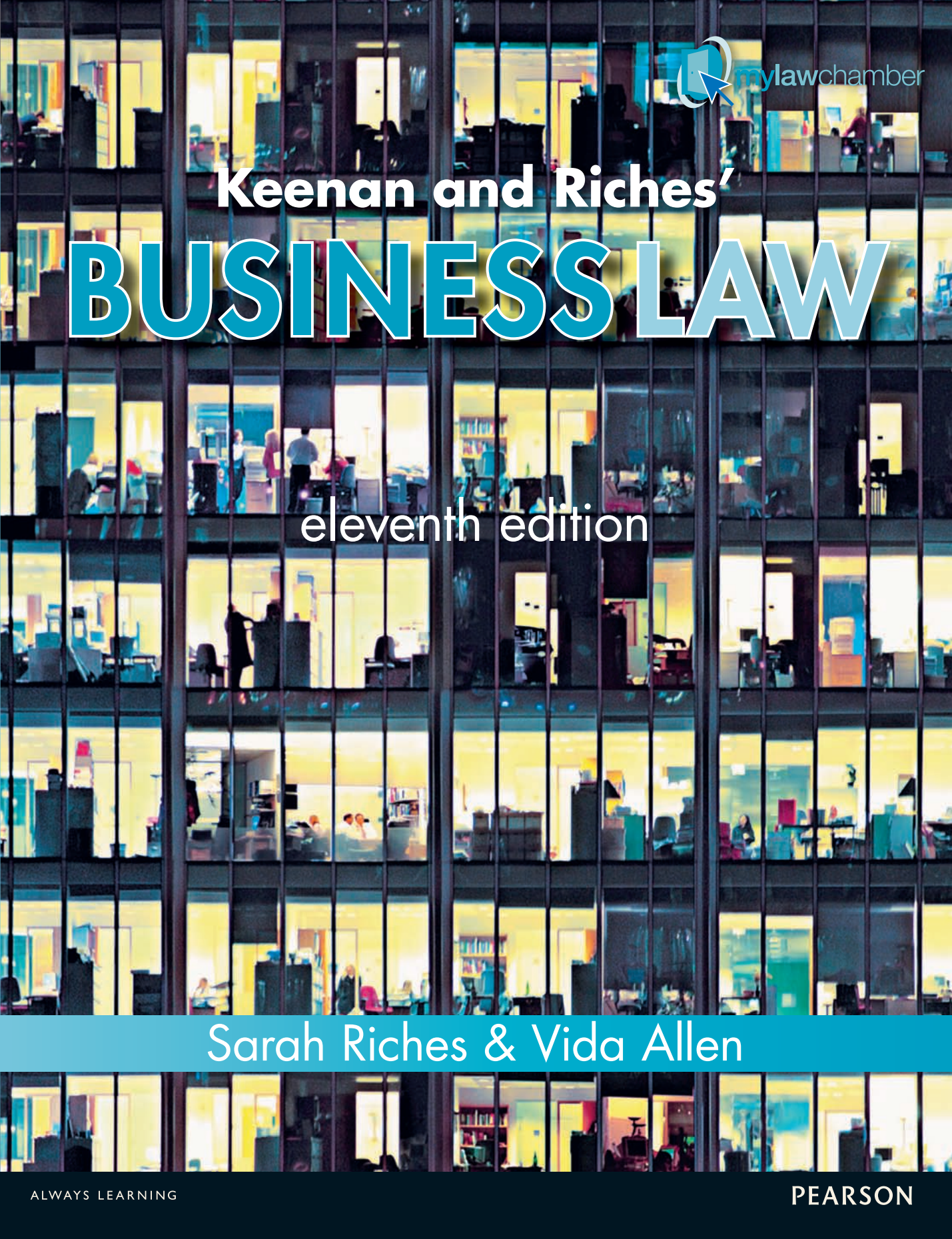
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BUSINESS LAW

***Re H S Smith and Sons* (1999)**

H S Smith and Sons was a family farming partnership comprising Harry Seabrook Smith, Frances Smith and their son Ivan Smith. The firm was unable to pay its debts and applied to the court for an administration order. The application stated that the appointment of an administrator would be likely to achieve the survival of the firm. However, the difficulty was that under the rule of joint and several liability of partners for the debts of the firm Harry Smith could comfortably afford to pay off the firm's debts. Did this prevent the court from making an administration order?

The court has a discretion whether or not to make such an order and the judge exercised that discretion by making the order. Although the creditors would have had full recourse against Harry Smith, the firm itself was unable to pay its debts. The making of the order would, said the judge, hold off creditors from petitioning the court to wind up the firm and give Harry Smith time to recapitalise the partnership. In this way the business would survive as a going concern.

As a result of amendments to the Insolvent Partnerships Order 1994, partnerships can use the out-of-court appointment of administrators procedure set out in amendments made to the Insolvency Act 1986 by the Enterprise Act 2002. The partners or a majority of them are able to use the out-of-court route into administration in addition to the route into administration by means of a petition to the court for an administration order. They also have the advantage of the revised purpose of administration which gives primary weight to rescuing the partnership as a going concern. The out-of-court procedure mirrors that for corporate appointments set out in Chapter 6 ➡.

Winding-up by the court

Under Art 7 any insolvent partnership may be wound up by the court (there is no provision for voluntary winding-up) under Part V of the 1986 Act (as modified by Sch 3) where no concurrent petition is presented against the partners. They become contributories to the full amount of the firm's debts. Before the court has jurisdiction, the firm must have carried on business in England and Wales at some time within the period of three years ending with the day on which the winding-up petition was presented.

A petition against the firm may be presented by a creditor or creditors and also by the liquidator or administrator of a corporate member of the firm or former corporate member. Also included are the administrator of the firm, a trustee in bankruptcy of a partner or former partner and the supervisor of a relevant voluntary arrangement.

The grounds are set out in s 221 of the 1986 Act as modified and set out in Sch 3. Of these, inability to pay debts will be the usual creditor ground but there are others, e.g. cessation of business and just and equitable ground, but in all cases the firm must be insolvent. Inability may be proved under s 222 of the 1986 Act (as modified and set out in Sch 3) by serving a written demand on the firm requiring it to pay a debt or debts exceeding £750 then due and the firm does not pay, secure or compound the debt within three weeks of service.

Application of Company Directors Disqualification Act 1986

Where there is a winding-up of the firm by the court, each partner is deemed an officer and director of the firm. If the court is satisfied that they have not run the firm responsibly, the partners could be disqualified as unfit to act as a director or in the management of a company (registered or unregistered (i.e. a trading partnership)) for up to 15 years. Article 16 and Sch 8 apply.

Ordinary limited partnerships

Generally

The Limited Partnerships Act 1907 provides for the formation of limited partnerships in which one or more of the partners has only limited liability for the firm's debts. These partnerships are not common because in most cases the objective of limited liability can be better achieved by incorporation as a private company. However, they are increasingly used by institutional investors, such as insurance companies and pension funds, that are wholly or partially exempt from tax. These investors can, through the medium of the limited partnership, invest jointly with other investors who are liable to tax without losing their own tax status. Limited partnerships are also used extensively by venture capitalists.

A limited partnership is not a legal entity but can have an unlimited number of members. There must also be one general partner whose liability for the debts of the firm is unlimited. A body corporate may be a limited partner.

The reforms introduced by the Legislative Reform (Limited Partnerships) Order 2009 (SI 2009/1940) came into force on 1 October 2009. Articles 4 to 7 of this Order form a series of new sections to be inserted in the 1907 Act in place of s 8 concerning registration.

Registration

Every limited partnership must be registered with the Registrar of Companies. A certificate of registration will be issued.

An application for registration, as set out under the new s 8A, must:

- specify the firm name, complying with the new requirement as set out under s 8B, ending with 'limited partnership';
- be signed or otherwise authenticated by or on behalf of each partner;
- be made to the Registrar for the part of the United Kingdom in which the principal place of business will be situated; and
- state where the principal place of business of the limited partnership is to be situated.

Information concerning the general nature of the partnership business, the name of each general partner or limited partner and the amount of his capital contribution will also need to be set out.

Any change in the above particulars or the fact that a general partner becomes a limited partner must be notified to the Registrar within seven days. Failure to register means that the limited partner is fully liable as a general partner. When a general partner becomes a limited partner, the fact must be advertised in *The London Gazette* if the transaction is to be effective in law.

The Register of Limited Partnerships is open to inspection by the public who may also obtain certified copies of, or extracts from, any registered statement.

Rights and duties of a limited partner

A limited partner is not liable for the debts of the firm beyond his capital, but he may not withdraw any part of his capital and, even if he were to do so, he would still be liable to the firm's creditors for the amount he originally subscribed.

A limited partner has no power to bind the firm and may not take part in its management. If he does manage the firm, he becomes liable for all the liabilities incurred by the firm during that period. Nevertheless, he may give advice on management to the other partners and he may also inspect the books.

The death, bankruptcy or mental incapacity of a limited partner does not dissolve the partnership and a limited partner cannot dissolve the partnership by notice.

In addition, any question arising as to ordinary business matters may be decided by a majority of general partners, and a new partner can be introduced without the consent of the existing limited partners.

Limited liability partnerships

We have now completed our study of the ordinary partnership and the ordinary limited partnership. Quite a lot of material is involved and the reader may wonder whether in view of the changes to be introduced by the new limited liability partnership it is worth looking at the older forms of business organisation. The answer has to be yes because the newer limited liability arrangements are designed mainly for the professional firms of lawyers and accountants who have for so long been liable to the full extent of their capital in the firm and personal property in meeting claims for negligence even though full indemnity insurance is not normally available. There are in the field of UK business many other partnerships consisting of trading firms and some small professional firms which, of course, can use the limited liability regime. However, many may feel that registration and the filing of accounts for public inspection and other central controls are not worth a measure of limited liability. These trading partners are not really at risk of the major claims for damages faced by professional firms. This plus sheer inertia will mean that a large number of somewhat informal partnerships will continue to exist and that those embarking on a career in business will need to be familiar with all three structures, i.e. the unlimited partnership, the limited partnership, and the limited liability partnership which may be used mainly by the firms of those in professional practice of one sort or another.

The Limited Liability Partnerships Act

The Limited Liability Partnerships Act 2000 received the Royal Assent on 20 July 2000. It effects a radical change in the liability of the firm and its partners, for those who adopt this new form of business organisation. The Partnership Act 1890 and the Limited Partnerships Act 1907 remain in force and the law relating to them is unchanged.

The main purpose of the Act is to create a form of legal entity known as a limited liability partnership (LLP). An LLP combines the organisational flexibility and tax status of a partnership with limited liability for its members. The LLP and not its members will be liable to third parties, but a negligent member's personal assets may be at risk.

Section 1. This states that an LLP is a legal person with unlimited capacity. Its members may be liable to contribute to its assets on winding-up.

Section 2. This deals with incorporation and requires at least two people to subscribe to an incorporation document to be sent to the Registrar of Companies. The contents of the incorporation document are dealt with – in particular, the situation of the registered office and the members on incorporation and whether some or all of them are to be 'designated members' (see below).

Section 3. This deals with the issue of a certificate of incorporation by the Registrar and provides that it is conclusive evidence that all requirements have been complied with.

Section 4. This deals with membership and provides that the members are those who sign the incorporation document or who become members by agreement with the other members. Cessation of membership is also by agreement.

Section 5. This is concerned with the relationship of the members, which is to be governed by any agreement between them or, failing such agreement, is to be governed by any provision in regulations to be made by the Secretary of State.

Section 6 states that each member of the LLP is an agent of it, unless he has no authority to act in a particular matter, although there are ostensible authority provisions, in that the outsider must, for example, be aware that there is no authority to act.

Of particular importance in terms of liability is s 6(4), which provides that where a member of an LLP is liable to any person (other than another member of the LLP) as a result of a wrongful act or omission of his in the course of the business of the LLP or with its authority, the LLP is liable to the same extent as the member. *This provision does not make other members personally liable*.

Thus, if in a firm of accountants one partner negligently prepares accounts for a client that to the knowledge of the firm are to be relied on, for example, by a person intending to make a bid for the business, the firm's assets will be liable to pay damages for negligence, but only the negligent partner's assets may be liable if the firm's assets are insufficient. The other partners may, therefore, lose their capital in the firm but no more. They are, however, liable to contribute to the assets of the firm if it is wound up because of non-payment of business debts.

In practice, the negligent member or partner will not often be personally liable to the third party for loss caused by his or her negligence. This personal liability will only occur when it appears from the circumstances that the negligent member was undertaking a personal duty to the third party. Provided all correspondence and dealings with the third party are clearly made by the negligent partner in the capacity of agent of the firm, then only the LLP's assets will be at risk. None of the members will have personal liability.

Section 7 gives a member's representatives, e.g. executors or trustee in bankruptcy, a right to receive amounts due to the member (or former member) but with no power to interfere in management.

Section 8. This deals with designated members who achieve such status by being specified as such on the incorporation document or by agreement with members. These members are required for certain compliance functions under the Act, e.g. notification to the Registrar of a name change.

Section 9 provides for the registration of membership changes.

Sections 10 to 13 are concerned with taxation. These clauses are expressed in broad terms to apply in general existing rules for partnerships and partners.

Sections 14 to 17 are concerned with regulation-making powers, and *s 18* deals with interpretation.

The Schedule is concerned with names and situation of registered office. These provisions are similar to those applying to companies.

Limited liability partnerships: the regulations

Detailed provisions contained in the Limited Liability Partnerships Act 2000 and regulations were made largely under the Companies 1985 Act. Accordingly, the LLP Regulations were brought up to date with the 2006 Act.

An LLP is required to display its name at its registered office, other places of business and on all business communications. It must also include its registration details in its letters (including those sent electronically), order forms and websites. These requirements are contained in the following regulations:

- Limited Liability Partnerships (Application of Companies Act 2006) Regulations 2009 (SI 2009/1804)
- Companies (Trading Disclosures) Regulations 2008 (SI 2008/495) (as applied to LLPs and as amended by the Companies (Trading Disclosures) (Amendment) Regulations 2009 (SI 2009/218)).

Accounts and audit exemption

The requirements of company legislation relating to the keeping and retaining of accounting records and the preparation and publication of annual accounts, the form and content of annual accounts and the audit requirement are applied to LLPs in the same way as to companies with the members of the LLP taking on the duties of directors and their responsibilities. There is, however, no need to prepare the equivalent of a directors' report.

A period of 10 months is given for delivery of the annual accounts to the Registrar of Companies from the end of the financial year. Small LLPs and medium-sized LLPs can take advantage of the provisions of the Companies Act 2006 in terms of abbreviated and modified accounts and the qualifying thresholds in regard to turnover, balance sheet total and number of employees are the same as the corporate thresholds. The usual company audit exemptions apply as do the dormant company rules apply to dormant LLPs.

The disadvantages of financial disclosure

One of the major disadvantages of the adoption of LLP status is the company-style financial disclosure. Even under the regime of abbreviated accounts, financial disclosure which is not required of other forms of partnership may make an LLP vulnerable to commercial pressure. Furthermore, where it is necessary to disclose the income of the highest paid member of the LLP (which is where the profit share of the member exceeds £200,000), there may be repercussions from clients, creditors and staff. The government is being pressed to remove the disclosure requirements and in general terms the company analogy is not perfectly made out because the disclosure, auditing and accounting rules in a company are largely to protect the shareholders against the directors. This is not the case with the members/managers of the LLP. United States LLPs do not have to disclose financial information at all, though some states do not permit the formation of LLPs.

Other provisions

- *Execution of documents*. Instead of the company rule of signature by a director and/or the secretary, it is provided that two members of an LLP are to be signatories for a valid document.
- *Register of debenture holders*. An LLP must keep a register of debenture holders (i.e. those who have lent it money) and the debenture holders have a right to inspect it.
- *Registered office*. The Registrar of Companies will receive notice of the address of the registered office and must be notified of changes.
- *Identification*. The name of the LLP must appear outside its place of business and on correspondence and on its common seal if it has one.
- *Annual return*. The regulations provide that an LLP must deliver an annual return to the Registrar of Companies and set out the requirements as to contents.
- *Auditors*. Subject to the applicability of the audit exemption rules, an LLP is, in general, required to appoint auditors. Provision is made for the Secretary of State to appoint auditors where an LLP is in default. The auditors have various rights including the right to have access to an LLP's books, accounts and information as necessary, the right to attend meetings of the LLP and certain rights in the event of being removed from office or not being reappointed. Provision is also made for the resignation of auditors and the making of a statement by a person ceasing to hold office.
- *Registration of charges*. An LLP is required to register charges with the Registrar of Companies. The relevant sections of the Companies Act 2006 apply.
- *Arrangements and reconstructions*. An LLP has power to compromise with its members and creditors.
- *Investigations*. An investigation of an LLP may be made following its own application or that of not less than one-fifth in number of its members.

- *Fraudulent trading*. This is punished in the case of an LLP in the same way as a company trading fraudulently.
- *Wrongful trading*. There are provisions relating to wrongful trading on the lines of the Insolvency Act 1986 provisions but with modifications to suit an LLP.
- *Unfair prejudice*. Schedule 2 to the regulations applies the Companies Act 2006 so that in general there is a remedy for the members of an LLP who suffer unfair prejudice. The members of an LLP may, however, by unanimous agreement exclude the right set out in s 994(1) of the Companies Act 2006 for such period as may be agreed.
- *Matters arising following winding-up*. There are provisions dealing with the power of the court to declare a dissolution void, the striking out by the Registrar of Companies of a defunct company and Crown disclaimer of property vesting as *bona vacantia*.
- *Functions of the Registrar of Companies*. These are set out in Sch 2 and include the keeping of records of an LLP's filed documents on the same lines as for registered companies.
- *Miscellaneous provisions*. These include the form of registers, the use of computers for records, the service of documents, the powers of the court to grant relief and the punishment of offences.
- *Disqualification*. Part III of the regulations applies the provisions of the Company Directors Disqualification Act 1986 to LLPs with appropriate modifications. Under the provisions members of an LLP will be subject to the same penalties that apply to company directors and may be disqualified from being a member of an LLP or a director of a company.
- *Insolvency*. Under Part IV of and Sch 3 to the regulations the insolvency provisions applied to LLPs include procedures for voluntary arrangements, administration orders, receivership and liquidation. There are two notable modifications to the company rules, i.e.:
  - a new s 214A under which withdrawals made by members in the two years prior to winding-up will be subject to clawback if it is proved that, at the time of the relevant withdrawal, the member knew or had reasonable grounds to believe that the LLP was or would be made insolvent;
  - a modified s 74 providing that in a winding-up both past and present members are liable to contribute to the assets of the LLP to the extent that they have agreed to do so with the other LLP members in the partnership agreement.

  In effect, therefore, this gives members of an LLP protection in terms of limited liability. However, the matter is not straightforward. There is no obligation either in the 2000 Act or the regulations to have a written agreement and the default provisions in reg 7 do not deal with the extent of the liability of each member on liquidation. The position is therefore left ill-defined, there being no relation between capital contributed and liability to contribute to deficits as there is with companies. In these circumstances insolvency practitioners may find difficulty in determining the liability of members of an LLP on liquidation. This problem area underlines once again the need for a written agreement to be made in an LLP governing the maximum liability of each member on liquidation or stating that a member is to have no liability so that creditors would have to rely on the assets of the LLP alone. Unfortunately this situation would not necessarily be known to creditors since there is no requirement to file LLP agreements so that they are not open to public inspection.

  It should be noted that the insolvency provisions relating to limited liability partnerships are subject to s 14 of the Insolvency Act 2000 since they follow corporate procedures. This means that if an LLP does business in other countries of the EU and becomes insolvent it may find that insolvency proceedings may be brought in regard to a place of operations in a particular EU territory.
- *LLPs authorised under the financial services regime*. There are in corporate law special insolvency provisions for companies involved in the financial markets because of the special problems of corporate failure in that field. These provisions contained in Parts XV and XXIV of the Financial Services and Markets Act 2000 are applied to relevant LLPs.
- *Default provisions*. Part VI of the regulations contains 'fall-back' provisions that apply where there is no existing limited liability partnership agreement or where the agreement does not wholly deal with a particular issue. The provisions represent a modification of s 24 of the Partnership Act 1890. There are provisions relating, e.g., to profit share, remuneration, assignment of partnership share, inspection of books and records, expulsion and competition.

Need for membership agreement

The fall-back provisions of the regulations are not really a suitable basis on which to run a business. They are rigid and introduce a measure of inflexibility into the arrangement. There is nothing that is the equivalent of the detailed provisions of Table A that may be adopted by companies. The parties to the agreement and their professional advisers should therefore consider the construction of an agreement to cover:

- the matter of what business shall be conducted by the LLP and how it may be added to or changed (there is of course no *ultra vires* rule);
- the ownership of property;
- capital, e.g. interest on capital if any;
- profits and losses, e.g. division and drawings;
- banking arrangements;
- members' entitlements, e.g. pensions, salaries, cars and health insurance;
- authority of members;
- meetings and voting;
- admission of members;
- retirement of members;
- rights and obligations of retiring members;
- serving of notices;
- arbitration provisions;
- winding-up. This is of particular importance because neither the Act nor the regulations are specific about membership liability.

Membership agreement: confidentiality

It is worth noting that the contents of the membership agreement do not become known to the public. It is not registered with the Registrar of Companies either on incorporation or subsequently and there are no rights of inspection in terms of outsiders such as creditors.

Insolvency

The Limited Liability Partnerships Regulations 2001 (SI 2001/1090) apply and LLPs follow insolvency patterns in line with companies. Part III of the regulations applies the insolvency provisions of the Companies Act 2006 and the Company Directors Disqualification Act 1986 to LLPs. Part IV applies the provisions of the Insolvency Act 1986 to LLPs in terms of voluntary arrangements, administration and winding-up. Company procedures are followed.

Reform: a partnership with legal personality

The Law Commission issued a *Consultation Paper on Partnership Law* in response to a request from the then DTI (now BIS). There are also proposals regarding partnerships in Scotland made by the Scottish Law Commission that are not considered here. The review was being conducted in respect of the provisions of the Partnership Act 1890, many but not all of which operate as default provisions in the absence of a contrary agreement of the partners, and the Limited Partnerships Act 1907. The Limited Liability Partnerships Act 2000 (see above) is not involved. The reforms would, however, if implemented, narrow the present distinction between ordinary partnerships and the new limited liability partnership.

The three main proposals were:

1 Proposals to introduce separate legal personality. There are two sub-proposals here:

(a) to confer legal personality on all partnerships without registration. There would be a transitional period to allow the parties to a partnership agreement to organise their affairs or to opt out of the continuing aspect of separate personality of the firm;

(b) to make legal personality depend on registration. Under this sub-proposal only a registered partnership would have legal personality capable of continuing regardless of changes in the membership of the firm. Under this option non-registered partnerships would not have legal personality.

The Commission feels that having a system of registration would create a more complex situation in which there would be a legal environment for registered partnerships and another for non-registered firms. The Commission also feels that many small firms would not register and so lose the benefits of legal personality.

On balance, therefore, the provisional view of the Commission is the first option, i.e. continuity of legal personality without registration, and views are invited on this. The creation of a registered partnership regime would bring partnership law in the UK closer to those legal systems in Europe in which legal personality is conferred by registration.