Partnerships

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Background

When two or more people carry on a business for profit, the law recognizes the existence of a general partnership. Unlike CORPORATIONS, limited liability companies, limited partnerships, and limited liability partnerships, owners of a business do not need to follow specific formalities to form a general partnership. At the same time, however, partners are not protected from liability for the business' debts. Sole proprietorships and general partnerships are considered the "default" forms of business when an individual or more than one individual establish a business, since one form of business entity or the other is generally established if the parties do not choose an alternate form.

Partnerships are governed in the vast majority of states by one of the versions of the Uniform Partnership Act (UPA), which was originally drafted by the Uniform Law Commissioners in 1914. Prior to 1994, every state, with the exception of Louisiana, adopted the UPA. The National Conference of Commissioners on Uniform State Laws significantly revised the UPA in 1994, with subsequent modifications in 1995, 1996, and 1997. The majority of states have adopted the 1997 version of the act, which is generally referred to as the Revised Uniform Partnership Act (RUPA). The RUPA revised the UPA in several key areas, though many of the basic rules governing partnerships did not change from the older law to the new law.

The UPA and RUPA, in many ways, provide "default" rules that govern general partnerships. That is, the rules in the UPA and RUPA govern the partnership, unless the partners agree otherwise. Thus, each partner generally has a right to manage the partnership that is equal to the rights of other partners. Similarly, partners can agree how they will share profits, how they will contribute to pay for losses, how they will divide the labor, and how the partnership will DISSOLVE when the partnership ends. Parties cannot, however, agree to shield personal liability from one or more of the partners. If a partner or partners want to avoid personal liability for the debts of the partnership, they will need to form one of the business entities that provide limited liability.

Forming and Managing a General Partnership

Several of the rules related to general partnerships vary between the UPA and the RUPA. Individuals who are forming a general partnership or are concerned about management issues should consult their state statutes to determine which law is in effect in that state.

Characteristics of a General Partnership

A general partnership must consist of two or more individuals or entities, including another partnership or corporation. Thus, it is possible that two very large corporations could form a partnership between the two entities, though in the modern business world, when large entities agree to form a new business entity between them, they most often form some kind of limited liability entity. In order to form a general partnership, the business must be unincorporated and intended to make a profit. The "unincorporated" requirement is obvious; an entity that has complied with the formalities to form a corporation cannot be a partnership. Partnership law is limited to entities organized to make a profit, since partnership law is a subcategory of commercial law. Other business entities, such as corporations, do not need to be formed to seek a profit. Agreeing to share a profit creates a rebuttable presumption under the RUPA that a partnership exists.

Generally, each partner in a partnership has something to offer the business, including labor, ideas, money, and/or property. Each of the partners in a general partnership co-owns the business and has a right to manage the business with other partners. This right, however, can be modified by agreement of the partners. Similarly, partners have a general right to share profits and contribute to pay for losses, though either of these can be modified by agreement of the parties.

Many partnerships are formed when one or more partners agree to provide money, property, and other types of capital to the business ("capital partners"), while one or more of the other partners agree to provide work and other labor expertise ("labor partners"). For example, assume that two people agree to form a business to build custom furniture. One partner agrees to provide the work facility and office and also agrees to supply $100,000 to finance the business. The other partner, who is an expert in building furniture, agrees to build all of the furniture and manage the business. The first partner is the capital partner, while the latter is the labor partner. This general partnership can be beneficial to both parties if the business is successful but can cause significant problems if the business fails. Many of these problems are cause for disputes over which party should bear the burden of the losses suffered by the partnership.

Partnerships are generally categorized in three types, which are defined by the agreement of the partners. In a partnership at will, every partner has the right to end the partnership, subject to some restrictions. In a partnership for a term, the partners' agreement determines the time when a partnership will end. In a partnership for a particular undertaking, the partners' agreement indicates that completion of a particular task or goal will cause the partnership to end.

Consent and the Partnership Agreement

As noted above, forming a partnership requires few specific formalities, such as a written agreement or registration with a state agency. Nevertheless, all parties that are considered partners must consent to be such. The consent may be express, such as signing a written partnership agreement or implied by the conduct of the parties. Parties do not need to agree specifically to form a "partnership;" rather, their agreement or conduct must be such that they agree to run a business for profit. Even if the parties agree that their business will not be labeled a partnership, the business may be found to be one if it meets the definition of a partnership.

If two or more individuals enter a partnership without a partnership agreement, problems are likely to arise. The DEFAULT rules found in the UPA and the RUPA may not be sufficient for the parties based on their wants and needs when they formed the business. Similarly, the rules in the UPA and RUPA may not reflect the understanding of the parties when they entered into the business. Since all partners are liable for the debts of the partnership, if a partnership is formed inadvertently, it may cause significant problems for the partner who was not aware of the legal consequences of his or her decision. Should an individual wish to enter into a business that has not been registered as a limited liability entity, he or she should be sure to demand the drafting of a written partnership agreement so that the understanding and agreement of the parties can be

reflected more clearly in a document.

Profit Sharing

Agreeing to share profits is a precondition for the formation of a partnership. Sharing profits is not the same as sharing revenues. Revenues refer to all of the money received by a business, including income, receipts, or proceeds. Profits are the amount remaining of the revenue after expenses incurred by the business are subtracted. If one party agrees to share revenues with another party, but the agreement makes not stipulation for profits, then a partnership has not been formed. The focus on profits requires the partners to pay attention to the management of the entire business, not only the amount of money taken in by the business. By comparison, a person who receives revenues, but not profits, is much more likely to focus on the sales of a business but not the costs in doing business.

Partners do not need to share profits equally. Under both the UPA and the RUPA, partners can agree to the division of profits made by a business. In a situation where there is a capital partner and a labor partner, the partnership agreement will most likely include a salary for the labor partner, with the capital partner receiving the profits.

Loss Sharing

An agreement to share losses in all jurisdictions is strong EVIDENCE that a partnership exists. Though neither the UPA nor the RUPA expressly requires an agreement to share losses to find that a partnership exists, some jurisdictions require a finding of such an agreement as a prerequisite for a finding that a partnership has been formed. Under both the UPA and the RUPA, the definition of partnership does not include sharing losses but rather requires that losses be shared in the same proportion as profits. Like many other rules in the UPA and the RUPA, the parties can agree otherwise.

Ownership and Management

All partners in a general partnership are considered co-owners. By default, partners also have equal rights to manage the partnership. If an agreement contemplates joint ownership of a business for profit, as well as joint decision-making regarding the partnership's business, then the likelihood increases that a partnership exists. More difficult questions are raised when co-ownership and co-management are considered in the context of control of the partnership. For example, under the default rules in the UPA and RUPA, both a capital partner and a labor partner have equal rights to manage the partnership, even if the labor partner is much more qualified to manage the business. Similarly, all partners have the authority to bind a partnership by transacting partnership business. In almost all situations, it is beneficial to include management and control provisions in a partnership agreement to avoid conflicts.

Liability and Duties of Partners in a General Partnership

Partner as an Agent of a Partnership

Under both the UPA and the RUPA, all partners serve as general agents of the partnership. Accordingly, partners may bind the partnership through their actions. They often have the actual authority to conduct partnership business, though the extent of this authority often focuses on the language included in a partnership agreement. Authority may be implied through the action or inaction of other partners in the management of the business. For example, if one partner has entered into contracts on behalf of the partnership in the past, and none of the partners has objected (assuming they have knowledge of the

transaction), the partner most likely has implied authority to enter into the contract.

Tort Liability to Third Parties

Since partners are considered agents of the partnership, a partner's wrongful act or omission can bind the partnership if the wrongdoing partner has acted within the ordinary course of the partnership's business. Such liability is referred to as vicarious liability, a term that is also used when a business is liable for the acts of an employee acting within the scope of his or her employment. Moreover, partners in a partnership generally are jointly and severally liable for torts charged against the partnership. Thus, any or all of the partners in a partnership can be sued individually for the entire amount of the injury caused by the partner. For example, if two lawyers form a general partnership, and one lawyer is liable for MALPRACTICE, then the person injured by the malpractice may sue the partnership, the lawyer who committed malpractice, and/or the other lawyer in the partnership. In this situation, the person who is injured could chose to sue only the lawyer who did not commit malpractice, since that lawyer is jointly and severally liable for the torts of the other partner acting in the partnership's business.

Well-planned businesses will usually avoid the seemingly harsh consequences caused by joint and several liability. One of the more obvious solutions is for the partnership to form a limited liability entity, such as a LIMITED LIABILITY PARTNERSHIP. Other solutions may be provided in a partnership agreement, such as the inclusion of a provision requiring the wrongdoing partner to indemnify the other partners if the other partners are vicariously liable for the torts of the wrongdoing partner.

Contract Liability to Third Parties

Under the UPA, partners are jointly liable for contractual liability of the partnership. The RUPA modifies this provision so that partners are jointly and severally liable for the contractual liability of the partnership. The difference between the two types of liability is really procedural. If partners are jointly liable, all of the partners must be sued at the same time, and omission of a partner means that the suit must be dropped. By comparison, if partners are jointly and severally liable, suits may proceed against individual partners even if some partners are omitted from the suit.

Tax Liability of Partners and Partnerships

One of the most practical benefits of forming a partnership, as opposed to a corporation, is the tax treatment of partnerships by the federal government in the Internal Revenue Code. Owners of a corporation, in effect, pay double taxes. The corporation itself must pay taxes on business income. The money, which has already been taxed, is eventually distributed to pay salaries, dividends, and other forms of income to those involved in the corporation. These individuals must pay tax on the money received, even though the corporation was initially taxed. Partnerships, by comparison, are treated as so-called "pass-through" entities. The partnership itself does not pay taxes. The partnership's income "passes through" the partnership and is distributed to the partners. When the partners pay taxes on their income, this money has not yet been taxed.

Ownership of Property

Since partners often contribute property for the use of the partnership, the question of ownership of this property is sometimes difficult. For example, if a partner purchases PERSONAL PROPERTY with his own money, but the property is used exclusively by the partnership, then it could be questionable whether this property is the partner's separate property or whether it is the partnership's property. The UPA creates a presumption that property acquired with partnership funds is partnership property, unless the partners intend otherwise. The RUPA extends this presumption and adds a presumption that if one or more partners purchase property in their own name and without use of partnership funds, the property is considered the separate

property of the partner or partners. This is true even if the property is used for partnership purposes.

Both the partnership and individual partners can hold legal title to real property, and both the UPA and the RUPA contain provisions prescribing the conveyance of real property by partners or the partnership. Under the RUPA, partners and partnerships have the option of filing and recording a statement indicating the authority of the partners to transfer real property in the name of the partnership.

Duties of the Partners

Partners in a partnership owe each other certain FIDUCIARY duties. One of the more significant changes between the UPA and the RUPA was the clarification of fiduciary duties in the RUPA. Under the revised act, partners owe each other the duty of loyalty and the duty of care. The RUPA restricts the ability of partners to waive these fiduciary duties.

Duty of Loyalty

The duty of loyalty refers to the duty of a partner to refrain from competing with the partnership in another endeavor or profiting individually from a transaction related to the partnership. This duty does not mean that a partner cannot further his or her own interests; a partner may not further his or her own interests to the detriment of the partnership. Application of this duty may arise when one of the partners owns several businesses, and the potential for competition between a separate business and the partnership arises. Another situation occurs when one the partners wants to leave the partnership. It is not uncommon that the partner may take steps to set up a separate business, and establishing the new business may conflict with the interests of the partnership.

Duty of Care

The duty of care does not refer to acts of mere NEGLIGENCE by a partner. For example, if a partner unintentionally makes a bad business decision, his or her negligence will not necessarily violate the duty of care. On the other hand, the duty of care proscribes GROSS NEGLIGENCE, recklessness, intentional misconduct, or knowing violation of the law on the part of each of the partners. Though partners cannot waive the duty of care under the RUPA, partners can hold themselves to a higher standard of care, including ordinary negligence.

Dissociation and Dissolution

The RUPA made other significant changes with respect to the DISSOLUTION of a partnership and winding up of partnership affairs. Under the UPA, if a partner withdraws from the partnership, an event occurs that ends the partnership, the partners agree to end the partnership, or any of a number of situations occurs, the partnership dissolves. When dissolution occurs, the partnership's business generally ends, the affairs of the business wind up, and partnership property is sold. Partnership agreements, even before the enactment of the RUPA, often provide a method whereby the withdrawing partner's interests are purchased and the partnership continued. In the absence of such an agreement, the remaining partners may continue the partnership's business, but the resulting business is considered a completely new partnership.

The RUPA altered this situation, providing that when certain events occur, such as a partner's withdrawal from the partnership, the partnership is not necessarily dissolved. The RUPA introduced dissociation, whereby a partner can be dissociated from a partnership without the partnership ending. If a partner dissociates from a

partnership, the partnership will not necessarily dissolve. The remaining partners can instead purchase the interests of the dissociating partner and continue partnership business.

When a partnership is dissolved, it enters into a stage called winding up. Both the UPA and the RUPA provide rather detailed provisions for winding up the affairs of the partnership. One restriction is that partners who have wrongfully caused the dissolution of the partnership or have wrongfully dissociated from the partnership cannot participate in the winding up process. The most significant part of the winding up process is the LIQUIDATION of partnership assets and payment of partnership creditors. When the assets are liquidated, creditors who are not also partners are generally paid first. If a partner is also a CREDITOR of the partnership, he or she is then reimbursed. Once each of the creditors is reimbursed, partners may recover their capital contributions. Finally, if assets remain, the partners will receive their share, in accordance with a partnership agreement or according to the provisions of the UPA or the RUPA.

State Laws Governing Partnerships

The majority of states have adopted the Revised Uniform Partnership Act, though some have retained the Uniform Partnership Act. Some states have modified certain provisions of their versions of the UNIFORM ACTS, so researchers should be sure to check their states' versions of the act to determine which provisions may differ from the uniform law. The only state that has not adopted the uniform law is Louisiana.

ALABAMA: Adopted the Revised Uniform Partnership Act in 1998. Previously adopted the Uniform Partnership Act in 1972.

ALASKA: Adopted the Uniform Partnership Act in 1917.

ARIZONA: Adopted the Revised Uniform Partnership Act in 1996. Previously adopted the Uniform Partnership Act in 1954.

CALIFORNIA: Adopted the Revised Uniform Partnership Act in 1996. Previously adopted the Uniform Partnership Act.

COLORADO: Adopted the Revised Uniform Partnership Act in 1997. Previously adopted the Uniform Partnership Act in 1931.

CONNECTICUT: Adopted the Revised Uniform Partnership Act in 1995. Previously adopted the Uniform Partnership Act in 1961.

DELAWARE: Adopted the Revised Uniform Partnership Act in 1999. Previously adopted the Uniform Partnership Act in 1947.

DISTRICT OF COLUMBIA: Adopted the Revised Uniform Partnership Act in 1997. Previously adopted the Uniform Partnership Act in 1962.

FLORIDA: Adopted the Revised Uniform Partnership Act in 1995. Previously adopted the Uniform Partnership Act in 1973.

GEORGIA: Adopted the Uniform Partnership Act.

HAWAII: Adopted the Revised Uniform Partnership Act in 1999. Previously adopted the Uniform

Partnership Act in 1972.

IDAHO: Adopted the Revised Uniform Partnership Act in 1998. Previously adopted the Uniform Partnership Act in 1919.

ILLINOIS: Adopted the Uniform Partnership Act in 1917.

INDIANA: Adopted the Uniform Partnership Act in 1949.

IOWA: Adopted the Revised Uniform Partnership Act in 1998. Previously adopted the Uniform Partnership Act in 1971.

KANSAS: Adopted the Revised Uniform Partnership Act in 1998. Previously adopted the Uniform Partnership Act in 1972.

LOUISIANA: Louisiana is the only state that has adopted neither the Uniform Partnership Act nor the Revised Uniform Partnership Act. Though many of the provisions of the Louisiana law governing partnership are similar to the UPA and RUPA, individuals in Louisiana should consult the Louisiana Civil Code to determine the law of Louisiana with respect to partnerships.

MAINE: Adopted the Uniform Partnership Act in 1973.

MARYLAND: Adopted the Revised Uniform Partnership Act in 1997. Previously adopted the Uniform Partnership Act in 1916.

MASSACHUSETTS: Adopted the Uniform Partnership Act in 1922.

MICHIGAN: Adopted the Uniform Partnership Act in 1917.

MINNESOTA: Adopted the Revised Uniform Partnership Act in 1997. Previously adopted the Uniform Partnership Act in 1921.

MISSISSIPPI: Adopted the Uniform Partnership Act in 1976.

MISSOURI: Adopted the Uniform Partnership Act in 1949.

MONTANA: Adopted the Revised Uniform Partnership Act in 1997. Previously adopted the Uniform Partnership Act in 1947.

NEBRASKA: Adopted the Revised Uniform Partnership Act in 1997. Previously adopted the Uniform Partnership Act in 1943.

NEVADA: Adopted the Uniform Partnership Act in 1931.

NEW HAMPSHIRE: Adopted the Uniform Partnership Act in 1973.

NEW JERSEY: Adopted the Revised Uniform Partnership Act in 2001. Previously adopted the Uniform Partnership Act in 1919.

NEW MEXICO: Adopted the Revised Uniform Partnership Act in 1997. Previously adopted the Uniform Partnership Act in 1947.

NEW YORK: Adopted the Uniform Partnership Act in 1919.

NORTH CAROLINA: Adopted the Uniform Partnership Act in 1941.

NORTH DAKOTA: Adopted the Revised Uniform Partnership Act in 1997. Previously adopted the Uniform Partnership Act in 1959.

OHIO: Adopted the Uniform Partnership Act in 1949.

OKLAHOMA: Adopted the Revised Uniform Partnership Act in 1997. Previously adopted the Uniform Partnership Act in 1959.

OREGON: Adopted the Revised Uniform Partnership Act in 1997. Previously adopted the Uniform Partnership Act in 1939.

PENNSYLVANIA: Adopted the Uniform Partnership Act in 1915.

RHODE ISLAND: Adopted the Uniform Partnership Act in 1957.

SOUTH CAROLINA: Adopted the Uniform Partnership Act in 1950.

SOUTH DAKOTA: Adopted the Revised Uniform Partnership Act in 2001. Previously adopted the Uniform Partnership Act in 1923.

TENNESSEE: Adopted the Revised Uniform Partnership Act in 2001. Previously adopted the Uniform Partnership Act in 1917.

TEXAS: Adopted the Revised Uniform Partnership Act in 1998. Previously adopted the Uniform Partnership Act in 1961.

UTAH: Adopted the Uniform Partnership Act in 1921.

VERMONT: Adopted the Revised Uniform Partnership Act in 1998. Previously adopted the Uniform Partnership Act in 1941.

VIRGINIA: Adopted the Revised Uniform Partnership Act in 1996. Previously adopted the Uniform Partnership Act in 1918.

WASHINGTON: Adopted the Revised Uniform Partnership Act in 1998. Previously adopted the Uniform Partnership Act in 1945.

WEST VIRGINIA: Adopted the Revised Uniform Partnership Act in 1995. Previously adopted the Uniform Partnership Act in 1953.

WISCONSIN: Adopted the Uniform Partnership Act in 1915.

WYOMING: Adopted the Revised Uniform Partnership Act in 1993. Previously adopted the Uniform Partnership Act in 1917.

Additional Resources

Agency and Partnerships: Examples and Explanations. Kleinberger, Daniel S., Aspen Law and Business, 1995.

Agency, Partnership, and the LLC in a Nutshell. Hayes, J. Dennis, West Group, 2001.

Partnerships: Laws of the United States. Sitarz, Daniel, Nova Publishing Company, 1999.

Partnership Laws of the United States: Introduction and List of Articles. USLaw.com, 1999. Available at http://www.uslaw.com/library/article/noparIntro.html

Uniform Partnership Act. National Conference of Commissioners on Uniform State Laws, 1997. Available at http://www.law.upenn.edu/bll/ulc/upa/upa1200.htm

Organizations

Council of Better Business Bureaus (CBBB)
4200 Wilson Blvd., Suite 800
Arlington, VA, VA 22203-1838 USA
Phone: (703) 276-0100
Fax: (703) 525-8277
URL: http://www.bbb.org/

National Conference of Commissioners on Uniform State Laws (NCCUSL)
211 E. Ontario Street, Suite 1300
Chicago, IL, IL 60611 USA
Phone: (312) 915-0195
Fax: (312) 915-0187
E-Mail: nccusl@nccusl.org
URL: http://www.nccusl.org/

Small Business Advancement National Center (SBANC)
University of Central Arkansas
College of Business Administration
UCA Box 5018
201 Donaghey Avenue
Conway, AR, AR 72053-0001 USA
Phone: (501) 450-5300
Fax: (501) 450-5360
URL: http://www.saber.uca.edu/

U. S. Chamber of Commerce
1615 H Street, NW
Washington, DC, DC 20062-2000 USA
Phone: (202) 659-6000
E-Mail: custsvc@uschamber.com
URL: http://www.uschamber.com

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