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Limited partners behaving badly: insolvency procedures and other options for general partners when limited partners default

Feature

Limited Partners Behaving Badly

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This feature discusses the options available to general partners in a limited partnership when limited partners default on their obligations.

KEY POINTS

· General partners may enforce the obligations of limited partners in accordance with a partnership agreement (if any).

· In the absence of a comprehensive agreement ousting the default provisions of partnership legislation, general partners may also enforce the obligations of limited partners under these provisions.

· However, in either event it may be necessary to resort to lengthy and costly litigation without any guarantee of success, and thus the possibility of termination of the partnership should be considered.

· One possibility is dissolution followed by an informal winding up by the partners.

· However, where the partnership is insolvent, the general partners may instead invoke one of the statutory insolvency procedures.

A limited partnership is defined, like a general partnership, as 'the relation which subsists between persons carrying on a business in common with a view of profit' (s 1 of the Partnership Act 1890). However, unlike a general partnership, it must be registered and must have at least one general and one limited partner (s 4 of the Limited Partnerships Act 1907). A limited partner must make a capital contribution (s 4), to which his liability is limited so long as he does not take part in management (ss 4 and 6). The certificate issued on registration constitutes conclusive evidence that the partnership came into existence on that date (s 8C), even if the definition is not at that time satisfied.

ENFORCEMENT OF THE PARTNERSHIP AGREEMENT AND/OR THE DEFAULT PROVISIONS OF THE LEGISLATION

Where the internal governance of the partnership is at issue, any agreement between the partners will take precedence. As a result, the way in which a partnership is run and the options available to general partners when things go wrong can vary between partnerships. However, it is not uncommon for a partnership to have an inadequate agreement or no agreement at all. In the absence of agreement on a particular issue, the default provisions of the Partnership Act, as amended by the Limited Partnership Act, will apply. For example, limited partners are required to provide the other partners with full information about anything affecting the partnership (s 28 of the Partnership Act), not to profit from use of the partnership name, property or connection (s 29) and to account for any profits from a competing business (s 30). These may be enforced by litigation if necessary, but this is likely to be not only lengthy and expensive but destructive of the partnership's reputation and, in most cases, of the partnership itself.

CONSENSUAL DEPARTURE OF A LIMITED PARTNER

One option which may be provided for in the agreement, or worth considering on an ad hoc basis, is for a defaulting limited partner to leave the partnership voluntarily. In this event, the remaining partners should ensure that they comply with the provisions of the Companies Act 2006 as to the use of business names, by changing the partnership name and/or changing the names of the partners disclosed on all documents. In the absence of prior agreement, there are no default provisions permitting a partner to leave without triggering dissolution (see below).

EXPULSION OF A LIMITED PARTNER

Another option which may be provided for in the partnership agreement is expulsion. However, there is no power to expel unless it has been expressly agreed by all partners (s 25 of the Partnership Act), and the courts have laid down certain conditions which must also be satisfied if an expulsion is to be valid. First, the agreed grounds for expulsion must cover the particular complaint (*Snow v Milford* (1868) 18 LT 142, 16 WR 554). Secondly, the partners must exercise the power to expel in all good faith (*Blisset v Daniel* (1853) 10 Hare 493, 68 ER 1022; *Barnes v Youngs* [1898] 1 Ch 414). This normally requires that the partner be given a fair hearing, and although it may be possible to expel a partner summarily where the facts are such that the expelled partner can be in no doubt that he has done something which would render him liable to expulsion (*Green v Howell* [1910] 1 Ch 495), this is not advisable.

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The relevant legislation is the Partnership Act 1890 as modified by the provisions of the Limited Partnerships Act 1907, and the Insolvency Act 1986 as modified by the Insolvent Partnerships Order SI 1994/2421. It should also be noted that the government is engaged in a review of limited partnership law which has already resulted in amendments to the Limited Partnerships Act and which is likely to produce further amendments.

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DISSOLUTION AND INFORMAL WINDING UP OF A LIMITED PARTNERSHIP

Dissolution marks the legal end of a partnership and is thus the option of last resort for the general partners where the partnership is solvent. In the absence of prior contrary agreement, any general partner may dissolve the partnership immediately by giving notice to all the other partners (ss 26(1) and 32 of the Partnership Act as amended by s 6 of the Limited Partnerships Act). Where this is prevented by the agreement, a general (or limited) partner may apply to the court for dissolution.

It should be noted that although the bankruptcy (or death) of a general partner will result in dissolution, and the other partners have the option to dissolve the partnership if he charges his share of the partnership property for a private debt (s 33 of the Partnership Act), these provisions do not apply where the partner in question is a limited partner (s 6 of the Limited Partnerships Act).

After dissolution, the partnership will be wound up by the general partners (s 6 of the Limited Partnerships Act). Where one or more of the partners object to this, an application may be made to the court for a receiver to be appointed to conduct the winding up. The court may appoint a receiver if it determines that it would be just and equitable to do so (s 37 of the Supreme Court Act 1981). Every partner is entitled to have the partnership property applied in satisfaction of the firm's debts and any surplus assets distributed to the partners (s 39 of the Partnership Act).

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In the event of a default by a limited partner, the most relevant grounds for judicial dissolution under s 35 of the Partnership Act are:

- conduct of a partner which is prejudicial to the business;
- wilful or persistent breach of the agreement (whether written or otherwise) by a partner;
- the business can only be carried on at a loss (which must not be merely temporary); or
- in the opinion of the court, it is just and equitable that the partnership be dissolved.

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FURTHER OPTIONS WHERE THE LIMITED PARTNERSHIP IS INSOLVENT

If the default of a limited partner causes or coincides with the insolvency of the partnership, the general partners may utilise one or more of the insolvency procedures available to partners under the Insolvent Partnerships Order 1994 SI 1994/2421 ('the IPO').

Use of these procedures may assist in the recovery of the business, or in its efficient termination. However, it is worth noting that the IPO is extraordinarily difficult to comprehend and apply for a number of reasons. First, it attempts to apply a statute largely aimed at corporate structures to partnerships, and the uses of corporate concepts in Insolvency Act 1986 ('IA 1986') do not always lend themselves to an interpretation appropriate to partnerships. Secondly, it has a complex internal structure of Regulations and Schedules, between which cross references have continually to be made. Thirdly, although it sets out in full the modified provisions of IA 1986, provisions which are simply applied are not set out and so constant cross-references have to be made to IA 1986.

PARTNERSHIP VOLUNTARY ARRANGEMENTS

Under IA 1986 as applied and modified by arts 4 and 4A and Sch 1 IPO, a partnership voluntary arrangement ('PVA') is largely similar to the corporate or individual equivalent, consisting either of a composition in satisfaction of the partnership's debts or a scheme of arrangement of its affairs.

A proposal for a PVA may be made by 'The members' unless an administration or winding up order has already been made, in which case a PVA may only be proposed by the administrator or liquidator.

One difficulty is that, thanks to the clumsy adaptation from company law, the legislation does not specify whether the partners have to act unanimously, by a simple majority, or otherwise, in proposing the PVA, although presumably the use of the plural ('The members') precludes the making of a proposal by a single partner. Ideally, the partnership agreement should include a clause specifying the manner in which such a proposal is to be approved.

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The IPO applies with modifications certain of the procedures available to companies and (LLPs) under the Insolvency Act 1986 (IA 1986); voluntary arrangements, administration, and winding up as an unregistered company.

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The terms of the proposed PVA must be submitted to a nominee who will report to the court whether the PVA has a reasonable prospect of being approved and implemented, and whether meetings of the partners and its creditors should be summoned to consider it.

Partners of a small partnership (defined in paras 3 and 4 of Sch A1 IA 1986) which is not already subject to an insolvency procedure may obtain a moratorium, which comes into force when the documents are filed. The effect of the moratorium is to protect the assets of the partnership, as set out in para 12 Sch A1 IA 1986. The moratorium ends when the meetings are held, or on the expiry of 28 days if no meetings have been held.

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The term 'members' in this context means partners and anyone who has incurred liability under s 14 of the Partnership Act as a result of being held out as a partner (art 2 IPO).

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The nominee monitors the partnership's affairs to assess whether there is a reasonable prospect of the proposed PVA being approved and implemented, and whether the partnership is likely to have sufficient funds available to it during the remainder of the proposed moratorium to enable it to carry on business.

The proposed PVA must be approved by three quarters in value of the creditors and one half in value of the members (defined as above) present and voting (para 4A Sch A1 IA 1986 and r 1.20 of the Insolvency Rules 1986). Rule 1.20 states that, for the purpose of voting, the value of members is to be determined by reference to the number of votes conferred on each member by the company's articles of association, and so if the partnership agreement lays down the usual voting entitlement of each partner, or a procedure whereby this entitlement may be ascertained, this will presumably apply. However, where there is no partnership agreement or where the agreement makes no provision as to voting entitlement, the way in which r 1.20 should be applied to partnerships is unclear, and voting rights for this purpose should therefore be specified in the partnership agreement.

A further difficulty particular to partnerships is that creditors are unlikely to approve a PVA if partners remain solvent. This may be overcome if the partners' private assets are effectively brought into the PVA by the use of concurrent individual voluntary arrangements ('IVAs') or corporate voluntary arrangements ('CVAs') by the partners.

Once approved, the PVA will be implemented by the nominee, who becomes the supervisor of the arrangement. It binds all creditors and partners who had notice of the meeting and were entitled to vote, but does not bind any secured or preferential creditors who did not agree to it, and may be challenged by a creditor, partner, nominee, administrator, liquidator or trustee in bankruptcy of the partnership, on the ground either of a material irregularity concerning the meetings or of unfair prejudice to the interests of a creditor, member or contributory of the partnership.

The advantages of a PVA are that the procedure is relatively quick and inexpensive, and that it may assist in the survival of the business. The disadvantages are that non-assenting preferential and secured creditors are not bound by the PVA; that the moratorium is of a very short duration, and not all partnerships are eligible for it; and that personal creditors of partners cannot be involved in or bound by a PVA. The latter means that personal creditors could be paid off ahead of partnership creditors, unless all partners utilise IVAs or CVAs.

ADMINISTRATION

Under IA 1986 as applied and modified by s 6 and Sch 2 IPO there are three possible procedures to put a partnership into administration, but one -- the appointment of an administrator by the holder of an agricultural floating charge -- is of course not an option available to the general partners.

The partners may appoint an administrator so long as no petition for winding up or application for administration has been presented, and no administrative receiver is in office (para 25 Sch B1 IA 1986). This provision, like that relating to the proposal of a PVA, refers simply to 'The members' (defined as above) and does not clarify what proportion must support the appointment (para 22 Sch B1 IA 1986). Again, the partnership agreement should ideally deal with this issue. Notice of intention to appoint must be given to any floating charge holders entitled to appoint an administrator or an agricultural receiver, and filed at court together with a statutory declaration that the partnership is unable to pay its debts and is not in liquidation and that the appointment is not prevented because a previous administration has ended within the previous 12 months.

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RELEVANT PERSONS ARE DEFINED (PARA 47 SCH B1 IA 1986) AS:

- a person who is or has been an officer of the partnership (defined as below);
- a person who took part in the formation of the partnership during the period of one year ending with the date on which the partnership enters administration;
- a person employed by the partnership during that period; and
- a person who is or has been during that period an officer or employee of a partnership which is or has been during that year an officer of the partnership.

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Alternatively, the partners (or one or more creditors, or a combination of both) may make an application to the court for the appointment of an administrator on the grounds that the partnership is unable to pay its debts, and that the order would be likely to achieve the purposes of administration. Again, the provision refers simply to 'the members' without clarifying what proportion must support an application (para 12 Sch B1 IA 1986). As soon as reasonably practicable after making the application, the applicant must notify any person entitled to appoint an administrator or administrative receiver, or who has appointed an administrative receiver.

On presentation of the application to the court, or filing of notice of intention to appoint an administrator, a moratorium is created (para 44 Sch B1 IA 1986), which becomes more comprehensive on the making of an order (paras 42 and 43 Sch B1 IA 1986). However, it should be remembered that while the moratorium protects the partnership assets, the partners' private assets may still be subject to attack unless the partners themselves utilise IVAs or CVAs.

A further issue particular to partnerships is that if the partnership is 'at will', that is to say no fixed duration has been agreed by the partners, any partner may dissolve it without court involvement simply by giving notice to the other partners (s 26 of the Partnership Act), and an informal winding up under the Partnership Act will then commence. This would allow dissenting members of such a partnership to defeat the objectives of an administration, unless giving notice of dissolution is prohibited by the provisions on administration. However, it seems unlikely that the giving of such notice would amount to a 'legal process', which would be prohibited by the moratorium (in the absence of the consent of the administrator or permission of the court), or indeed to a 'management power ... which could be exercised so as to interfere with the exercise of the administrator's powers', which would be prohibited as an interference with the functions of the administrator (in the absence of the latter's consent).

While a partnership is in administration, the name of the administrator and a statement that he is managing the partnership must appear on every business document and partnership website, and failure to do so renders not only the administrator but also the partners liable to a fine.

As soon as reasonably practicable after his appointment, the administrator must request from one or more relevant persons a statement of the partnership affairs.

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An officer of the partnership means a member (defined as above) or person with management or control of the partnership business (art 2 IPO).

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The administrator must call a creditors' meeting to approve the proposals by majority in value unless he thinks creditors can be paid in full, or the purpose cannot be achieved, or a distribution cannot be made to the unsecured creditors. If the proposals are approved, the administrator takes custody of the partnership property and manages its affairs in accordance with the proposals. The powers of the administrator are set out in Sch 1 IA 1986. The administration will be terminated after a year (unless extended) or when the administrator applies to the court for the ending of the administration on the basis that its purposes have been achieved or cannot be achieved.

Administration may promote the survival of the business, and offers a longer moratorium than a PVA. Alternatively, it may improve the position on a winding-up. However, it has a number of disadvantages; the administrator may not deal with partners' personal assets, certain prior transactions may be set aside (see below) and the partners become liable to a disqualification order under the Company Directors Disqualification Act 1986 (see below).

WINDING UP

In addition to the informal winding-up of a solvent partnership under the Partnership Act, the IPO provides for four formal winding-up procedures, in which the partnership is wound up as an unregistered company. Two of them must be initiated by a creditor (or certain other third parties), and are not available to the partners. The two which may be initiated by partners are a members' winding up without concurrent actions against the partners (IA 1986 as modified by art 9 and Schs 3 and 5 IPO) and a members' winding up with such concurrent actions (IA 1986 as modified by art 10 and Schs 4 and 6 IPO). If there is any doubt about the partnership's solvency, the latter is the appropriate procedure in order to ensure that partners' personal assets are available (*Investment and Pensions Advisory Services Ltd v Gray* [1990] BCLC 38).

Any partner may present a members' petition without concurrent petitions if there are eight or more partners in the partnership, or with leave of court. Leave will be granted if:

- the partner has served a written demand on the partnership in respect of a joint debt exceeding £750 which was due from the partnership but was paid by the partner;
- the partnership has not reimbursed the partner within three weeks; and
- the partner has obtained judgment against the partnership for reimbursement and all reasonable steps have been taken to enforce it.

The grounds of the petition are that:

- the partnership has dissolved or has ceased to carry on business or is doing so only to wind up its affairs;
- the partnership is unable to pay its debts; or
- the court considers it to be just and equitable to wind up the partnership.

Any partner may present a members' petition with concurrent petitions if:

- the partnership is unable to pay its debts; and
- petitions are presented against every partner including the petitioner; and
- each partner is willing to be petitioned against and a statement to that effect is included in the petition.

However, the court may dismiss a concurrent insolvency petition against a limited partner if he lodges in court sufficient money or security to meet his liability for the debts and obligations of the partnership or satisfies the court that he is no longer under any such liability (s 125A IA 1986 as modified by Schs 4 and 6 IPO). A limited partner will be able to do the latter if he has fully paid his mandatory capital contribution and has not participated in management (see further s 4 of the Limited Partnerships Act).

The procedure differs little from that applicable to LLPs and companies when they are wound up by the court. When a winding-up order is made or a provisional liquidator appointed, the official receiver may require a statement of the partnership's affairs from officers of the partnership (defined as above) or employees capable of giving the information, or those who were officers or such employees within a year of the date of the winding up order, or anyone who took part in its formation within one year of that date. The official receiver may also apply to the court (and must do so if one half in value of the creditors request) for the public examination of an officer (defined as above), liquidator, administrator, receiver or manager of the partnership, or a person who has taken part in its formation.

The liquidator's powers are set out in Sch 4 IA 1986 as amended. Partnership property must be delivered up to the liquidator, who will secure it and distribute it to the creditors. A final meeting of creditors must be called when the process is complete.

When the estate is distributed, the expenses of the liquidation are paid first, then preferential debts, then other debts. Any surplus from the partnership estate is divided amongst the partners. If there are concurrent petitions and the funds in the partnership estate are insufficient to meet its debts, then debts in each category abate equally amongst themselves and are provable in each partners' estate, ranking equally in the partners' estates with debts of the same category. If there are insufficient funds in a partner's estate, abatement applies similarly, but there is no right for the partner's debts to rank equally with joint debts in the partnership estate, and they will therefore rank after such debts.

LIABILITY TO DISQUALIFICATION

General partners considering initiating an administration or winding up should be aware that if a winding up order is made against an insolvent partnership or it enters administration, an officer of a partnership (defined as above) is liable to a disqualification order under the Company Directors Disqualification Act 1986 ('CDDA') as modified by art 16 and Sch 8 IPO.

The court must make an order against an officer of a partnership which has at any time become insolvent if his conduct as an officer, either in relation to that partnership alone, or when taken together with his conduct as an officer of any other partnership or partnerships or as an LLP member or director of a company or companies, makes him unfit to be concerned in the management of a company. Matters determining unfitness are listed in Sch 1 CDDA.

The Secretary of State may make an application for such an order if it is in the public interest or, in the case of an officer of a partnership which is being wound up by the court, direct the official receiver to do so, unless a voluntary disqualification undertaking has been offered and the Secretary of State considers that it is expedient in the public interest to accept it. A disqualification undertaking is an undertaking that for a specified period of two to 15 years the person will not be a director or LLP member, act as a receiver of the property of a company or LLP, or be concerned with the promotion, formation or management of a company or LLP without leave of the court, or act as an insolvency practitioner.

The effect of an order is that a partner may be disqualified from being a company director or LLP member, acting as a receiver of the property of a company or LLP or being concerned with its promotion, formation or management without leave of the court, or acting as an insolvency practitioner, for a period of up to 15 years. If he acts in contravention of that order, he may become personally liable for the debts of the company or LLP with which he is involved, and is liable on conviction to a fine, or imprisonment, or both.

It should be noted that a partner subject to a disqualification order is not disqualified from remaining or becoming a partner, and need not disclose the existence of the order to any partnership he may join. However, an order can only have been made where the partnership is insolvent, and in such circumstances it is likely that the partner will have been made bankrupt. The restrictions imposed by bankruptcy law are likely to limit the number of persons able to practice in partnership while subject to a disqualification order.

APPLICATION OF THE ANTI-AVOIDANCE PROVISIONS

General partners considering initiating an administration or winding up should also be aware that if a winding-up order is made against an insolvent partnership or it enters administration, this may trigger the application of the anti-avoidance provisions of IA 1986, under which certain prior transactions may be set aside or a contribution from a wrongdoing partner or other person ordered. The application of these provisions is largely as for insolvent companies and LLPs.

CONCLUSION

General partners have a number of options where a limited partner is in default. The least disruptive to the business is to negotiate an agreed departure, with reference to any relevant provisions in the partnership agreement. If this is unsuccessful, and there is an appropriate clause in the partnership agreement, they may be able to expel the partner. Alternatively, they may litigate to enforce a limited partner's duties under the agreement (if any) or the default provisions of the legislation. However, expulsion or litigation may be injurious to the reputation of the business and, indeed, to its existence.

The most disruptive option under the partnership legislation is dissolution. This may be used as an alternative to expulsion where the partnership agreement has no provision for expulsion, since the partnership may be dissolved but immediately re-formed, without the defaulting partner and -- ideally -- with a more comprehensive agreement.

Where the partnership is insolvent, the general partners also have the options provided by the insolvency legislation. The least disruptive of these to the business, potentially, is a PVA or administration. If there is insufficient support to put either of these in place, or they are unsuccessful, then winding up remains an option with a view to the efficient termination of the business.