Solving the problem of capital loss distribution upon dissolution of a service partnership

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Killing Kovaci: Solving the problem of capital loss distribution upon dissolution of a service partnership
By Jeffrey John Miles

This is an excerpt from my Comment, which is currently under consideration for publication in 2013.

I. The Kovacik Problem: What is the Current Law?

This Comment offers a potential solution to the conflict between the common law tradition exemplified by Kovacik v. Reed\(^1\) and the Revised Uniform Partnership Act\(^2\) (“UPA (1997)”\(^3\)). The paradox arises at the dissolution of a partnership where one partner (the “capital partner”) has provided money to the venture and other partner (the “service partner”) has simply contributed his services, without drawing a salary. The partners have agreed to share future profits equally. Like many partners, they have not bargained at the outset over what will happen if their venture loses money. When the partnership does lose money, the capital partner seeks contribution from the service partner. Both the original Uniform Partnership Act\(^3\) (“UPA (1914”) and the UPA (1997)\(^4\) require, in absence of contrary agreement, that the service partner share losses equally with the capital partner. But the Kovacik rule says that the service partner need not pay in for losses.\(^5\)

When faced with the dissolution of a service partnership, do courts know whether they are to apply the standards of the UPA (1997), in most states the controlling law, or are they to continue to jam the odd and hyperspecific Kovacik exception into the gap? It is my theory that

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\(^{1}\) 315 P.2d 314 (Cal. 1957).
\(^{3}\) Unif. Partnership Act §§18(a) & 40(b) (1914).
\(^{5}\) Kovacik, 315 P.2d at 314.
no one quite knows the answer to the question, including the most sophisticated jurists who have been asked to state the current law.6

Imagine that a client walked into an attorney’s office asking for advice on a potential partnership agreement in California. The attorney might check the California Transactions Forms for Business Entities to learn about the current law. She would discover that the most recently updated entry on Dissolution of Partnerships states that the law is that “irrespective of any inequality in the character or amount of partnership contributions, partnership profits and losses must be shared equally between the partners.”7 The entry cites for that proposition, Kovacik v. Reed.8 This is but one example of the current uncertainty about the distribution of losses in a service partnership dissolution.9

At the time of writing, the UPA (1997) has been adopted in all states except thirteen.10 Therefore, this paper will examine the conflict between the law under the UPA (1997) and that of the common law Kovacik exception. This could be analyzed through the California lens, but the same conflict can be seen in states like New Jersey, Texas, Illinois or Kentucky where a

8 Id., stating, “The mere fact that the partners' capital contributions are unequal, or that one has put in all the capital and the others have contributed only skill and industry, does not change the rule as to equal sharing of profits and losses” citing, Griggs v. Clark, 23 Cal. 427 (1863).
10 In Wisconsin, Michigan, Indiana, Missouri, Georgia, North and South Carolina, Pennsylvania, New York, Massachusetts, Rhode Island, and New Hampshire the UPA (1914) remains good law. Uniform Law Commission, http://www.nccusl.org/Act.aspx?title=Partnership%20Act, (Accessed 4/6/2012). Louisiana is the only state to adopt neither the UPA (1914) or the UPA (1997); they operate under the idiosyncratic Louisiana Civil Code. See La. Civ. Code §2817 (West 2011) stating,“A partner is bound for his virile share of the debts of the partnership…”
Kovacik-style common law exception exists despite a clearly delineated UPA (1997) default for equal profit and loss sharing.  

One might think that the contradiction between a default rule that divides profits and losses equally amongst partners, and a state common law exception that levies the partnership losses squarely on the capital partner would alert state legislatures of a need to address the paradox before implementing the UPA (1997). However, the California legislature adopted the UPA (1997), silent on the issue, in 1999, while at the same time mentioning other important ramifications of the update on the state’s partnership code.  

The lack of insight by the state legislature in implementing the UPA (1997) is notably more negligent when considered in the light of the commentary to the loss distribution provisions in the relevant section of the code, which expressly disclaims the validity of the Kovacik exception and its kin.  

As Professor Bainbridge has noted, the commentary was not adopted when the California Corporate

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11 See Val D. Ricks, Service Partner Capital Agreements, 12 U. PA. J. BUS. L. 1, 6 n.24 (2009-2010).
13 Unif. Partnership Act §401, cmt. 3 (1997), stating, “The default rules apply, as does UPA Section 18(a), where one or more of the partners contribute no capital, although there is case law to the contrary. See, e.g., Kovacik v. Reed, 49 Cal.2d 166, 315 P.2d 314 (1957); Becker v. Killarney, 177 Ill.App.3d 793, 523 N.E.2d 467 (1988). It may seem unfair that the contributor of services, who contributes little or no capital, should be obligated to contribute toward the capital loss of the large contributor who contributed no services. In entering a partnership with such a capital structure, the partners should foresee that application of the default rule may bring about unusual results and take advantage of their power to vary by agreement the allocation of capital losses.”
Code\textsuperscript{15} implemented the UPA (1997) and the same is true of other states’ codification of the partnership law\textsuperscript{16}.

In order to evaluate the lacuna in the law, and how best to address the problem, it will be useful to sketch out the *Kovacik* exception and where the case fits into the distribution of losses at dissolution by partnership code.

**A. The chimerical *Kovacik v. Reed***

*Kovacik* is not the only case that indemnifies a service partner from providing a share of losses upon the dissolution of a partnership. Yet, perhaps because of the shortness of the opinion, and the case’s intrinsic appeal to a sense of equity and fairness, the case remains probably the most prominent exemplar of a legal rule that has persisted in other states.\textsuperscript{17}

Although *Kovacik* does seem simple on the facts, it is a chimera. One may take it on the surface as does Professor Ricks in his paper, and explains its basic rationale and holding in a page of five paragraphs, outside the superstructure of the UPA in which it is in fact nested.\textsuperscript{18}

Alternatively, one may look at *Kovacik* in the context of the UPA provisions that the rule alters so starkly. This is the method employed by Bainbridge in a more nuanced five-page exposition

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\textsuperscript{17} *But see*, Ricks, *supra* note 11, at 7-8. For example, his discussion leads with the case of *Becker v. Killarney*, 532 N.E.2d 931 (Ill. Ct. App. 1988)(holding cash partners not entitled to recover any initial cash layout from service partners where agreement specifically monetize the service contributions). Interestingly, *Becker* leans toward my answer to the *Kovacik* problem, the requirement of increased evidentiary burden to demonstrate an agreement if the court is to absolve the service partner from losses.

\textsuperscript{18} Ricks, *supra* note 11, at 8-9.
of the problem.\textsuperscript{19} There is not much I can add to an overview of the case when viewed alongside the coverage by Ricks and Bainbridge, however, I will lay out the case here so that my paper will self-inclusively describe the progenesis of the Kovacik problem. It is my hope that my normative position in evaluating the case will peek through in my summary without borrowing too much from past scholarship.

\textbf{B. Statement of the case}\textsuperscript{20}

In November 1952, Kovacik asked Reed if he would like to be his job superintendent for some remodeling work for Sears in San Francisco. Kovacik said he would invest $10,000 in the venture, and if Reed did his part, they would share profits on a 50-50 basis. The record showed no evidence they had ever discussed possible losses. For ten months, the venture operated until Kovacik noticed that losses were piling up, and their arrangement was terminated. Kovacik sued to recover half of his losses from Reed, and the lower court found for Kovacik in accord with the California Corporate Code\textsuperscript{21} embodiment of the UPA (1914). The Supreme Court of California\textsuperscript{22} delineated a special exception, holding that Reed would not be liable for losses. The

\textsuperscript{19} Bainbridge, \textit{supra} note 14, at 636-641.

\textsuperscript{20} \textit{See Kovacik}, P.2d at 315-317. The basic facts of the case are summarized.


\textsuperscript{22} The decision was \textit{en banc}, authored by Justice Schauer, and included the dominant figure of Justice Roger J. Traynor. His activist judicial philosophy was reflected in the decisions of the California Supreme Court during the thirty-year period surrounding Kovacik. \textit{See}, BEN FIELD, \textsc{Activism in Pursuit of the Public Interest: The Jurisprudence of Chief Justice Roger J. Traynor} (2007); \textit{See also}, Walter V. Shaefer, \textsc{Justice Roger J. Traynor}, 13 Stan. L. Rev. 717 (1961), \textit{quoting} Justice Traynor, “Courts have a creative job to do when they find that a rule has lost its touch with reality and should be…reformulated to meet new conditions and new moral values.”
rationale of the rule was based on two rather old Kentucky cases, *Heran v. Hall*\(^ {23} \) and *Meadows v. Mocquot*\(^ {24} \). The Court held broadly that “upon the loss of the money the party who contributed it is not entitled to recover any part of it from the party who contributed only services.”\(^ {25} \)

The court provides two rationales for the doctrine:

The rationale of this rule, as expressed in *Heran v. Hall* and *Meadows v. Mocquot*, both supra, is that (1) where one party contributes money and the other contributes services, then in the event of a loss each would lose his own capital the one his money and the other his labor. (2) Another view would be that in such a situation the parties have, by their agreement to share equally in profits, agreed that the value of their contributions the money on the one hand and the labor on the other were likewise equal; it would follow that upon the loss, as here, of both money and labor, the parties have shared equally in the losses.\(^ {26} \)

Notably absent from the Court’s decision is an explication of the binding statutory regime provided by the governing UPA (1914) provisions §18 and §40, as codified by the California Corporate Code §15018(a), and §15040(b)&(d), respectively. In the brief decision, the applicable California code provision is mentioned only once. And in the absence of a discussion of the binding statutory regime, the decision makes its own sort of sense. However, the mechanics of the code, as discussed by Bainbridge in his exposition of the problem\(^ {27} \) suggest a radical departure from the normal partnership accounting upon dissolution. Therefore, I will next discuss the structure of the UPA (1914) at the time *Kovacik* was decided as well as the


\(^{25}\) Id. at 316.

\(^{26}\) Id.

\(^{27}\) Bainbridge, supra note 14, at 636-638.
alterations that have led to the current state of the UPA (1997), in order to put the rule in contrast with the infrastructure it seems to ignore.

C. The UPA: then and now.

i. UPA (1914)28

The UPA (1914) governed in California until 1999, when the UPA (1997) went into effect.29 The NCUSL commentary suggests the departure of the UPA (1997) from the earlier code, emphasizing the extent of the deviance of Kovacik decision.

The crux of the statute for the purposes of determining losses on dissolution under the UPA (1914) was §18(a), the Rules Determining Rights and Duties of Partners, which states:

The rights and duties of the partners in relation to the partnership shall be determined, subject to any agreement30 between them, by the following rules:

(a) Each partner shall be repaid his contributions, whether by way of capital or advances to the partnership property and share equally in the profits and surplus remaining after all liabilities, including those to partners, are satisfied; and must contribute towards the losses, whether of capital or otherwise sustained by the partnership according to his share in the profits.31

This section alone would not reveal the order in which partnership obligations

28 Id. at 636-638. This section closely mirrors Bainbridge; no other order of analysis of the statutory provisions makes sense.
30 It is worth noting that the UPA (1914) does not include a definition of agreement in its definition of terms, Unif. Partnership Act §2 (1914); The UPA (1997) does define agreement and includes implied agreement. Unif. Partnership Act §101(7) (1997), “‘Partnership agreement’ means the agreement, whether written, oral, or implied, among the partners concerning the partnership, including amendments to the partnership agreement.”
31 Unif. Partnership Act §18 (1914).
should be satisfied. It is §18(a) in tandem with §40(b), The Rules for Distribution, which mandate that Reed should have paid in to split the losses with the capital partner Kovacik. In settling accounts after dissolution, subject to contrary agreement, §40(b) ranks the order of preference:

I. Those owing to creditors other than partners,
II. Those owing to partners other than for capital and profits,
III. Those owing to partners in respect of capital,
IV. Those owing to partners in respect of profits.\(^\text{32}\)

If neither partner had contributed anything, they would split the loss under §18(a), but neither would be required to pay into the partnership because there would be nothing “owing to partners in respect of capital”. The loss would be a wash. It would have been easy enough for the court to apply the default provisions to the facts of Kovacik. Kovacik paid in $10,000 to his capital account, against $0 contributed by Reed.\(^\text{33}\) The partnership accumulated $8,680 in losses.\(^\text{34}\)

However, since Kovacik contributed $10,000, this amount was owed to him upon dissolution under §40(b) as the case does not mention outside creditors or other money owed to the partners. With only $1,320 in cash remaining to repay Kovacik’s capital outlay, the partnership owed him the difference of $8,680 under §40(b). That loss would be split between the two parties, Kovacik takes his half of the loss and Reed owing him $4,340 in order to equalize the loss as provided by §18(a).\(^\text{35}\)

\(^{32}\) Unif. Partnership Act §40(b) (1914).
\(^{33}\) Kovacik, P.2d at 315.
\(^{34}\) Id. at 316.
\(^{35}\) See also, Bainbridge, supra note 14, at 638, explaining the Kovacik loss distribution under the UPA (1914).
Indeed, courts have sometimes been content to apply the UPA (1914) rules to disburse losses upon dissolution.\(^{36}\) \textit{Kovacik} does not disclaim the UPA (1914), instead crafting two justifications for excusing Reed’s obligation: crediting Reed with a capital contribution based on his service to the partnership, or, inferring an implied agreement to circumvent the statutory language based on the character of the partnership as a capital-for-service anomaly.\(^{37}\)

However, the changes in the UPA (1997) made very clear that the \textit{Kovacik} rationale should not survive. The commentary to the statute expressly invalidates the rule.\(^{38}\)

Even without this clear guidance, the structure of the UPA (1997) suggests a fundamental clarification of the nature of partnership accounting that emphasizes the inapplicability of the \textit{Kovacik} rule in the modern scheme. I will next evaluate the gaps in the UPA (1997) that might be said to allow the \textit{Kovacik} rationale to endure. In order to envision the UPA (1997) as terminating the \textit{Kovacik} exception, it is important to analyze the structure of the new code.

\textbf{ii. UPA (1997)}

One important reason to revisit the \textit{Kovacik} exception now is to evaluate its survival or demise in the light of a significant period of time for scholarship and case law to absorb the

\(^{36}\) Ricks, \textit{supra} note 11, at 2, n.5,


\(^{37}\) \textit{Kovacik}, P.2d at 316.

\(^{38}\) Unif. Partnership Act §401, cmt. 3 (1997).
ramifications of the adoption of the UPA (1997). Yet, the most recent serious examination of the Kovacik question by Professor Ricks, in 2008, assumes without analysis that the UPA (1914) and the UPA (1997) are essentially equivalent instruments, and that the changes in the latter have no bearing on Kovacik-style exceptions.\(^{39}\) But the changes in the UPA (1997) fundamentally altered the rules governing partnerships so it is worth evaluating, as Professor Bainbridge has\(^{40}\), whether the rule survives based on the new structure of the code.\(^{41}\) On one hand, as mentioned, the code writers explicitly kill Kovacik and uphold the default rule of equal sharing of profits and losses in the commentary.\(^{42}\) Yet, states adopt the code without its accompanying commentary, leaving the matter unclear and in need of clarification.\(^{43}\)

a. Capital Accounts

The explicit enunciation of the structure of distinct capital accounts represents a major UPA (1997) difference from the UPA (1914), and it strongly suggests that modern courts should no longer apply Kovacik. In defining how a partner’s account is to be credited, the statute is very clear in stating that the only cognizable contribution is “…money plus the value of other

\(^{39}\) Ricks, supra note 11, at 33 n.148, citing Steven G. Frost, Illinois' Revised Uniform Partnership Act, 90 ILL. B.J. 644, 648 n.7 (2002) (“Presumably, the account provisions added in the Act will not change the results of this decision [Becker v. Killarney].”).

\(^{40}\) Bainbridge, supra note 14, at 641-643.


\(^{42}\) Unif. Partnership act §401 cmt. 3 (1997), stating, “The default rules apply, as does UPA Section 18(a), where one or more of the partners contribute no capital, although there is case law to the contrary. See, e.g., Kovacik v. Reed…”; But see, Bainbridge, supra note 14, at 641-642, stating, “The difficulty is that section 401(b) deals with charging profits and losses to the partners’ capital accounts on a going concern basis.” This leads to the natural question why didn’t the drafters attach this comment to 807(b), the handling of dissolution accounts, the situation to which Kovacik actually applies.

property.”\textsuperscript{44} The decision by the code drafters to exclude services as a quantifiable contribution distinguishes partnerships from LLCs and Corporations, which allow shares to be purchased with services or the promise of services.\textsuperscript{45}

By emphasizing capital accounts as partnership’s default accounting mechanism, and limiting contributions to cash or property, the code rejects the second rationale offered by the Kovacik court, that “the parties have, by their agreement to share equally in profits, agreed that the value of their contributions the money on the one hand and the labor on the other were likewise equal.”\textsuperscript{46} One reason the code may not capitalize a partner’s account for services is the inherent difficulty in estimating the value of those services\textsuperscript{47}, a concern that would exacerbate judicial cost in any \textit{ex post} adjudication. This distinction in classifying contributions differentiates the partnership from the LLC or corporate form in a way that some critics have argued is a non-arbitrary structural element that establishes a set of “‘norms’ for the relationship.”\textsuperscript{48}

\begin{footnotes}
\item[45]\textit{See}, e.g., MBCA §6.21(b)(2002)(stating that shares will be rendered for “any tangible or intangible property or benefit to the corporation, including…services performed, contracts for services to be performed.”); For discussion of accounting valuation of services, \textit{see}, LAWRENCE A. CUNNINGHAM, \textit{INTRODUCTORY ACCOUNTING AND FINANCE FOR LAWYERS}, P.113 (2d. Ed.1999).
\item[46]Kovacik, P.2d at 316.
\item[47]For a discussion of the valuation of human capital, \textit{see} BROMBERG AND RIBSTEIN, \textit{supra} note 6, at §6.02.
\end{footnotes}