repudiate all right to control.[69] He should demand that

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[61] See notes 8 and 11 *supra* and accompanying text.

[62] This is especially true where the retiring partner participates as a consultant, see note 45 *supra* and accompanying text, or where the new partnership keeps its old name, see note 52 *supra* and accompanying text.

[63] See note 36 *supra*.

[64] It is contended that the statutory plan requiring consent as therein outlined consistently provides that the *quid pro quo* is the right to a proportionate share of the profits of the new partnership if the personal representative so chooses, *for the assumption of the additional risk of claims of the new creditors. . . .* [I]n that construction we concur.

Blut v. Katz, 13 N.J. 374, 379-80, 99 A.2d 785, 787-88 (1953). (Emphasis added.)

[65] See specifically M. & C. Creditors Corp. v. Pratt, 172 Misc. 695, 17 N.Y.S.2d 240 (Sup. Ct. 1938), *aff'd without opinion,* 281 N.Y. 804, 24 N.E.2d 482 (1939).

[66] Note, *Profit Rights and Creditors' Priorities after a Partner's Death or Retirement: Section 42 of the UPA,* 63 Yale L.J. 709, 713 (1954).

[67] See note 3 *supra* and accompanying text.

[68] Section 41(3) automatically assumes that rights have been assigned at retirement. Of course, the purpose of assigning expressly is to *prove retirement.*

[69] See note 58 *supra*. The court in Martin v. Peyton, 246 N.Y. 213, 158 N.E. 77 (1927) stated the following: "Mere words will not blind us to realities." Martin v. Peyton, *supra* at 78. And yet wise drafting was certainly a reason for denial of partnership liability.

the agreement recite his status as a creditor of the partnership. Finally, he should have the instrument include specific provisions aimed at meeting the requirements of the section 7(4) exception which he feels is most appropriate and feasible. Certainly 7(4)(b)[70] (wages or rent to landlord) and 7(4)(e)[71] (payment for good-will or other property) offer attractive possibilities.

Adequate notice is needed in any retirement,[72] and it is probably most important where the retiring partner continues receiving payments from the partnership.[73] Safeguards similar to those included in the retirement agreement should, a fortiori, be included in the notice to prospective creditors of the continuing partnership.

Another precaution against estoppel liability involves changing the balance sheet of the continuing partnership so that it no longer shows the retiring partner in the capital account. The amount owed him should be transferred into a liability account. Ideally, the partnership will draft a promissory note to increase evidence supporting his new status as a creditor. Likewise, all liens on partnership property should be promptly recorded and noted on the balance sheet.

An indemnification agreement is often used as a protective device. This agreement allows automatic recovery or at least a personal action against the continuing partner for amounts the retiring partner must pay for new partnership debts. Since demands on the retiring partner would normally be made after the partnership and continuing partners had been drained, indemnification without a third-party guarantee, lien, or escrow account is not of great value. Retiring partners, in fact, often insist on such security for retirement payments due them as well as for indemnification.[74]

A final approach which may be worth considering is the transfer of the retiring partner to the status of a limited partner. Of course the new amount of his interest in the partnership is liable to creditors.[75] But filing a limited partnership agreement provides extra protection when creditors try to reach the retiring partner personally. Where payments are to consist entirely of a percentage of profits and where the retiring partner wishes to assume a passive advisory

[70] See text accompanying note 48 *supra*.
[71] See text accompanying note 54 *supra*.
[72] See notes 8 and 11 *supra* and accompanying text.
[73] See text accompanying note 61 *supra*.
[74] See also text accompanying note 48 *supra*. Express repudiation of control is all the more important here.
[75] UNIFORM LIMITED PARTNERSHIP ACT § 23.

role,[76] the limited-partnership approach should be seriously considered since partnership elements are so prevalent. Where they are not so prevalent the limited partnership is probably more expensive than it is worth.

Retirement, then, must be well-planned and well-executed. Although litigation has been scant, dangers of continued liability await the partner who continues to receive payments from his former firm without taking precautions. No set of rules has been established as yet, but, of course, the wise businessman avoids becoming the test case to establish the rules. A retiring partner should realize the possible dangers and should take the extra effort necessary to avoid liability.

[76] Section 7 of the Uniform Limited Partnership Act indicates that the limited partner will be liable personally to creditors if he "takes part in the control of the business." Section 4 indicates that any services put him in danger. Certainly a controlling interest would make him a full partner. Holzman v. De Escamilla, 86 Cal. App. 2d 858, 195 P.2d 833 (1948). But courts have allowed limited activity without establishing partnership liability. Plasteel Products Corp. v. Helman, 271 F.2d 354 (1st Cir. 1959).