Think Ahead ACCA

Technical factsheet

Partnership law and practice

INTRODUCTION

This factsheet focuses on general partnerships only. It does not cover the law and practice relevant to limited partnerships.

General partnership is still a fairly common way of running a business, particularly in the professional sphere. Partnerships may be set up from the start of a business or they may grow naturally from the expansion of a sole trader's concern. It is surprising to note that the governing law for such arrangements, the Partnership Act 1890, is over 100 years old. Any references in this factsheet to section numbers are to sections in the act unless otherwise stated.

Despite a number of moves towards reform over the years, including recommendations from the Law Commission and the Scottish Law Commission, there has been no move to change the basic legal position set out in the act, nor any attempt to reform the law.

It may also seem remarkable that a partnership can be created without any formalities. Although it is not a legal requirement to have a partnership agreement, we hope that this factsheet emphasises the importance of putting such a document in place for partners and advisers. In each of the main areas discussed, we have highlighted why this is crucial and the implications of not having a formal agreement. We have summarised many of the points raised into a checklist on the content of the partnership agreement, which appears at the end of this factsheet.

WHAT IS A PARTNERSHIP?

Partnership is defined as 'the relation which exists between persons carrying on a business in common with a view to profit' (s1). Whether or not a partnership exists is a question of fact, and it is not up to the parties to determine. Having said that, if the partners have formally agreed to be partners, either within a partnership agreement or otherwise, it will usually be concluded that they are, particularly if they have a ulterior motive for doing so.

For example, in Young Legal Associates v Lees 2006**,** L had become a partner in a firm of solicitors purely so that the practice would meet the criterion of the Solicitors' Practice Rules, as he was a solicitor qualified to supervise. When proceedings were taken against the firm, L denied that he was a partner. He did not contribute any capital and received a fixed annual sum from the firm. He argued that he was a figurehead. It was held that the law required compliance with the practice rules and that is why the parties had formed a clear intention to enter into a partnership, and that is what they had done.

A person may be taken to be a partner by estoppel if they have held themselves out as being so, and the law may prevent them from denying it later. Jacqueline Sangster v Biddulph and Haw 2005 [2005] PNLR 33, [2005] EWHC 658 concerned a negligence action taken by S, who was one of the victims of a scam, against a firm of solicitors that had acted for a fraudulent mortgage broker. H had tried to avoid liability on the basis that he was not a partner in the firm of solicitors. An agreement had been signed entitled 'Partnership Agreement', which described B as 'principal' and H as 'partner', and provided that H was entitled to a certain percentage of fees in relation to one particular client. H's name was on B's letterheads. At the time, H was a partner in another firm and had no direct involvement with B. It was agreed that the document did not create a partnership in law because H had no share in profits. However, it was held that the mortgage broker had induced S to retain B as her solicitors on the basis that they were a two-partner firm, H had held himself up as being a partner and was estopped (prevented) from denying that he was a partner in B at all material times.

However, the way in which the parties have described themselves is only one part of the story, and the courts will be willing to examine the nature of the relationship and how it is conducted in order to determine status. The agreement is only an indication of the relationship and, as in many areas of law, the courts are more interested in the substance of the arrangements than how the parties describe them.

HOW IS A PARTNERSHIP CREATED?

Normally, the courts will be guided by the contractual agreement between the parties, but the essence of a partnership is the continuing relationship, both personal and commercial. If the way in which the business is carried on is not indicative of a partnership existing, the mere fact that the parties have said it is will not be determinative, especially where one party is trying to manipulate the relationship to suit themselves in an underhand way, or to avoid some kind of legal liability.

In Train v DTE Business Advisory Services Ltd 2008, a former accountancy partnership adopted a corporate structure and traded through a group of limited companies, of which the former equity partners were shareholders and directors. One of the shareholders, Mr Train, resigned as a director and 'employee', and claimed that he had been unfairly constructively dismissed, but the employment appeal tribunal held, on the facts, that Train was a partner, not an employee.

On the other hand, in Protectacoat Firthglow Limited v Szilagyi 2009, an arrangement set up by PF Ltd, which required people working for the business to sign a document stating that they were partners providing services to the company, was a sham designed to disguise the fact that they were employees. The arrangement was forced on the employees who were paid in cash, and it had been set up for tax purposes and to benefit the employer.

A partnership has to be carried on 'with a view to profit', but this does not mean that profit must actually be made – only that this should be the intention. Thus, charitable or not-for-profit concerns cannot constitute partnerships.

Owning property in common or sharing of gross returns (as opposed to net profit) do not of themselves create a partnership. Except in certain specified cases, sharing of net profits of the business is *prima facie* evidence of partnership (s2(3)). However, the existence of a partnership is not evidenced by the opening of a bank account together. Elite Business Systems Ltd v Huw Price 2005 involved a father, P, who opened an account in his own name which his son could use, as he had no banking facilities and wished to set up in business dealing in mobile phones.

Without P's knowledge, the son stated in an agreement with Elite that his father was a partner in the business. The court found that P did not know of the representation so did not hold himself out as being a partner, the bank account did not indicate that he was, and opening the account was not enough to create a partnership.

LEGAL IMPLICATIONS

Under English law, a general partnership has no separate legal personality, which means that it cannot make contracts, or own assets or grant security over them as a legal entity. This is unlike a limited partnership, which is a legal person. However, court rules now permit general partnerships to be sued and to sue in the firm name.

WHEN DOES A PARTNERSHIP START?

The act sets out rules for determining the existence of a partnership (s2). The actual date of commencement is not always easy to determine but may be important – for instance, in considering the tax position or the power of partners to bind each other. For example, in Miah v Khan 2001, the parties had agreed to form a partnership to run a restaurant in Reading, Berkshire. They fell out before it opened. No bookings had been taken and no food bought, but they had acquired, converted and fitted out premises. The House of Lords (now the Supreme Court) found that as the parties had embarked on the business, a partnership had come into existence, even though trading itself had not commenced.

Professionals should make it clear to clients that if business activity begins before the commencement date stated in their partnership agreement, the partnership may have started then and not on the stated commencement date. Where they know this to be the case, the partners should consider giving an indemnity to any partner who entered into a contract for the benefit of the partnership before the commencement date, with their express or implied consent. This would be given in return for an acknowledgment by the partner concerned that the contract is held for the benefit of the partnership.

WHO CAN BE PARTNERS?

Partners can be individuals or companies. Spouses can be partners, and this can be particularly important as regards taxation. HMRC may, however, seek to establish that the arrangement is a sham if one spouse plays no active part in the running of the business and has not invested in it.

As a partnership has no legal personality, it cannot become a partner in another firm. If it purports to do so, all its partners will become the partners in the other firm.

HOW LONG WILL THE PARTNERSHIP LAST?

Partnerships may be for a fixed term, in which case they are automatically dissolved when that term expires. Where they are set up to undertake a particular activity or project – for example, the renovation and sale of a house – then they will terminate when the project is complete.

Partnerships at will or for an indefinite term can be terminated at any time by notice given by any partner to the others (ss26(1) and 32(c)), unless the partnership agreement specifies otherwise. This is one of the main reasons for having a partnership agreement, because if these sections apply and no alternative arrangement is made, then any one partner can bring the whole thing to an end immediately, at will.

The courts have been quite ready to find an alternative intention, and almost any provision in the partnership agreement relating to the termination of the partnership will have the effect of displacing those sections. For example, in Moss v Elphick 1910 1 KB 846, it was sufficient that the agreement stated that it could only be terminated by mutual consent.

WHAT NAME CAN THE PARTNERSHIP CHOOSE?

Generally, the partners can choose any name for the partnership, although, like all businesses, they must beware a 'passing-off' action. To avoid this, they must not choose a name that is so similar to another existing business that it causes confusion in the minds of potential customers or clients.

If the name of the business is different from those of all the partners, it is subject to the same rules as companies under part 41 of the Companies Act 2006. For example, the partners must not choose a name that is offensive or sensitive, or suggests a connection between the business and government, or a link with certain professions or institutions. Where this part of the Companies Act applies, partnerships must state the names of each partner (and an address in the UK at which each may be served with any documents) on all business letters, written orders for goods, invoices, receipts and written demands for payment. This requirement does not apply to partnerships of more than 20 people, provided that those documents state that a list of all partners is available at the address of its principal place of business, which also has to be stated. In the case of these larger partnerships, the partners must either choose one approach or the other; these documents must state the names of all the partners, or none of them.

The capital of the partnership

The capital of a partnership is a fixed sum whereas the value of its assets may vary from day to day. It is important to distinguish between the two.

Where the act applies, partners are entitled to share equally in the capital of the business (s24(1)). This also applies to capital profits (including post-dissolution profits), as found in Popat v Shonchhatra 1997. This is another key reason to have a partnership agreement; if the partners' contributions are not equal in terms of capital, they will need a specific agreement about the share of capital and profit to which each is entitled.

The partners are not entitled to interest on capital unless there is an agreement to the contrary, unless a partner is making an additional contribution above and beyond what was originally agreed, in which case they are entitled to interest at the rate of 5% per annum from the date of the advance (s24(3)).

The partnership agreement should state the amount of fixed capital originally introduced by each partner, and this may be adjusted as sums are added or withdrawn. Clarity on this is important because profits earned by a partner may be capitalised by being transferred from their current account. Partners may also decide to capitalise all or part of increases in value of assets, particularly when they are deciding to admit new partners and assets are valued at that time.

The case of Hopper v Hopper 2008 is very interesting on the issue of capital and the role of the accountant. It involved a dispute between members of a family who had run a fruit and vegetable business for many years. The partners were two couples: Mr and Mrs Hopper Sr and their son

and daughter-in-law. There was no written agreement, which meant that the business was treated as a partnership at will, and it had been agreed that each of the four family members involved was entitled to 25% of the profits per annum. The parties fell out following the automatic dissolution of the partnership on Mr Hopper Sr's death in 2003. Mr and Mrs Hopper Sr had never withdrawn the whole of the profit to which they were entitled.

One of the many issues that arose was whether that undrawn profit was capitalised, and therefore whether Mrs Hopper Sr had a right to the accumulated sums, which she and her husband had left in the business over many years.

The appeal court judge noted that partnership capital cannot be increased or withdrawn without the agreement of all the partners, otherwise it can only be recovered at dissolution. On the other hand, partnership profit belongs to the partner as of right and can be withdrawn as soon as it is credited, or can be left as a balance on the current account, or can be added to the partner's capital.

A claim for undrawn profit or capital expires after six years, but in relation to capital, time starts to run only on the date the partnership is dissolved, whereas with profit it is on the date that it is credited to the partner's account. Therefore, if the judge concluded that the parties had agreed to capitalise the profit, Mrs Hopper Sr would be unaffected by the six-year limitation period and had a right to claim the whole balance of capital, but if it was concluded that it was undrawn profit, it was too late for her to be able to recover most of the undrawn money.

The decision was to some extent determined by the accounting treatment of accumulated profit, in that undrawn profit was added to the capital account each year. In fact, the accountant did not retain separate current and capital accounts at all. In deciding whether the parties had expressly or impliedly agreed to capitalise profit, the appeal court decided that the judge had been entitled to conclude that this was evidence of the parties' intention to treat accumulated sums as capital, and Mrs Hopper Sr's claim was successful.

Partnership property

S20(1) states that 'partnership property' includes 'property originally brought into the partnership stock or acquired…for the purposes and in the course of the partnership business'.

It is important to specify what property belongs to the partnership and what belongs to individual partners because:

- In the event that the partnership becomes insolvent and individual partners are bankrupt, there are two sets of creditors: the joint creditors of the firm and the separate creditors of the individual partners. The partnership assets are applicable in the first instance to pay the partnership's creditors (in priority to a partner's individual creditors) with any unpaid balance of those creditors being met out of the partners' individual estates. By contrast, both sets of creditors rank equally with respect to the partners' individual estates.

- Where partnership property increases in value, the increase belongs to the firm. Where the asset is owned by an individual partner, that increase will generally belong to the individual partner.

- A partnership does not have a separate legal personality and it cannot own assets in its own name. Therefore, property is normally held in the name of individual partners who hold as trustees for the partnership. There is a presumption that partnership property is held by partners as tenants in common and not as joint tenants. This can be varied by agreement so that partners can create a beneficial joint tenancy.

It is quite common for the business to occupy premises owned personally by one of the partners, or for partners to allow the business to use assets that belong to them personally. It is really important that there is a clear agreement about which assets are personal and which are partnership assets, and what the terms of the use or occupation are, eg rental, hire cost, return of assets to partner.

Normally, the accounts of the partnership will make clear what are and what are not partnership assets, but it is preferable that the matter is covered by explicit agreement, as there have been occasions when the courts have not accepted the evidence of the accounts. In Barton v Morris 1985 1 WLR 1257, a man and woman who were unmarried but cohabited bought a farm that they held as joint tenants. They lived at the property and carried on a partnership, but without a written partnership agreement. The woman died in an accident and she had no will. If the farm had become partnership property, this would have terminated the joint tenancy, and the value of her share would pass to relatives in accordance with intestacy rules. If it had not, her partner would become solely entitled as a survivor as a result of the joint tenancy. The High Court held that though the farm was shown as a partnership asset in the draft accounts, it had not been made partnership property.

PROFITS AND LOSSES

The act provides that all the partners are entitled to share equally in the profits of the business and must contribute equally towards the losses, whether of capital or income (s24(1)). Capital profits are 'profits' for these purposes, which applies equally both before and after the dissolution of the partnership. (See the decisions in Popat v Shonchhatra 1997 (above) and in Gill v Sandhu 2005 where, after a partnership had been dissolved, each partner had an interest in all the profits derived from the partnership assets.)

The act applies in the absence of contrary intention, so it is likely that the partners will want to alter the default provision in their agreement. Frequently, where one or more partners are taking responsibility for the lion's share of the work in the business, the partners will want the profit share to reflect this. Where a partner has contributed most of the capital, it might well be desirable to share capital profits in different ratios to income profits. The share of capital profits might also be apportioned depending on the length of time that the partner has been in the firm, with the assumption that the value has accrued over a period of time. It may also be that more senior partners take a greater share of profit in return for limiting the liability for losses for more junior partners.

There are many ways of providing for shares of profit to vary, and this is common in professional firms of various sizes. For instance, partners may obtain a fixed percentage increase in their share for each year they are members of the firm (lockstep). Alternatively, shares may be subject to variation by the decision of a management committee elected by the partners or by a vote of the partners (often by a specified majority, such as 75% of the votes) in the light of performance reviews. This latter approach is common in larger firms.

It is important to determine any special rules by which profits or losses are to be calculated, especially if these vary from generally accepted accounting principles in the UK. The partnership agreement will need to deal with:

- expenses incurred by the partners
- any fees or other payments to partners from appointments held by them or work done outside the partnership
- any interest payable on the partners' capital accounts
- any prior share of profits paid to any partner, which will be deducted from the net profits before they are divided. If so, will the prior shares be reduced if profits are insufficient to cover them all (and how will such reduction be allocated between the partners?), and will they be paid at all if the partnership makes a loss? If they are not paid, will the right to a prior profit share be carried forward and be made prior to the division of net profits in the next accounting period that there are profits available for division? Which will take priority: interest payments on capital or prior shares of profits?

ACCOUNTS

There is no express requirement under the act for the partnership to prepare accounts in the normal sense, so the partnership agreement should expressly provide for a balance sheet and profit-and-loss account to be drawn up in respect of each accounting period.

The act does require the partners to render true accounts and full information in matters affecting the partnership to any partner; s28 and s24(9) refers to partnership books being kept at the place of business. There is an implication under the act, therefore, that books of accounts will be kept and that some form of accounts will be produced.

The partnership must have accounts for the purposes of tax in any event. The accounts do not have to be audited.

Relationship between partners and outsiders

S5 of the act provides that every partner is an agent of the firm for the purpose of the partnership business. This means that the partner can bind the firm in respect of any commitments they enter into in the usual course of business. A single partner has authority to do most everyday business transactions, eg hiring and firing of staff, buying and selling goods and drawing cheques or equivalent.

It has been held that a single partner does not have authority to execute deeds, grant a guarantee on behalf of the firm or authorise a third party to use the name of the firm. Neither can a partner pledge the firm's credit in relation to a purpose apparently not connected with the firm's normal business, without the authority to do so. The individual partner giving that commitment will remain personally liable.

The extent to which partners are liable for each other's acts varies depending on the kind of act in question.

- Partners are jointly responsible for the contractual debts of a partnership (s9). If a creditor obtains judgment against one, or a number of the partners, this will not discharge the others, but if they enter into a compromise with the defendant partner(s), this will operate to release the other partners.
- The estate of a deceased partner has several liability for the debts of the firm to the extent that they are not otherwise satisfied (s9). Several liability means that they are liable only for their portion of the debt.

Where a partner is liable for wrongs, such as torts, and is acting in the ordinary course of business or with the authority of the other partners, liability is joint and several. The partners will be jointly and severally liable for fraudulent and negligent acts that are carried out by any other partner(s) in the course of business. This means that each partner is potentially liable for the whole debt, and the claimant can sue all the partners or one partner at a time until the liability is satisfied.

McHugh v Kerr 2003 involved the liability of partners for fraud committed by the senior partner, who misappropriated the proceeds. The defendants were partners in an accountancy practice, and their senior partner, G, committed a series of frauds against a client by forging her signature on five stock transfer forms for the sale of shares in a company (W). The forms were sent to a stockbroking firm; the London Stock Exchange asked the brokers to confirm the genuineness of the signatures, which they did. The sale of the shares was registered, and G received the proceeds. The client claimed its losses against W, which settled and then sued the stockbrokers, who then pursued the accountancy firm. The firm argued that the forged signatures were not in the ordinary course of the firm’s business.

It was held that there was no prospect of the firm arguing this successfully; it was part of the business of any accountancy firm to buy and sell shares on behalf of clients, and this is what had happened. G was guilty of fraudulent misrepresentation and his partners were liable to the same extent. Where the partner acts within their apparent authority and receives property or money from a third party and misapplies it, liability is joint and several. The same would be true where the firm receives funds that are misapplied by another partner while the firm is in possession of them.

RELATIONSHIP BETWEEN PARTNERS

s24: default terms

The following applies subject to the partners agreeing to the contrary:

- an entitlement to share capital and profits equally (s24) (dealt with above)

- an obligation on the firm to indemnify every partner in respect of payments made, and liabilities incurred by them, in the course of the firm’s business or ‘necessarily done’ in preserving the business or property of the firm (ss 24(2)(a) and 24(2)(b))

- an entitlement to interest on advances to the partnership (s24(3))

- a requirement that every partner take part in the management of the partnership (s24(5))

Under s24(8), in relation to ordinary matters connected with partnership business, decisions are made by a majority of the partners. Any change to the nature of the partnership business needs the consent of all the existing partners. In practice, this provision is often altered – for example, voting can be in proportion to entitlement to partnership profits rather than per capita.

In equity, partners owe to each other fiduciary duties, ie:

- a duty of the utmost good faith – that is, to act honestly towards the other partners
- to act for the benefit of the partners as a whole
- not to put themselves into a position where their duty to the firm and their own interests conflict
- to make full disclosure of any fact relevant to the partners and not to make an unauthorised personal profit. This also applies to negotiations leading to the partnership being set up and is still owed by an outgoing partner to the partnership, after a dissolution, until the firm is wound up
- to account for any benefit derived from any transaction concerning the partnership, which is made without the consent of the other partners, or from any use by a partner of the partnership property, name or business connection for his own benefit s29(1)
- to account for all profits made by a partner from carrying on any business of the same nature as and competing with that of the firm, without the consent of other partners

Broadhurst v Broadhurst 2006 was a good example of a failure to fulfil these duties when one partner in a car import business, P, promised to ensure that cars bought by the other, M, were imported, registered in the UK and sold. When cars were impounded due to P's private debts, he was only able to sell some and did not remit the full proceeds to M, keeping some for costs and expenses. The cars should not have been impounded and he should have remitted all income. He was liable for breach of duty and to account for profits he made selling some spare parts, keeping a deposit for a car and wrongly converting a car for his own use.

An odd exception to the principle is that a partner is permitted to buy the share of another partner of the firm without making prior disclosure to the other partners.

Maternity, paternity, adoption and parental leave and pay

Partners are not entitled to statutory maternity and paternity leave and other family-friendly rights, since they are not employees. Firms can, though, adopt equivalent or enhanced provisions as a matter of contractual arrangement between the partners.

Admission of new partners

Admitting a new partner requires the unanimous consent of the other partners (s24(7)) unless otherwise agreed. If a new partner is admitted, then the new partnership will be a partnership at will, unless the existing agreement caters for the admission of new partners and they agree to be bound by its terms.

An incoming partner does not take on liability for anything done before they were admitted (s17). It is usual for new partners, as between themselves and the continuing partners, to agree to take on the existing liabilities of the firm.

New partners will not be liable for old debts unless there has been an express novation. In Burton Marsden Douglas 2004, Marsden and Douglas entered partnership with a sole practitioner, Burton, and the name of the firm was changed to reflect this. At the time, Burton had been engaged for some time in the administration of an estate in which the Guide Dogs for the Blind and some other charities were beneficiaries. The client was never officially told that the status of the firm had changed, although they had been told orally. The work took 18 months to complete, during which time Burton took money on account of costs from the estate but without delivering interim bills. At the end, he rendered a bill in the firm's name which corresponded with the amount he had taken, and left the partnership. The client lodged a request for a detailed assessment of the bill.

It was held that 'special circumstances' would have to be shown in order for the new firm to be treated as having taken over the debts and obligations of the old one. One of these was that there had been an express novation as regards existing liabilities. The mere entry into a new partnership did not constitute this. Marsden and Douglas were not liable to repay any of the money taken in costs in excess of entitlement and without authority.

OUTGOING PARTNERS

The following sections deal with situations where a partner retires, dies, goes bankrupt or is expelled from the partnership, or where the partnership ends in some other way. A formal agreement dealing with this is critical, since the act makes no provision for how this is to be dealt with. A great many matters need to be covered, in particular the drawing up of accounts, the valuation and distribution of assets, and the allocation of liabilities.

Retirement

A partner has no right to retire from the partnership (that is, leave the partnership) other than:

- where the agreement allows for retirement, or
- with the consent of all the other partners, or
- in the case of a partnership at will, by giving notice under s26 or 32(c), which will have the effect of dissolving the partnership

It used to be common to provide for compulsory retirement in partnership agreements, but the law that came into force on 1 October 2006 made age discrimination unlawful, and this applies to partnerships. (All discrimination provisions are now contained in the Equality Act 2010.) Therefore, any provision in a partnership agreement that requires a partner to retire at a certain age is potentially discriminatory, unless it can be objectively justified.

To avoid claims, firms will have to identify the aim(s) that they intend to achieve by fixing a retirement age, that they are legitimate objectives, and that compulsory retirement is a proportionate means of achieving them.

The issue of objective justification of direct age discrimination against partners has been considered by the tribunal in Bloxham v Freshfields Bruckhaus Deringer 2006. Here, it was found that transitional changes to a pension scheme put in place for partners over 55 were directly discriminatory on grounds of age but were justified because reform of the pension scheme was a legitimate and necessary aim, and the firm was able to show that the means used to achieve that aim were proportionate.

Seldon v Clarkson Wright and Jakes 2014 was the culmination of long-running litigation arising from the compulsory retirement of Mr Seldon from the partnership at the age of 65, in accordance with provisions in the partnership agreement. The Supreme Court ultimately held that the objectives that the firm put forward for the policy were legitimate aims, ie retention of younger solicitors, workforce planning and 'congeniality', meaning that they did not have to performance manage a colleague in later life. The court remitted the question of whether retirement at that age could be justified as a proportionate means of achieving that, and ultimately the courts decided that it was.

A partner retiring from the firm remains liable as regards the outside world on the commitments entered into by the partnership up to the date of retirement, but it is normal for continuing partners to give the retiring partner an indemnity against this liability, at least in relation to matters that do not arise from their own wrongful acts or omissions, where these are not covered by insurance.

Death and bankruptcy

Under the act, the estate of a partner who dies, becomes bankrupt or retires from the firm, and was not known as a partner by the person dealing with the firm, is not liable for partnership debts contracted after the date of the death, bankruptcy, or retirement (s36(3). The partnership agreement will usually provide an indemnity for future debts. Sometimes, firms will give an additional indemnity for debts that arise out of actions carried out before the leaving date. Such an indemnity will usually exclude any debts that are incurred as the result of any fraudulent (or negligent) acts of the outgoing partner, and their personal tax, and may not extend to outgoing partners who are expelled. If such an indemnity is given, then the continuing partners may be required to carry appropriate insurance.

Under s33(1) of the act, every partnership is dissolved by the death or bankruptcy of any partner. In practice, the partnership agreement normally makes provision for the partnership to continue after the death of any partner. A partnership may be dissolved if any partner allows their share of the partnership property to be charged for their separate debts, if the partners choose to provide this.

Expulsion

There is no power for a majority of partners to expel any partner unless it is included in the partnership agreement (s25). The agreement can provide for expulsion on notice with or without grounds and/or to expel where there is a particular ground for expulsion. In any event, the power to expel must be exercised in good faith for the good of the firm and not to secure a collateral advantage.

Expulsion is not allowed if it constitutes unlawful discrimination by reason of sex or gender reassignment, or on grounds of race. In Dave v Robinska 2003, one partner in a two-partner medical firm was able to take action for sex discrimination when one partner gave notice to the other, who was pregnant, to terminate the partnership because of this fact. This case highlights

the fact that protection from discrimination based on pregnancy or maternity gives partners and prospective partners the same rights against the firm as an employee or prospective employee would have.

Common grounds for expulsion of a partner include breaches of the partnership agreement, ceasing to hold relevant professional qualifications, conduct having an adverse effect on the partnership business, poor performance of duties and ill health. On this latter point, care must also be taken not to breach the disability discrimination legislation.

Provisions for outgoing partners

The partnership agreement should contain detailed provisions dealing with the position of outgoing partners. Normally, accounts would be prepared, as at the leaving date, on a similar basis to the normal partnership accounts. The outgoing partner is then entitled to be paid the amount due to them as shown in the current and capital accounts. Often, payment is made by instalments, to assist the continuing partners in financing the payment to the outgoing partner.

Any special provisions relating to the leaving accounts need to be included in the agreement. In particular, it should cover whether or not assets are to be revalued and whether goodwill is to be included. A mechanism needs to be established for any special treatment of assets in the leaving account – for example, the revaluation of property being evidenced by the certificate of an appropriately qualified valuer.

As an alternative to leaving accounts, payment to the outgoing partner can be calculated with reference to the accounts prepared for the accounting period during which the outgoing partner leaves, with their share of profits being based on a time-apportioned part of the profits for the whole period, up to the leaving date.

For convenience, partnership agreements often provide that notice to leave, given by a retiring partner, has to expire on the last day of an accounting period.

The partnership can also obtain and finance ‘key person’ insurance on the lives of all or any of the partners. The proceeds of such policies are retained by the partnership and may be used to enable it to recruit suitable new partners to replace the deceased one.

A person dealing with a firm, after a change in its membership, is entitled to treat all apparent members of the old firm as still being members, until they have notice of the change. Where the firm is established in England and Wales, an advertisement in the *London Gazette* is sufficient notice to persons who have not had dealings with the firm before the date of the change. Anyone who has had dealings with the firm before a partner retires must be specifically notified of the change, to ensure that the retiring partner does not incur any liability for the firm’s post-retirement dealings.

A retired partner and the estate of a partner who dies or becomes bankrupt remain liable for the debts incurred up to the date of ceasing to be a partner.

Post-termination restrictions

Unless partners otherwise expressly agree, once partners have left the firm, they are free to establish another business of a competing nature as close to the firm's premises as they like. They can also provide services to former customers or clients. However, they cannot solicit

existing clients of the firm, so damaging the goodwill, as this is now the property of the continuing partners.

In addition, a former partner cannot represent themself as carrying on business as a successor to the firm or use a similar name. Even if their name was or formed part of the firm name, they can be restrained from using it, if they are trying to mislead customers.

Because of the very limited protection given to the ongoing partnership, it is normal to include specific covenants in the partnership agreement, to prevent the outgoing partner dealing with all or some of the clients or customers of the firm for a period after they have left. In certain cases, there may be a bar on engaging in a competing activity within a defined geographical area for a period of time. The enforceability of such covenants is governed by the rules regarding restraints of trade, and the party seeking to use the clause will have to prove that the covenant is reasonably necessary for the protection of the goodwill of the ongoing business of the firm.

Generally, clauses in partnership agreements are easier to enforce than those contained in employment contracts. The reasoning behind this is that an equity partner does not merely leave a partnership as an employee does; they effectively sell their share in the partnership and its goodwill as a business person. Whether or not payment is made for the goodwill is not relevant to the enforceability of the covenant. Further, having benefited from the covenants during their time as equity partners, the courts are reluctant to allow partners to then seek to avoid them when leaving.

Although the characterisation of the relationship between the parties (employer/employee, vendor/purchaser) is relevant in determining the enforceability of restrictions, the true test of enforceability is whether the legitimate interests of the party trying to enforce the restriction are protected by them.

Post-dissolution, where a partner goes off and sets up another firm, they will have to get written authority from clients to transfer their files to that firm, otherwise the other partners will be entitled to delivery up of those files. (See Ingram v Keeling and MK Legal Solicitors 2006 EWHC 2325.)

DISSOLUTION

This can take place by

- unanimous mutual agreement (s19)
- the exercise of an express power set out in the agreement (which could be by way of a majority agreement)
- rescission for fraud or misrepresentation
- the occurrence of an event specified in the act, for example:
    - expiration of a fixed term or the end of the venture for which the partnership was established or, if the partnership was entered into for an undefined time, by any partner giving notice (s26(1) and s32(c))

    - by bankruptcy or death of a partner, or a charge being created on a partner's share in the partnership property for payment of their separate debts (s33)

    - by an event making it unlawful for the business of the firm to be carried on or for the members to carry it on in partnership (s34)

    - dissolution by the court (s35). This can be on grounds of permanent incapacity, conduct by a partner calculated to prejudice the carrying on of the business, deliberate or persistent breach of the partnership agreement by a partner, the partnership business only being carried on at a loss, or on the grounds that a dissolution is 'just and equitable'

The right to terminate by notice and automatic termination by death or bankruptcy can be excluded by express or implied agreement. Termination when a partner allows their share to become charged is at the option of the other partners, acting unanimously.

If a partnership is insolvent, its dissolution may be ordered under the Insolvency Act 1986. The court cannot make a dissolution order where there is an administration order in force or a pending application for an administration order.

Winding up

Following a general dissolution, the next step is to wind up the business – to get in and value all the assets, pay off partnership debts and distribute the surplus to the former partners). After dissolution, each partner continues to have authority to bind the firm so far as is necessary to wind up the affairs of the partnership and to complete any work undertaken prior to dissolution (s38).

Under the act, every partner is entitled to have the partnership property applied in payment of all debts and liabilities of the firm, and to have any surplus divided between the partners in accordance with their respective entitlement (s39). Any sums due from a partner to the firm are deducted from what they would otherwise be entitled to be paid.

The rules governing the final settlement of accounts between the partners are contained in s44 of the act and apply subject to any contrary agreement. The rules are that:

- Losses (including capital losses) are paid first out of profits, then out of capital and lastly, if necessary, by the partners individually in the proportion in which they were entitled to share profits.

- The assets are applied:

    - in paying the debts and liabilities of the firm owed to non-partners, then

    - in repaying to each partner rateably any advances (as opposed to capital) made by them to the firm, then

    - in paying each partner (rateably) what is due to them from the firm in respect of capital

Any residue is then divided between the partners in the proportion in which profits are divisible.

If, after paying all debts and liabilities, there is a surplus but not enough to repay all of the partners' capital, the amount of capital that cannot be repaid will be treated as a loss that will be divided between the partners in the proportion in which they are entitled to share the profits.

If a partner is insolvent and therefore unable to contribute to the loss of capital, the solvent partners do not have to make up any shortfall (so the trustee in bankruptcy of the insolvent partner cannot obtain any further assets this way). This means that there will be less capital available for distribution (being the surplus and the notional contributions from the solvent partners only) and this will be distributed according to capital entitlement.

APPENDIX

CHECKLIST OF MATTERS TO INCLUDE IN A PARTNERSHIP AGREEMENT

This is not exhaustive, and it is essential that partners obtain specific legal advice in relation to their particular business and in the context of their personal circumstances. This list is useful in establishing a baseline of matters to be discussed:

- name of partnership
- date of commencement of partnership
- indemnity for partners who have incurred expense or taken on obligations in setting up the business prior to that date
- duration of partnership, eg fixed term, to complete a particular project, or indefinite in length
- notice required for partners to bring partnership to an end
- fact that this notice, or death of a partner, will not bring about automatic dissolution of the partnership
- capital provisions
    - how much is to be brought in by each partner and how it is constituted, eg assets or cash
    - whether interest on capital is to be paid, and/or interest on additional capital contributed, and, if so, at what rate
    - whether capital is to be held in a separate account for each partner
- partnership property
    - which property to be used by the business is partnership property and which is acknowledged to be personal property of the partner(s) (if any)
    - terms of use of any personal property used in the partnership or reference to separate written agreement detailing this
    - treatment of sums on revaluation of partnership property
- share of profits and losses
    - treatment of capital profits both before and after dissolution
    - treatment of income profits

  - treatment of expenses incurred by partners

  - how are fees paid to partners for external appointments or work done outside the business to be treated?

  - any priority in payment of profit share to any partner(s)

- the provision of insurance protecting the partnership, eg business interruption, key person insurance

- agreement as to preparation of partnership accounts, who by, when prepared, what format etc

- any limitation on the authority of partners to transact business, sign documents or incur expense on behalf of the partnership

- management of the partnership – details about how the business is to be run, how regular meetings should be, voting rights as between partners etc

- arrangements for admission of new partners

- how a partner retires from the business, including notice to be given, and any indemnity to be provided to the retiring partner

- any circumstances that would bring about an automatic dissolution of the partnership

- circumstances that would allow the partners to expel another partner, eg what situations, what proportion of partners would need to vote for this

- provisions covering ill health, eg critical illness insurance

- the procedure following retirement, expulsion etc in relation to leaving accounts, liability and indemnity of outgoing partners, order of allocation of losses and of profits

- post-termination restrictions for outgoing partners

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