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Partnership law in the twenty-first century

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*J.B.L. 357 What is a Partnership

As far as the law is concerned, a partnership at the start of the twenty-first century is still much the same animal that it was in the 1890s, when it was defined by section 1 of the Partnership Act 1980 ("the Act") as "the relation which subsists between persons carrying on a business in common with a view of profit". The "persons" may be companies or individuals, or any combination of the two, with a maximum of twenty,[1] although in recent years most professional partnerships have been exempted from this limit.[2] All partners have the right to participate in management (the meaning of the term "in common") and are jointly and severally liable without limit for the debts and obligations of the partnership.[3] Partnerships are not required to register as such[4] and there are no filing requirements. In effect, the partners are a group of sole traders co-operating within an informal business medium which is recognised by the law only for limited purposes. The lack of change to the partnership entity may be contrasted with the plethora of legislative and judicial developments which have influenced the development of its chief rival, the limited company, during the last century.

However, the partnership is now set to enter into a period of transition. The Law Commission and the Scottish Law Commission have produced a Joint Consultation Paper on Partnership Law[5] ("the Consultation Paper") which is likely to result in significant changes to partnerships and partnership law. Unfortunately, the majority of partnerships, who have limited resources and therefore limited access to professional advice, will not be assisted in understanding or responding to the Consultation Paper by its length (346 pages) or its lack of clarity.

J.B.L. 358 The purpose of this article is threefold: first, to assess the reforms to partnership law required if the partnerships entity is to continue to flourish in the twenty-first century; secondly, to consider the extent to which these reforms are reflected in the Law Commission's proposals; and thirdly, to evaluate the likely effect of the reforms on the flexibility, informality and privacy which are the strengths of the general partnership. The importance of these strengths has been demonstrated by surveys[6] in which flexibility and ease of operation have been the advantages of unincorporated status cited most often. Partnerships can be set up, operated and dissolved without any formality or publicity, and partners can vary the way in which the business is run, including their roles within it and the size of their respective profit shares, according to their own wishes and in response to changing business needs. They do not have to take into account the wishes of investors or, in most areas, legal regulation. The surveys also indicate that privacy of finances is much valued. At present, partnerships are not bound by the accounting and disclosure requirements which apply to companies (unless all partners with unlimited liability are themselves limited companies.[7] Although professional bodies such as the Law Society may impose accounting restrictions, these do not include disclosure.[8] If the partnership is to continue as a successful entity in the face of competition from companies and limited liability partnerships (LLPs), then any reforms must at least preserve those qualities, and preferably enhance them.

The Need for Reform

Although the legal regime has changed little, the business climate is now very different to that of 1890, and both professional and trading partnerships are different to their nineteenth century predecessors. The nature of most professions has changed radically in terms of their membership, the services offered, and the expectations of clients; and all partnerships have been influenced by fundamental changes in the nature of commerce, such as globalisation and consumerism. A number of the Act's provisions are simply outdated in their language, but others are inappropriate for large or complex organisations.

J.B.L. 359 The need for more fundamental reform of partnership law has also been identified, both by the Law Commission and by firms themselves,[9] particularly in relation to the lack of continuity on a change in ownership and problems in raising finance. The Law Commission also identified the lack of a model agreement and separate legal personality as areas for reform and, while firms did not, this is likely to be due to a failure to make the connection between difficulties in practice and a non-existent or inadequate agreement and the lack of legal personality.

The Law Commission's remit related in particular to independent legal personality, continuity, the simplification of changes of ownership and a model partnership agreement. The Consultation Paper also examines a considerable number of other areas of partnership law at length, although it frequently reaches the conclusion that there is no significant need for reform in the particular area. It seems at times as if the Law Commission wished to ensure that no stone was left unturned, perhaps anticipating that another hundred years might pass before it was next given the opportunity to conduct such an exercise.

Potential Reforms to the Definition of a Partnership

Section 1 of the Act

The definition of a partnership in section 1 of the Act has stood the test of time and no significant changes are required, although it is one of several areas where any general reform of partnership law should address the outdated language of the Act, not to change its meaning but to make it more readily comprehensible. In section 1, the “relation” which “subsists” between persons must be better expressed as a “relationship” which “exists”, it should be carried on “together” rather than “in common” and the “view of profit” should be replaced by an “intention to make a profit”. However, other changes are not desirable.

Despite this, the Law Commission proposes to make a number of significant changes. First, an agreement would be expressly required. It is not entirely clear from the discussion in the Consultation Paper whether this would be an agreement to form a partnership, or an agreement to carry on a business, in common, with the intention of making a profit. The former would represent a significant change in the law, and is presumably not intended since the Law Commission recognises (at 6.23 of the Consultation Paper) the continued existence of partnerships in which the participants are unaware that in law they are partners. It would certainly make partnerships less informal, and it might also give rise to problems of proof. The latter--an agreement to do the things which constitute a partnership--must in practice exist, at least impliedly, if there is to be any kind of business. Including it in the definition would therefore not alter the current position and might cause confusion.

J.B.L. 360 Secondly, the Law Commission proposes that partners need only to have the objective of carrying on business, rather than actually to do so. This is intended to simplify the legal position of businesses which are in the process of being set up, but it is unlikely to do so because the degree of intention required is unclear. For example, at what stage would two accountants with dreams of running a restaurant together be held to constitute a partnership? Would the joint purchase of premises be sufficient? What about a sole purchase, or the joint purchase of just a pan? If the Law Commission wishes to reflect the House of Lords' ruling in *Khan v. Miah* [10] that preparatory acts are sufficient for a partnership to exist even where the intended business never gets off the ground, a better approach would be for the definition of “carrying on” business to include both the carrying on of a business, and preparatory acts which could have no purpose other than the carrying on of the business in question.

Thirdly, the Law Commission proposes that, if the partnership is to have separate legal personality, it should be the partnership (rather than the partners in common) which carries on a business. The difficulty here is that a circular argument results; there is only a partnership if a business is carried on (or intended to be carried on) by it, but until a partnership exists, it cannot carry on business. The solution is to retain the status quo, that is to say, the partners must carry on a business.

The limit on the number of partners

Although not part of the section 1 definition, most partnerships are subject to a limit of 20 partners under section 716 of the Companies Act 1985. However, the justification that large numbers of partners are difficult to sue no longer applies, and exceptions in section 716 and various statutory instruments mean that few professional firms are subject to this limit. The advantage of a limit is that small numbers of partners are more likely to work informally and flexibly. Where large numbers of partners are involved, a partnership cannot realistically be run “in common”, and will in fact be run more formally and like a company than a true partnership. However, it is clearly inequitable to have one rule for some partnerships and another for everyone else, and impractical to re-impose the limit for all. A lifting of the restriction is therefore essential. The Law Commission proposes to do this, and the DTI is also considering the issue.[11]

Potential Reforms to the Setting-up of a Partnership

Registration

At present there is no register of general partnership, although limited partnerships and LLPs must register in order to give notice to outsiders of their limited ***J.B.L. 361** liability status. The mere fact of registration would alter one of the key features of the partnership, its informality, and the details registered would mean that two other key features, privacy and flexibility, would be adversely affected. The partnership would have to consider which partners should be authorised to sign the forms to be filed, partnership names which were the same or too similar to other partnership names might not be accepted by the Registrar, and alteration of any registered details would be less simple than before. Filing, including an annual return, would impose an administrative burden, and a fee would be payable. Failure to update the required information promptly would incur civil or criminal penalties. For example, fines might be imposed, unregistered changes in membership might be unenforceable against third parties, and there could be restrictions on the partnership's ability to bring or defend civil actions.

Despite these disadvantages, the Law Commission proposes a system of registration for those partnerships which wish to obtain separate legal personality. Although it proposes the registration only of minimal details (the names and addresses of the partners and the partnership, and the names of a minimum number of partners entitled to deal with land), the nature of such systems is that further information could, and almost inevitably would, be required once the system was in place. Registration does have potential advantages, but it is submitted that these are unlikely to materialise or could be bestowed on partnerships in other ways.

First, registration could provide transparency as to the identity of partners at a particular time (for the benefit both of creditors wishing to sue,[12] and employees or partners who were not partners at the time liability arose who wish to avoid liability). It could also provide transparency as to when a partnership has commenced, avoiding the problems which have arisen over this issue in cases such as *Khan v. Miah* [13] and *Spicer (Keith) Ltd v. Mansell,* [14] where courts were required to rule on whether preparations to start a business had reached the stage where a business could be said to have been carried on for the purposes of section 1(1) of the Act. However, it is unlikely that genuine transparency would result from registration. First, in certain circumstances, sections 14 and 36 of the Act impose liability on non-partners as if they were partners. If these sections prevail in favour of third parties, the position will not be transparent. If they do not, then registration will produce transparency, but third parties will be prejudiced. Secondly, a partnership is currently formed where the definition in section 1 is fulfilled. If this is to be a strict pre-requisite for registration as a partnership, this could make the Registrar's task impossible. If it is not, then there will be a lack of transparency over what constitutes a partnership, especially since the Law Commission proposes that partnerships without legal personality would not be ***J.B.L. 362** registered. The potential difficulty is similar to that for LLPs, since section 2(1) of the Limited Liability Partnerships Act 2000 provides that an LLP is formed by the registration of two persons carrying on a lawful business with a view to profit. Companies House guidance on the formation of LLPs does not indicate that any inquiry will be made as to whether this business is carried on, or whether it is with a view to profit. Indeed, in its section on Frequently Asked Questions, Companies House states simply that: “Any new or existing firm of two or more persons will be able to incorporate as an LLP”.[15]

Secondly, although registration could confer legal personality, it is not essential for this purpose. In Scotland and the United States the latter is conferred without the former, and the Law Commission admits that legal personality could be granted to all partnerships without registration.

Thirdly, registration could provide a gateway to advice, mitigating the problem, identified by the Law Commission in its 1994 Feasibility Study, that small businesses lack access to advice.[16] However, the Law Commission study related to all small businesses, which indicates that registered companies are as affected by the problem as unregistered firms. In addition, the businesses most in need of advice are those least likely to register.

Finally, registration could enable partnerships to grant floating charges under a scheme similar to that for companies. However, it is separate legal personality rather than registration which is essential, since a special register could be set up for the registration of partnership floating charges (see below).

The agreement

Two related problems arise in the context of the partnerships agreement. First, there is no model agreement capable of easy use or adaptation by partnerships. This undoubtedly contributes to the fact that at least half of all partnerships have no comprehensive agreement[17] and therefore rely--unwittingly in many cases--on the default provisions of the Act. In addition, those partnerships which do have an agreement have either had to incur the costs of obtaining professional advice or have drawn up their own agreement in the absence of appropriate guidance and thus have almost certainly missed a relevant provision or included an inappropriate one.

An optional model agreement should therefore be annexed to the Act. It would remind intending partners of the desirability of an agreement, and provide a starting point for the drafting of such an agreement (and indeed a finishing point for those with minimal resources or information). The Law Commission itself recognises that it would be possible to have such an optional agreement alongside the default provisions of the Act. Its objection that the law imposes insufficient ***J.B.L. 363*** regulation on partnerships to form the basis of a model agreement may change if a majority of the proposals in the Consultation Paper are enacted. In any event, if the model agreement is optional, there can be no objection to including provisions (and indeed alternative options within provisions) which are not contained in the Act.

Although the Law Commission previously identified the lack of a model agreement as a problem for partnerships,[18] and it was one of the express areas to which its remit related, the Consultation Paper does not propose the introduction of a model agreement.

The second problem relating to agreements is that the default provisions of the Act, which apply to hundreds of thousands of partnerships, are inappropriate for most. The Act requires substantial amendment in three respects if the situation is to be improved. First, its language needs to be updated in a number of areas (for example, the duty to render true accounts and full information in section 28, discussed below). Secondly, some provisions which are currently omitted (for example, the power to apply to court for the expulsion of a partner) should be included. Thirdly, provisions in certain areas must be made more acceptable to the majority of partnerships. Although some provisions of the Act reflect the most popular approach (such as retiring partners not being liable for debts incurred after their retirement in section 9) or provide a default provision which is as good as any other in the absence of a consensus (such as equal sharing of profits and losses in section 24), there are also other provisions which are almost certainly contrary to the wishes of most partnerships (such as those providing for automatic dissolution in sections 32-4).[19] The Law Commission proposes a number of reforms which will go some way to improving the default position, and these are discussed further below.

The Introduction of Separate Legal Personality

At present, partnerships in England and Wales have no separate legal personality, unlike partnerships in other jurisdictions, such as the United States[20] and Scotland.[21] The law does recognise the partnership entity for some purposes--for example, a partnership can sue and be sued[22] (with execution against partnership property if judgment is obtained against the firm[23]), is recognised for value added ***J.B.L. 364*** taxation purposes,[24] and if insolvent is would up as if it were an unregistered company.[25] However, problems remain in a number of other areas, including property, contracts, the execution of deeds, continuity, the availability of the floating charge and the recognition of English partnerships in foreign jurisdictions. The introduction of separate legal personality could therefore be an important advance for partnerships.

Unfortunately, the Law Commission proposes separate legal personality only as a consequence of voluntary registration, although it does offer as an alternative separate legal personality as a mandatory feature of all partnerships. Not only is registration inherently undesirable, as discussed above, but the existence of partnerships with legal personality alongside those without would be likely to cause confusion among third parties and, quite possibly, among partners.

Continuity

Partnerships with separate legal personality would no longer have to dissolve automatically on the happening of certain events to partners, such as death or bankruptcy, since a change in membership would not affect the partnership entity. However, since continuity is not an inevitable consequence of separate legal personality, it will be dealt with below in the context of automatic dissolution.

Land

Legal personality would enable a partnership to own land in its own name, instead of through up to four partners as trustees for the partnership. However, practical difficulties could arise as a result of the absence both of statutory presumptions on the execution of documents by partners, and of public disclosure of the authority of particular partners to transact in land (in contrast to company directors). The first issue requires reform to the rules on the execution of documents, and this is discussed further below.

In respect of the second issue one solution would be for a statutory presumption similar to section 36A of the Companies Act 1985 to be included in the Act, to the effect that due execution would be deemed to have been effected where two partners signed the document. Alternatively, the Land Registry could enter on the register a statement that details of partners authorised to transact land were available on request from the partnership. This would put third parties on notice that particular partners might not have authority. This second solution might be preferable for partnerships, but the first would be simplest and most certain for third parties.

***J.B.L. 365** Unfortunately, the Law Commission links separate legal personality to registration, and so although partnerships with legal personality would state in register of partnerships the names or minimum number of partners entitled to buy or sell land, other partnerships would continue to be unable to own land. Alternatively, if all partnerships were to have separate legal personality without registration, the Law Commission proposes a voluntary register of such information. The requirement to register would create undue bureaucracy, as discussed above, while a voluntary register would lead to uncertainty.

Other property

Whether property belongs to the partnership is crucial not only for accounting purposes, but also because it determines the priority of creditors (partnership property is only available to partners' personal creditors after all partnership creditors have been paid, whereas partners' private property is available equally to both sets of creditors[26]). In addition, in the absence of contrary agreement, partnership property may only be used for the purposes of the partnership (section 20 of the Act).

Legal personality could enable non-land property ownership to be simplified, but an overhaul of the definition of partnership property in sections 20 and 21 of the Act is required if full advantage is to be taken of its introduction. At present, although the partnership cannot own property in its own name, the partners can own it collectively as partnership property. However, the distinction between property owned in this way and property owned by one or more partners as a private asset is often difficult to draw. While separate legal personality would enable the partnership to own property and thus reduce the scope for confusion as to what is partnership property, it would not eliminate it unless the definition of partnership property in sections 20 and 21 is clarified.

The definition currently includes property brought into the partnership stock, bought on account of the partnership and bought with the partnership's money. The difficulty lies in establishing that any one of these events, particularly the first two, has in fact occurred. If it can be proved that property has indeed been brought into the partnership stock or bought on account of the partnership, then it is unlikely that its status as partnership property will be disputed, and sections 20 and 21 are superfluous. If it cannot be proved, then these sections provide no assistance in determining whether the property in fact belongs to the partnership. The resulting problems have been demonstrated in cases such as *Miles v. Clarke* [27] and *Waterer v. Waterer.* [28] In both cases, it was unclear what was partnership property, and the courts held that only property necessary to give business efficacy to the partnership arrangement had become partnership property.

***J.B.L. 366** What is needed is a definition or presumption that applies to events more readily susceptible of objective proof, such as use or accounting practice. For example, the Act could provide that property paid for with partnership money, credited to a partner's capital account, or used regularly by more than one partner is presumed to belong to the partnership unless a contrary intent can be proved.

Given the importance of the definition and the problems currently associated with it, it is curious that the Law Commission asserts (at 11.4 of the Consultation Paper) that these provisions “do not cause any legal problems”. It makes only minimal proposals for clarification of section 20 in respect of partnerships with legal personality, and none at all for other partnerships.

Contracts

Although separate legal personality would enable partnerships to enter into contracts, disputes as to agency and authority could still arise over whether the partner(s) who signed on behalf of the partnership had authority to commit it to the contract.[29] Internal disputes of this kind are always possible, but the scope for external disputes to arise is minimised by section 5 of the Act. This provides that acts of a partner which are usual for the kind of business carried on by the partnership will bind the partnership, unless the third party knows that the partner has no authority or does not know or believe him to be a partner. Thus, a bona fide third party may rely on the appearance of authority when dealing with an unauthorised partner.

Execution of deeds

Separate legal personality could facilitate a simplification of the rules relating to the execution of deeds. At present, deeds must be executed either by all partners, or on their behalf by an attorney authorised for that purpose by all the partners. If a partnership had legal personality, any partner could execute a deed on its behalf if authorised by deed to do so. However, in order for the partnership to execute the deed, either a partnership seal must be affixed, or a provision must be inserted into the Act stating that a document would be duly executed if expressed to be so and signed by a partner. The Law Commission proposes the latter, in which case it is essential to adopt its suggestion that these provisions make clear that they are without prejudice to sections 5 and 6 of the Act (on the express and ***J.B.L. 367*** apparent authority of partners). In the interests of clarity and transparency, the provisions on execution should refer expressly to an “authorised” partner.

Floating charges

Separate legal personality would enable partnerships to grant floating charges, although these would have to be registered. In the absence of a partnership register, a separate register for partnership floating charges would have to be set up. In practical terms, floating charges would enable the raising of additional finance, but they would also give rise to the risks associated with additional borrowing and the granting of such wide-ranging security.

The Law Commission's preferred option--for separate legal personality to be granted only to registered partnerships--would mean that only those partnerships could grant floating charges.

International recognition of partnerships

The introduction of separate legal personality would promote the international recognition of English partnerships, thus reducing the difficulties encountered by English partnerships overseas in setting up business, employing people, buying or leasing premises and resolving the tax position. However, what is really needed is significant harmonisation involving rationalisation of the disparate forms of partnership and partnership law prevailing across the European Union.[30] This would, of course, have to be decided at European level, and there is no indication that it is a political priority for the European Union or its Member States.

Potential Reforms Affecting the Relationship of Partners *Inter Se*

Duties

Partners are subject to a common law duty of good faith,[31] and to the three statutory examples of this duty in the Act: to disclose information (section 28); to account for benefits derived from the firm name or connection (section 29); and to account for the profits of a competing business (section 30). In the interests of transparency, the duty of good faith should be made statutory so that partners would be more likely to be aware of it. It could be expressed in a similar way to the duty of care under section

404(c) of the Revised Uniform Partnership Act ("RUPA") in the United States, which includes "refraining from engaging in grossly negligent or reckless conduct, intentional misconduct or a knowing violation of law". The Law Commission is consulting on whether the overriding duty of good faith and the fact that it may not be excluded should be stated in the ***J.B.L. 368** Act and, if so, whether the duty should be general or specific to certain circumstances.[32]

Secondly, section 28 should be updated since the duty "to render true accounts and full information" is not expressed as clearly as it might be. A simple improvement might be to substitute "to provide full information, including accounts". However, the Law Commission makes no such proposals.

Thirdly, section 29(2) provides that the duty to account for a benefit derived from use of the firm name or connection also applies between dissolution and winding up if dissolution is due to the death of a partner. This should be amended so that the duty does not apply after dissolution at all. Continuance of the duty only if dissolution is due to death is anomalous, and could cause problems for partners who commence work for a rival or on their own account immediately after such dissolution. The Law Commission has proposed no reform to this subsection, on the ground that its reforms to dissolution will reduce the scope for it to apply. However, since there could be situations where it will still apply, it should be deleted.

The Law Commission also considers two other reforms, both of which are unnecessary. The first is a statutory duty to the partnership to act with the care and skill to be expected of a person with the experience and qualifications possessed by that partner. In order to preserve flexibility and informality, these duties should not be statutory. Partnership is founded on mutual trust and good faith, and a statutory duty to act competently would not add anything to this. If there is to be a statutory duty, then a more objective standard would be preferable. This should be based on the skill and experience which a person in the position of a partner in that area of work could be expected to have, and would be similar to that imposed on company directors. The Law Commission argues for a subjective standard on the basis that the expectations of a partner are derived from perceptions of the person, rather than the post. The difficulty with this argument is that in modern partnerships, with large numbers of partners and new partners often entering the firm from outside, this assumption is not really justified.

Secondly, the Law Commission consults on whether some duties should be owed to the partnership and others to the partners, instead of duties being owed to all other partners. This would be very complicated, not least because it would be inapplicable to partnerships which did not have legal personality. In the case of certain duties, it would also be difficult to justify why they should be owed only to the partners or the partnership. For example, the provision of full information is essential both to the partnership as a business, and to the mutual trust between partners. The Law Commission rejects the idea of duties being owed to the partnership only, on the basis that it would cause problems with derivative actions in the same way as the corresponding provision in company law has already done; or to the partners and the partnership concurrently on the basis that this could give rise to conflicts between them as to whether the duty should be enforced. Given the force of these arguments, the most satisfactory solution would be to make no change.

*J.B.L. 369 Management and decision-making

A minor reform is required to close a loophole in this area. At present, ordinary decisions are subject to the requirement of a majority while a change in the nature of the business or the partnership agreement, or the admission of a new partner, requires unanimity. There is, however, no provision for other extraordinary changes, such as dissolution of a fixed-term partnership before expiry of the term. A statement that all extraordinary decisions should be taken unanimously should therefore be included in the Act. There may be difficulty in deciding whether some decisions are ordinary or extraordinary, but this is also the case at present, and at least the consequences of the distinction will be clarified.

The Law Commission, however, proposes to extend the category of decisions requiring unanimity to include a change in the location of the partnership premises and a restriction on a partner's authority which was not imposed as part of a general restriction on all partners. It also consults on whether other decisions should be made subject to unanimity. While an extension of the specific instances in which unanimity applies would do no harm, it would be insufficient on its own to close the loophole.

Expulsion

In the interests of mutual trust and good faith, section 25 of the Act permits expulsion of a partner only if the partnership agreement so provides.[33] However, a partnership without such an agreement can achieve the same result, albeit by going through the more complex procedure of dissolving, and re-forming without the partner. Where dissolution by partners is not possible--for example, the partnership is for a fixed term and not all partners agree to dissolution--an application for dissolution must be made to the court under section 35 of the Act. The realities are, therefore, that relationships within a partnership can deteriorate to the extent that expulsion is required, and that expulsion can in practice be achieved through dissolution. In recognition of these, the Act should be amended to permit the partners to apply to the court to expel and take an account. This would be in some ways a lesser intrusion than dissolution into the flexibility, informality and privacy of the partnership, and would be consistent with the reforms to enable continuity (see below). Its implications for mutual trust and good faith would be no worse that those of the current position.

The grounds for expulsion by the court should be the same as those for dissolution by the court under section 35 of the Act. These are that the business can only be carried on at a loss, a partner has become permanently incapable of ***J.B.L. 370*** performing his part of the partnership agreement, a partner is guilty of conduct prejudicial to the business, a partner has wilfully or persistently breached the partnership agreement, or it is just and equitable to dissolve the partnership. It would be for the court to determine whether expulsion or dissolution is more appropriate in a given case.

The Law Commission proposes that a power to expel be given to the court. It also consults on safeguards, but these would be applicable only if the partners themselves are given a statutory power of expulsion.

Departures and Dissolution

Automatic dissolution

Reforms are required to the current provisions on automatic dissolution. At present, the Act provides that partnerships which have no contrary agreement dissolve automatically on the death (section 33), bankruptcy (section 33), or departure (section 32) of a partner or illegality affecting only one partner (section 34). This rule is unlikely to reflect the wishes of the partners, especially in larger partnerships, and the problems to which it gives rise for partnerships which do not want to dissolve are obvious.[34] It also contrasts with changes to the rules governing the taxation of partnerships which have dissolved automatically, since the Revenue now recognises only actual discontinuance of the business (section 113(2) of the Income and Corporation of Taxes Act 1988, as amended by the Finance Act 1994), rather than “accidental” dissolution followed by re-formation.

There are three basic alternatives for reform, all involving automatic termination as between the former partner and the other partners. First, it could be provided that the partnership does not dissolve on the happening of events previously giving rise to dissolution. While this would be simple, it would also be inflexible, since it could lock partners into a partnership which had radically changed as a result of the departure of a partner. Secondly, it could be provided that the partnership does not dissolve unless the remaining partners agree by majority that it should. This would achieve continuity without inflexibility, since the partners would have the option to dissolve where this was felt to be justified by events. Thirdly, the partnership could dissolve unless the partners opted to continue, which is the current position on expiry of a fixed-term contract (and also the position under section 802 of RUPA). The disadvantage of this is that the partners are required to do something positive to achieve continuity, as opposed to having to do something positive to bring about dissolution.

J.B.L. 371 The Law Commission proposes a combination of the first and second approaches. There would be no automatic dissolution on the happening of any event, subject to agreement to the contrary in the partnership agreement, in respect of death, bankruptcy (6.23 of the Consultation Paper) or illegality (6.25 of the Consultation Paper). For reasons which are not explained, the contrary agreement provision is not proposed where a partner leaves, so that in this event there would be no possibility of dissolution (6.19 of the Consultation Paper). The option to dissolve where a partner charged his share (under section 33(2) of the Act) would continue (6.53 of the Consultation Paper).

Any requirement for contrary agreement to be possible in some but not all circumstances would give rise to inconsistency and confusion. The requirement for contrary agreement, where permitted, to be found in the partnership agreement would impose an unnecessary degree of inflexibility, since the partners might not wish to decide in advance that the partnership should dissolve on the happening of certain events.

In addition, the provisions imply that only in the circumstances outlined may dissolution take place. In fact the partners may at any time unanimously dissolve the partnership. It should therefore be made clear that the partners have the option to agree to dissolve on the happening of any event previously triggering automatic dissolution. Subject to contrary agreement, this option should be exercisable by majority rather than unanimity, in order to compensate for the fact that dissolution must now be by agreement rather than automatic.

Automatic dissolution is, of course, inevitable where the death or bankruptcy of a partner leaves only one partner remaining. However, the Law Commission consults on whether a partnership which is reduced to one partner should be given a period of grace to find a new partner before automatic dissolution applies. This would reflect the position for other organisations with a minimum membership, the public company (under section 24 of the Companies Act 1985) and the LLP (under section 24 of the Companies Act as modified by Regulation 4 and Schedule 2 Pt. I of the Limited Liability Partnerships Regulations 2001, S.I. No. 1090). However, those bodies are not formed by a “relation” (section 1 of the Act) (or “voluntary association” as proposed by the Law Commission at 5.26 of the Consultation Paper), whereas such a relationship is fundamental to partnerships.

If dissolution is no longer to be automatic, a number of other issues assume a greater importance. First, there is the issue of how and to whom a partner's share may be transferred. Secondly, the question of valuation of the partner's share becomes event more sensitive.

Transfer of a partner's share

At present, if a partner's departure does not result in dissolution, his options are to assign his share to an assignee, or to sell it to a new partner. Section 31 of the Act restricts the rights of an assignee of a partner's share, including a transferee or inheritor of the share, and a trustee in bankruptcy or liquidator of the partner. An assignee is entitled only to the share of profits to which the partner or former ***J.B.L. 372** partner would otherwise have been entitled, and many not interfere in the management of the partnership or inspect the accounts. This means that the value of the share is less than if it included management rights. The right to sell to a new partner, while potentially a better option financially, is subject to section 24(7) of the Act which provides that a new partner (who could be an assignee) may be introduced only with the consent of all partners.

If departing partners are to lose the right to trigger dissolution, their financial interests must be protected in some other way. This could be achieved by granting the other partners first option to purchase the share of the departing partner and providing that if this is not exercised and instead the departing partner assigns the share, the partnership must compensate the departing partner for any difference between the value of the share to an assignee and its value to a new partner. This would protect the interests of the departing partner while preserving flexibility.

The Law Commission's proposal that the share be automatically assigned to the other partners and its value become a debt due to the departing partner, does not take into account the possibility that the other partners might be unable or unwilling to purchase the share. There is also no provision as to the proportion in which the other partners would own this share, and what their individual liability to pay for it would be. If the other partners only had an option to purchase, they would have to make an offer for the share, at which point issues of ownership and payment could be resolved.

Valuation of a partner's share

The first step in valuation is to ascertain the proportion of the partnership assets and income to which the partner is entitled. At present section 24(1) of the Act provides that income profits and capital are to be shared equally, subject to contrary agreement. It is silent on the question of capital profits (assets over and above the firm's capital), but in *Popat v. Shonchhatra* [35] the Court of Appeal held that in the absence of contrary agreement, capital profits must be shared in the same proportion as income profits. As a default provision, equal shares is as appropriate as any, and since partnerships which do not have an agreement on this issue are unlikely to make any strict distinction between income and capital profits, it is also appropriate to align the default provisions for capital profits with those for income, although the application of section 24(1) to the former should be made express.

However, the position as to capital is clearly unsatisfactory, since partners who have contributed less than the average would receive windfalls on dissolution, while those who have contributed more would be deprived of part of it. This is unlikely to be the intention in any partnership. Instead, section 24 should be amended so that capital contributed by a particular partner would be returned, subject to a proportionate reduction if there were insufficient funds.

The Law Commission appears to propose this amendment as to capital contributions, but to reverse the effect of *Popat v. Schonchhatra* as to capital ***J.B.L. 373** profits, so that they are shared proportionately to the capital contribution and not in the same proportion as income profits. The formulation used by the Law Commission (at 12.8 of the Consultation Paper) is that in the absence of contrary agreement, partners would be entitled to the “return of their capital contributions in the same proportion as they were contributed”. With respect, this is less than clear as to the position with capital profits, which was the original problem with section 24 prior to *Popat v. Shonchhatra.* If the Law Commission wishes to put on a statutory footing the decision in that case insofar as it relates to capital profits but to reverse the position as to capital contributions, it must produce a clearer provision.

The position is further complicated by section 24 of the Act, which provides an exception to section 24 for capital profits accruing after dissolution. Rather than sharing these equally, an outgoing partner may take either the profits attributable to the use of his share of the assets[36] or five per cent interest on that share. In *Barclays Bank Trust Co Ltd v. Bluff* [37] the court ruled that this only applied to profits made in the ordinary course of business, and not to capital appreciation, which was to be shared by the partners in proportion to the amount of capital which they had contributed. A partner was thus entitled both to the income profits attaching to his share of capital (or five per cent interest), and to a proportion of the capital appreciation. The Act should be amended to clarify the profits to which section 42 applies. The provision for five per cent interest should also be replaced by a provision based on the Bank of England base rate, since five per cent is often uneconomic for either the partnership or the partner.

However, the Law Commission proposes to replace the alternatives with a simple right to interest at the Bank of England base rate or a certain amount above it. Since there could be circumstances in which the profit attributable to use of the departing partner's share of the assets is greater than the interest payable, it seems unnecessarily restrictive to deprive him of the option. For example, if a farming partnership rents out its fields for use in connection with a pop concert, a former partner's share of income generated by the use of the field could easily exceed five per cent interest on his share.

The second step is to put a financial value on that share. The preset position is that the absence of dissolution giving rise to a realisation of the assets and thus an actual surplus or deficit, the valuation must be based on an account.[38] It is then necessary to ascertain the basis for that account from the partnership agreement (if any) and, in the absence of clear express agreement, the conduct of the partners.[39] Since the taking of an account is a matter for the court, there would be no loss of flexibility or privacy if a statutory method of valuation were to apply. It would provide certainty and give partnerships the opportunity to plan the financing of the payout.

***J.B.L. 374** The Law Commission proposes that the valuation should be based either on a notional sale of the business or on the accounting practice adopted in the partnership's last annual accounts. If the first option were to be adopted, the provisions must specify whether the notional sale would be as a going concern, or on a break-up basis, or the more (or less) valuable of the two (the option under section 701(b) of RUPA). The second option, valuation according to the last partnership accounts, could be problematic because the accounting practice may not be apt to apply to the situation which has arisen.[40] The first option, properly expanded, is therefore preferable.

Solvent dissolution

Limited reform is required to simplify and clarify the current position. At present, partnerships may be wound up informally or by the court under section 39 of the Act, possibly involving the appointment of a receiver or manager. Under the Rules of the Supreme Court (RSC) Order 30 as re-enacted and applied to the High Court and the County Court by Schedule 1 to the Civil Procedure Rules (CPR), the function of a receiver is to get in the assets of the partnership and pay the partnership debts. Running the business is the prerogative of a manager, but in practice where both are appointed, they are usually the same person. An account may only be taken by the court.

The CPR should therefore be amended so that a partnership receiver has the power to manage and to take an account, the latter to be subject to court approval so that the court remains the final arbiter of the determination of the rights of the partners *inter se.* In the interests of transparency, these provisions should also be included in the Act.

However, the Law Commission considers that solvent dissolution should be removed from the ambit of the courts where the partners cannot agree, and left to a partnership “liquidator” who would have the powers of a receiver and be able to determine the rights of the partners and to do all other acts necessary for winding up the partnership. It is perhaps curious, given the severe criticism which the Law Commission levels at the current system on the basis that the receiver has to consult potentially warring partners on a frequent basis, that the “liquidator” is to be required to get unanimous approval of the partners before making arrangements with creditors, compromising a partner's liability to contribute under section 44 of the Act, or carrying on the business. These exceptions would significantly detract from the advantages of a “liquidator” over a receiver, and since the Law Commission consults on a more appropriate name than “liquidator”, it is submitted that a “receiver” with the increased powers discussed above would fit the bill.

**J.B.L. 375* Liability of departing partners

At present, departing partners remain liable for debts incurred prior to their departure (section 17 of the Act) but are only liable for debts incurred after their departure if they fail to give adequate notice of their retirement (section 36 of the Act) or are held out as partners after retirement (section 14 of the Act). Section 14 requires amendment because it states that the continued use of a deceased partner's name in the firm name does not of itself amount to holding out. This provision should in fact apply to all partners who leave, subject to contrary agreement, so a partnership can retain a name to which goodwill is attached without a departing partner incurring liability as a result. The contrary agreement provision is important because it would give departing partners who wish to use their name in a new venture the opportunity to reach an accommodation with the partnership over use of that name by the partnership.

The Law Commission proposes to amend section 14 in this way, but also proposes that that section 17(2) should apply to all partners who leave, not just “retiring” partners. There is some merit in replacing the word “retiring” with “departing” or “leaving” in the interests of clarity, but the change is unnecessary as a matter of law. The word “retiring” in the Partnership Act encompasses all forms of voluntary departure, as can be seen in section 26 of the Act which uses this word in the context of termination of a partnership at will.

Conclusion

It is evident from this analysis of the existing law and potential reforms to it, that reforms are at least desirable and perhaps even essential. However, a number of factors suggest that reforms should be limited to those which are necessary to make the partnership a more attractive business entity, either by clarifying the existing law, or by introducing significant advantages.

First, many unincorporated firms do not currently perceive any significant disadvantage to their status, and the advantages evidently outweigh the disadvantages for the almost 40 per cent of businesses with more than one owner which opt for partnerships status.[41] Secondly, there is no way of notifying partnerships of any reforms, since they are informal and unregistered entities. Lack of notification is a particular problem for the huge number of partnerships which have no agreement, and to which the default provisions in the Act therefore apply, but all firms could be affected. Some will seek (expensive) legal advice, some will assume that the unamended Act still applies, and some will continue to act in ignorance of any legal provisions relating to partnerships. Thirdly, the current Act has the merit of brevity (50 sections) and as a result is simpler and more transparent than the Companies Act (over 700 sections). With the rationalisation or deletion of a number of clauses, it should be possible to keep a new Act to 50 sections.

****J.B.L. 376*** Most of the reforms suggested above, in particular the introduction of separate legal personality, would be justifiable as clarifications or significant improvements, and would not adversely affect flexibility, informality or privacy. However, some Law Commission proposals, particular registration and increased statutory duties, would have adverse effects on these qualities without a sufficient corresponding benefit and should therefore not be adopted.

The extent to which the proposals in the Consultation Paper are eventually taken up in legislation, and the timescale in which this takes place, remain to be seen. The Consultation Paper consists of proposals and suggested options, rather than definite recommendations, and is the start rather than the conclusion of the reform process. It will be some time before the responses to it are analysed and more concrete proposals made and implemented. In the meantime, the Limited Liability Partnerships Act 2000 may result in the diversion of some existing or would-be partnerships to the LLP (available from April 6, 2001). In particular, fewer large professional partnerships may be prepared to accept unlimited liability.[42] If reforms are significantly delayed, it may therefore be that the pressure for reform will reduce, or that reforms come to reflect the concerns and demands of smaller, often trading, partnerships. In particular, this might include a model partnership agreement.

The introduction of separate legal personality and other reforms to the general partnership inevitably represent a move away from its traditional form, but potential remains for it to survive as a flexible, informal and private entity run on principles of mutual trust and good faith. It is to be hoped that this potential is realised when the responses to the Consultation Paper are put forward and the reforms take on a more definite shape.

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1. s.716 of the Companies Act 1985.

2. s.716 of the Companies Act 1985 exempts solicitors, accountants and stockbrokers, and various Partnerships (Unrestricted Size) Regulations exempt certain other professionals.

3. ss.9 and 12 of the Act and s.4 of the Civil Liability (Contributions) Act 1978.

4. This applies to general partnerships. Limited partnerships are required to register by virtue of s.5 of the Limited Partnerships Act 1907.

5. The Law Commission and the Scottish Law Commission *Partnership Law: a Joint Consultation Paper,* Law Commission Consultation Paper No. 159 and Scottish Law Commission Discussion Paper No. 111, 2000. See also D. Faber “The Law Commission's Review of the Law of Partnership” (1997) June *Butterworth's Journal of International Banking and Finance Law* 242.

6. Surveys of limited companies, sole traders and partnerships conducted by J. Freedman and M. Godwin at the Institute of Advanced Legal Studies as part of the ESRC Small Business Programme, covering over 400 firms (J. Freedman *Small Business and the Corporate Form: Burden or Privilege?* (1994) 57 *Modern Law Review* 555); by J. Smallcombe, covering over 150 firms (A. Hicks, R. Drury and J. Smallcombe *Alternative Company Structures for the Small Business* (ACCA Research Report, Certified Accountants Educational Trust, London, 1995); and by the Business Development Centre, Manchester Business School, covering almost 200 firms (The Forum of Private Business *A Report into Business Legal Structures* (1991)).

7. Partnerships and Unlimited Companies (Accounts) Regulations 1993 (S.I. 1993 No. 1820).

8. See Chap. 28 of the Guide to the Professional Conduct of Solicitors (Eighth edition, 1999), ss.32-4 and 85 of the Solicitors Act 1974 and the Solicitors' Accounts Rules 1998. Firms of solicitors which incorporate will, of course, be bound by statutory requirements for companies as well as by professional requirements.

9. *op. cit* n. 6, and the Law Commission 1994 Feasibility Study incorporated in the DTI consultative document *Company Law Review: the Law Applicable to Private Companies* (URN 94/529).

10. [2000] 1 W.L.R. 2123. See further R. Linsell “When does a partnership exist?” (2001) 19 January *Solicitors' Journal* 45.

11. DTI Press Release P/2000/222.

12. However, such creditors may sue the partners in the firm name, and this will be taken to refer to all partners at the time at which the cause of action arose (Sched. 1 and 2 to the Civil Procedure Rules (CPR) re-enacting RSC Ord. 81 and CCR Ord. 5 r. 9). Sched. 1 and 2 also requires partnerships to disclose the names and addresses of the partners to a potential defendant in an action by the firm (RSC Ord. 81 r. 2 and CCR Ord. 5, r. 9).

13. [2000] 1 W.L.R. 2123.

14. [1970] 1 W.L.R. 333.

15. http://www.companies-house.gov.uk/.

16. However, professional firms have access to some advice through their professional bodies and general help on setting up a business may also be available through other channels. For example, the DTI has a Small Business Service and the European Union has initiatives on small and medium-sized businesses (SMEs). However, these forms of advice will not involve the specific legal aspects of the appropriate partnership agreement.

17. The Forum of Private Business, *op. cit.,* n. 6.

18. The Law Commission, *op. cit.,* n. 9 at 5.63. See also J. Freedman, *op. cit.,* n. 6.

19. See the recommendation of The Forum of Private Business, *op. cit.,* n. 6, that new legislation is required, covering "all areas included in a partnership agreement in plain and simple terms".

20. s.201 of the Revised Uniform Partnership Act 1996.

21. s.4(2) of the Act.

22. Scheds. 1 and 2 of the CPR re-enacting RSC Ord. 81 and CCR Ord. 5, r. 9.

23. Scheds. 1 and 2 of the CPR re-enacting RSC Ord. 81 and CCR Ord. 25, r. 9 and r. 10.

24. s.45 of the Value Added Taxes Act 1994. However, there is no joint assessment to income tax in the partnership's name. Instead, partners are taxed under the self-assessment regime and each partner includes his share of partnership income in his personal tax return and is solely liable for the tax on it.

25. Insolvent Partnerships Order 1994 (S.I. 1994 No. 2421).

26. Sched. 4 Pt. II para. 23 and Sched. 7 para. 21 of the Insolvent Partnerships Order 1994 modifying ss.175 and 328 of the Insolvency Act 1986.

27. [1953] 1 All E.R. 779.

28. (1873) L.R. 15 Eq. 402.

29. See, for example, *Mercantile Credit Co. Ltd v. Garrod* [1962] 3 All E.R. 1103; *United Bank of Kuwait Ltd v. Hammoud* [1988] 3 All E.R. 418; and *Re Briggs & Co, ex p. Wright* [1906] 2 K.B. 209. Equivalent problems arise for companies (which have separate legal personalities) and directors (who must actually commit the company to contracts. See, for example, *Freeman & Lockyer v. Buckhurst Park Properties (Mangal) Ltd* [1964] 2 Q.B. 480.

30. A useful summary of these is provided in *Company Law in Europe,* Butterworths.

31. *Const v. Harris* (1924) Turn. & R. 496, 37 E.R. 1191.

32. See also J. Thurston, "Partnership Act 1890--Time for Reform?" [1988] J.B.L. 155.

33. This may be contrasted with s.601(4) of RUPA which permits expulsion where it is unlawful to carry on the business with the partner, that the partner has transferred all or substantially all of his transferable interest or there is a court order charging it, that a corporate partner is dissolved or its right to carry on business has been suspended, or that a partner which is itself a partnership is dissolved. This reverses the previous position under the Uniform Partnership Act 1914 which provided (at s.31(1)(d)) that expulsion was possible only pursuant to a partnership agreement to that effect.

34. The European Commission has recommended that partnerships should continue on the death of a partner (Art. 5 of the Commission Recommendation 94/1069 on the transfer of small and medium-sized enterprises (O.J. 1994 L.384 p. 14)). The Commission has recently reaffirmed this view, criticising the effect of the present situation on business efficacy, in a further Communication on the transfer of small and medium-sized business enterprises (O.J. 1998 C93 p. 2).

35. [1997] 3 All E.R. 800.

36. See, for example, *Hugh Stephenson & Sons Ltd v. Aktiengesellschaft für Carton Nagen Industrie AG* [1918] A.C. 239.

37. [1981] 3 All E.R. 232.

38. See further the CPR, Parts 25 and 40 and relevant Practice Directions.

39. *Cruickshank v. Sutherland* [1922] All E.R. Rep. 716.

40. See, for example, *Re White (Deceased), White v. Minnis and another* [2000] 3 All E.R. 618.

41. *op. cit.,* n. 6.

42. J. Fleming "Wragge and Co pioneers limited liability trail" (2001) 98/03 15 January *Law Society Gazette* p. 1.