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PARTNERSHIPS FOR THE 21ST CENTURY? – LIMITED LIABILITY PARTNERSHIPS AND PARTNERSHIP LAW REFORM IN THE UNITED KINGDOM *

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The introduction of the limited liability partnership (LLP) into UK law has taken place against the backdrop of two fundamental law reform projects—one on company law which is currently being considered by the Government and one on partnerships and limited partnerships which is being conducted by the Law Commissions of England and Wales and Scotland—but oddly without reference to or by either. This article considers the unusual gestation process and resulting legal regulation and structure of the LLP against this background of law reform. It also considers whether the LLP will be used and/or is useable—in particular as a vehicle for obtaining immunity for members of the professions from direct or vicarious liability for negligent misstatements; whether the internal structure will be suitable for small businesses; and whether an appropriate creditor/member balance has been achieved. The article then considers some aspects of partnership law reform generally, welcoming the proposals for legal personality, continuity of association and simplification of the definition of a partnership. It suggests revisions to the proposals on contemplated partnerships, the effects of a repudiatory breach on a partnership agreement and the interaction of potentially conflicting fiduciary duties if legal personality is introduced. Finally it suggests a new approach to the law on the liability of innocent partners for the accessory liability of one partner incurred in connection with the firm's activities.

I. THE 20TH CENTURY—INCREMENTAL CHANGE

For almost a century the UK has pursued a policy of legislative inactivity in the area of partnership law (the 1890 Act, itself substantially a codifying

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* This article is an expanded version of a lecture given by the author to an invited audience in honour of the memory of David Marshall at the City Hall Chambers, Singapore Academy of Law on 19 October 2002. David Marshall was an outstanding criminal and commercial advocate and lawyer, the first Chief Minister of Singapore and later a distinguished ambassador for his country. He died in December 1995. The author wishes to express his gratitude to the Dean and Faculty of Law at the National University of Singapore and to Mrs Jean Marshall for the invitation to hold the David Marshall Chair of Law and is sensible of the honour involved.

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Act,[1] has only been amended in two minor respects since that date).[2] This policy of masterful inactivity has also been applied to the creation, or rather lack of creation, of any new business forms. The early years of the 20th century were, however, different. In 1907, some 80 years after it was first considered,[3] the Limited Partnerships Act introduced the limited partnership form with its distinction between general and limited partners.[4] Since it gives limited liability only at the expense of the loss of any management functions, the form is today confined in the UK generally to a niche market of venture capital and property investment vehicles, and for agricultural tenancies in Scotland.[5] Similarly, the first decade of that century also saw the decisive introduction of the private company in the Companies Act of 1907.[6] The private company has developed incrementally since then,[7] culminating in the single member company introduced in 1992,[8] but which is in essence still today the same concept as it was then—a public company

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1 See eg *Lindley & Banks on Partnership*, edited by Roderick I'Anson Banks, 18th ed (London: Sweet and Maxwell, 2002) at 4; Geoffrey Morse, *Partnership Law*, 5th ed (London: Blackstones, 2001) at 7 –10. The effects of the Act as a partial codification can also be seen in s 46. See also *Geisel* v *Geisel*, 72 DLR (4th) 245.

2 In 1959, s 35(a) as to dissolution of a partnership by the court on mental health grounds was repealed and replaced by the Mental Health Act 1959. See now ss 95 and 96 of the Mental Health Act 1983. Section 22, applying the equitable doctrine of conversion to a partner's share of partnership property, was repealed by s 3(1) of the Trusts of Land and Appointment of Trustees Act 1996. Both these amendments therefore reflect changes in other areas of the law rather than partnership law *per se*.

3 See Appendix No 1 to the *First Report of the Select Committee on Joint Stock Companies*, 1843, London, Parl Papers 1844 Vol VII: commissioned report in 1837 by Mr Bellenden Kerr QC. By the time of its introduction the original function of the LP, to provide limited liability for outside investors, had been taken care of by developments in company law.

4 See generally *Lindley & Banks*, *supra*, n 1, Part Six; Morse, *supra*, n 1 at 64-68. This form is not currently available in Singapore: see note 5 below.

5 Joint Law Commissions Consultation Paper: *Limited Partnerships Act 1907* (Law Com 161) (London: HMSO, 2001; Law Commission of England and Wales; Law Commission of Scotland) at 1-4: *The role of limited partnerships*. The LP form has, however, been exported to several other common law countries and proved advantageous in offshore banking transactions, *eg* hedge funds. Its introduction into Singapore has been recommended by the Company Legislation and Regulatory Framework Committee in its 2002 Final Report and this has been accepted by the Government of Singapore: see www.mof.gov.sg/cor/clrfc.html.

6 The basic definition was consolidated by the Companies (Consolidation) Act 1908. Initially private companies (which had to have between two and fifty members) were allowed to commence business immediately after registration and had certain exemptions from publicity. On the history of the private company see, *eg*, Paul Davies, *Gower's Principles of Modern Company Law*, 6th ed (London, Sweet and Maxwell, 1997) at 12-13.

7 The 1948 Act sub-classification into exempt and non-exempt private companies (which still appertains in Singapore) was repealed by the 1967 Act, which also removed most of the advantages of a private company. By way of contrast, however, more recent companies legislation has increasingly sought to de-regulate private companies from several of the controls applicable to public companies – see *Gower*, *supra*, n 6 at 91-97. That process is now regarded as one of the central tenets of company law reform: see note 20 below.

8 Introduced by the *Companies (Single Member Companies) Regulations* 1992 (UK), SI 1992 No 1699, implementing Dir 89/667 EC (OJ L395).

freed from some of the controls applicable to such companies.

For the remainder of the 20th century both these areas, of partnership law and the creation of new business forms, remained substantially free from parliamentary activity.[9] In essence therefore, during the whole of that period, the UK offered businesses, other than sole traders, two generic forms: the limited liability company, with its legal personality and limited liability, but subject to opportunity costs including various formalities and controls, not least the disclosure of information; and the partnership, which has neither limited liability nor, in England, legal personality,[10] but requires no disclosure and has no formalities. Indeed it is a feature of UK partnership law that a partnership can exist without any of the partners being aware of the fact.[11] Although there are private and public companies they differ only in the application of the controls imposed, and sometimes that variation is predicated on economic criteria rather than form.[12] These two generic forms, the company and the partnership, are both available to and used by virtually the whole spectrum of economic and constituent enterprises. Partnerships range from the very large accounting and legal firms to the very small owner-managed business. Companies range from the one man business, through the family business and the expanding business with external venture capital, to the substantial listed enterprise and the multi-national giants.

In terms of the company the success of the single generic form as a vehicle for such a wide range of enterprises has been in some part due to the ability of the legislature to vary the control and compliance elements, albeit

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9 The exceptions to this being first the European Economic Interest Groupings (EEIG) introduced by the EEIG Regulations 1989 (UK) SI 1989 No 638 as implementing EC Council Reg 2137/85 (see *Palmer's Company Law*, edited by Geoffrey Morse *et al*, 23rd ed (London: Sweet and Maxwell, 1992 *et seq*) at para 16.201). There were only 157 of these registered in the UK in 2000/1. The second is the Open-ended Investment Company introduced by Regulations in 1996 (UK) (SI 1996 No 2827) and now governed by their successor Regulations (SI 2001 No 1228). See *Palmer's Company Law*, *supra*, at part 5A. Other business forms have of course been created for specialised businesses—see *Palmer's Company Law*, *supra*, at paras 1.226 *et seq*.

10 For the position in Scotland see note 139 below.

11 The factual nexus of carrying on a business in common with a view of profit is all that is required. See generally Morse, *supra*, n 1 at 48-58. One of the possibilities canvassed by the Law Commissions of England and Wales and of Scotland in their 2000 *Joint Consultative Paper on Partnership Law* (Law Com. 159) (London: HMSO) Law Commission of England and Wales; Law Commission of Scotland) is for a registered partnership which would clearly require some formalities on formation, but that would still only be one form of partnership.

12 These are concerned with the presentation and publication of accounts and involve a classification of companies into "small", "medium" and "large" based on turnover, balance sheet total and number of employees (CA 1985 s 247). See *Gower*, *supra*, n 6 at 527-533. The former category of exempt private company which was exempted from the need to file accounts was abolished in 1967 although it still exists in Singapore (maximum of 20 members none of whom are companies or represent companies—see Singapore Companies Act 1967 s 4) and the Final Report of the Singapore Company Legislation and Regulatory Framework Committee, *supra* n 5, has recommended its retention.

only undertaken in more recent times as part of the process of implementing EC directives which gave the DTI access to valuable Parliamentary time.[13] The result has been at least some response to the needs of small(er) businesses (*eg* the ability to elect out of certain formalities such as the need for an AGM)[14] and to the need to maintain investor confidence in the larger ones (*eg* the revised rules on loans to directors in 1980).[15] Very occasionally it has even managed to implement the complete abolition of outdated restrictions. Whilst recent events suggest that the second may again be of some pressing concern it is not the subject of this paper. Nor is the third, of which the abolition of the *ultra vires* rule is a simple example[16].

With regard to the first, the needs of smaller businesses, over the years there have been abortive calls for the introduction of a separate small corporate form (in 1981 the DTI published a consultative document on the subject by Professor Gower[17] and in 1994 the Law Commission also considered the matter[18]—but neither led to the creation of a new form—albeit the 1981 report was influential in South Africa).[19] The recent Company Law Review Committee, instituted by the DTI and reporting to it in June 2001, (*Modern Company Law for a Competitive Economy – Final Report*)[20] also suggested the retention of the existing private company form rather than the creation of a new corporate vehicle, but with yet further modifications from the public company regime.[21] This recommendation has

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13 Thus the 1980 Act implemented the second EC company law directive, Dir 77/91 [1977] OJ L26/1; the 1981 Act, the fourth, Dir 78/660 [1978] OJ l222/11; and the 1989 Act, the seventh and eighth, Dirs 83/349 and 84/253 [1983] OJ L 193/1 and [1984] OJ L126/20. Each of these Acts soon outgrew their original impetus. The recent slowdown in EC company law directives (and implementation by means of delegated legislation) is at least partly responsible for the fact that there has been no really significant companies legislation since 1989.

14 See CA 1985 s 379A, added by the 1989 Act.

15 See now CA 1985 ss 330-342.

16 It is clear that the recast (in 1989) s 35 of the 1985 Act is intended to achieve this. There have been arguments to the effect that its wording is defective but the impact of EC law on this implementation of part of the first directive would preclude any such argument: see Geoffrey Morse, *Charlesworth and Morse*, 16th ed (London: Sweet and Maxwell, 1999) at 54. The UK government has recently indicated that it proposes to abolish any last remnants of the *ultra vires* rule by giving companies unlimited capacity: see the White Paper: *Modernising Company Law*, Cm 5553 (London: HMSO, July 2002) at para 2(2) and draft clause 1(5).

17 *A New Form of Incorporation for Small Firms*, Cmnd 8171 (London: HMSO, 1981).

18 *Company Law Review: The Law Applicable to Private Companies* (London: HMSO, November 1994).

19 By the South African Close Corporations Act 1984. See JJ Henning, HS Cilliers, ML Benade and JJ Du Plessis: *Close Corporations*, in *The Law of South Africa*, First Reissue, Vol 4 Part 3. (South Africa: Butterworths, 1996).

20 URN 01/942 and 01/943, DTI (London: HMSO, 2001). Available on http://www/dti.gov.uk.

21 *Ibid* at para 2.7. This was so even though the Group consistently adopted a policy of "think small first", and recommend legislation on the basis of that policy so that: (i) the law should be clear and accessible; (ii) accuracy and certainty should not be sacrificed unduly

been accepted by the Government in its 2002 White Paper, *Modernising Company Law*,[22] in the following terms:

> I.6 The Government agrees with the review that a more appropriate way forward is to tailor the core of company law to fit the smallest companies, which are mostly private companies. Additional safeguards can be added as necessary, for example for public companies which offer their shares to the public. In general therefore the proposed Bill[23] will, like the present Act, distinguish between public and private companies. But it will put private companies first.

Apart from the continuation of the rough and not always appropriate approximation between private and small companies inherent in this statement,[24] there is an apparent change of emphasis in that the core is to be designed for private companies with additions for public companies rather than it being for public companies with derogations for private companies. An examination of the draft clauses, however, suggests that just as before some will apply to all companies,[25] some only to private companies[26] and some only to public ones.[27] The "spin" might therefore prove to be more impressive than the reality.

But, by far the major factor in the success of the single corporate form is the ability of corporate lawyers to adapt the form to suit the needs of their clients. Two examples, one from each end of the spectrum, may be used to illustrate this. In terms of small companies the use of shareholder agreements to regulate the relationship between the members allows great flexibility, provided care is taken not to actually fetter the company's exercise of its statutory powers.[28] The courts have been willing to back these agreements even where they are intended to avoid the effects of a

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in an attempt to make the law merely superficially more accessible; and (iii) the legislation should be structured in such a way that the provisions that apply to small companies are easily identifiable (para 2.34).

22 Cm 5553, *supra*, n 16.

23 The White Paper, *supra*, n 16, in volume II contains a number of draft clauses for a future Companies Bill, although these are merely the first instalment of that Bill.

24 See, *eg, ibid*, draft clauses 164-8 which purport to introduce a new right to a scrutiny report on the conduct of a poll. The question is posed in the White Paper as to whether this right should apply to private companies on the basis that in most cases they will be small, with few members who will each know how the others voted. It follows that the right to demand such a report in such companies may merely give rise to a mischief. But, as the White Paper continues, some private companies have a large number of members, and so…?

25 Albeit sometimes applied with variations as between the two forms: see *eg* draft clause 149(4).

26 See *eg* draft clauses 170-177.

27 See *eg* draft clauses 13-16.

28 *Greenwell* v *Porter* [1902] 1 Ch 530; *Puddephatt* v *Leith* [1916] 1 Ch 200; *Russell* v *Northern Bank Development Corp Ltd* [1992] 1 WLR 588; [1992] BCLC 1016 (HL). See *Gower*, *supra* n 6 at 727-732.

statutory provision, (*eg* to prevent alteration of the company's constitution[29] or to entrench a member's right to veto any resolution by simply not turning up to the relevant meeting).[30] In terms of the largest multi-national companies, company draftsmen have been able to develop forms to allow their growth which it is suggested will make the new (and much belated) European Company irrelevant except as political window dressing.[31]

The success of the partnership form as lending itself to all sizes of enterprise is of course its inherent flexibility. Being based on the concept of an agreement (express or implied) with only default terms imposed by the Act in the main, it can be used to effect group partnerships, sub-partnerships and a myriad of other structures.[32] The larger firms, for example, are quite familiar with the terms: managing partner; equity partner; and salaried partner.[33] Partnerships, however, do not confer either limited liability or legal personality on the partners—yet statistics indicate that there are nearly as many partnerships as there are companies.[34] There are, of course, many reasons for this: for the regulated professions, the partnership form may be the only one allowed; for others, the benefits of the lack of compliance controls which thereby allows for privacy and flexibility may far outweigh the advantages of limited liability (which may in any event be more illusory than real, except for trade creditors[35]) and the tax position may be preferable—partnerships being tax transparent whereas companies are not.[36] In some cases of course the choice of medium may simply depend upon the adviser consulted, who may or may not be well informed.

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29 The *Russell* case, *supra*, n 28.

30 *Harman* v *BML Group Ltd* [1994] 1 WLR 893 (CA); [1994] 2 BCLC 502. Other possibilities include the use of weighted voting on specific resolutions on the principles developed in *Bushell* v *Faith* [1970] AC 1099 (HL).

31 *The Regulation to establish the European Company Statute*, 2001/2157/EC [2001] OJ L294/1 will come into force on 8 October 2004, accompanied by a related Directive on employee involvement, 2001/86/EC. This idea was first put forward in 1959 and a draft statute first appeared in 1967. A later 1975 proposal was suspended in 1982 and not revived until 1992. There has been little enthusiasm in the UK for this proposal although there are suggestions that the concept of a supra-national corporate form could be extended to private companies. See *Palmer's Company Law*, *supra*, n 9 at paras 16.306-16.306.3.

32 *Lindley & Banks*, *supra*, n 1 at paras 5.79-5.81, 11.21-11.31; Morse, *supra*, n 1 at 31-38.

33 Morse, *supra*, n 1 at 70-75.

34 See the Law Commissions' *Joint Consultation Paper on Partnership Law*, *supra*, n 11 at para 1.4.

35 *Ibid* paras 1.8-1.12. The standard practice of obtaining personal guarantees and charges on personal assets on those running small businesses to secure business debts is of course the major reason for this.

36 A company being a body corporate is subject to corporation tax (Income and Corporation Taxes Act 1988 s 832) which means that money taken out from a company is taxable either as emoluments or dividends. Partners are taxed as individuals and this has particular advantages for capital gains tax, whereby double taxation is avoided when an individual partner disposes of his or her share of the assets: see (UK) Inland Revenue Statement of Practice D 12 (London: HMSO). For VAT, however, both are taxed as separate entities.

II. Turn of the Century—Creation and Review

But the end of the 20th century, in addition to setting off the most fundamental review of company law for half a century, which the government has only recently started to digest,[37] also gave rise to the two topics for consideration in this paper—the creation of a new (albeit mainly derivative) business form, the Limited Liability Partnership (or LLP), and the first general consideration of partnership law, by the Law Commissions of England and Wales and Scotland, for over a century. Indications from the DTI that the LLP was on the way first occurred in late 1996,[38] culminating in its availability as from 6 April 2001. The remit to the Law Commissions on partnership law came from the DTI in November 1997 and their joint consultation paper was published in July 2000. The Commissions hope to have a final report and a draft bill sometime in 2002.[39]

What caused this burst of activity? It may well be the case that the ending, not only of the century but also the millennium, at least subconsciously and in part, inspired the DTI to set in motion the review of both company law and partnership law. It is also undoubtedly true that the company law review gained momentum from the dynamic presence of a particular individual at the DTI who chaired the steering group and who is now involved in a similar exercise in the EU,[40] but it is impossible to know whether he also inspired its inception. On the other hand, the original idea for an LLP was solely the result of a political reaction to the concerns of large firms faced with substantial damages awards against them for negligence which the law of joint and several liability laid equally at the door of each partner, however remote from the action and on a scale which made insurance prohibitive. That reaction survived not only a change of minister but also of Government. It may not be entirely a coincidence that the consultation paper on LLPs appeared in February 1997 and the reference on partnership law to the Law Commissions was formally made in November of that year. Partnerships were so to speak already in the frame.

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37 The Final Report of the Company Law Review Steering Group, *Modern Company Law for a Competitive Economy* (URN 01/942 and 943) was presented to the DTI in 2001. The DTI has now responded to part of that report in a White Paper, *Modernising Company Law*, *supra*, n 16, available on the DTI Company Law and Investigations website: www.dti.gov.uk/cld.

38 Written answer to a parliamentary question, November 1996.

39 Law Commission Website: www.lawcom.gov.uk. The Commissions are also considering the law relating to limited partnership, particularly in the light of the venture capital industry: see Consultation Paper 161, *supra*, n 6, available on the above website.

40 High Level Group of Company Law Experts established by the European Commission, 1 September 2001 (see IP/01/1237). They have already published a consultation paper: *A Modern Regulatory Framework for Company Law in Europe* (April 2002) which bears a strong relationship to the recent UK company law reform process, see *supra*, n 37.

III. Development and Nature of the LLP

Many countries have a business form called an LLP.[41] Not one of those corresponds to the UK version, principally because the UK LLP, despite its name, is not a modified form of partnership but a modified form of company—it was even suggested by one MP during the debates that it even fell foul of the Trades Description Act.[42] The DTI in fact somewhat cavalierly dismissed any attempt to utilise the experience of other countries' LLPs on the basis that they were designed for different purposes than the UK form and in any event bore little comparison to each other.[43] The initial consultation paper of February 1997 stated that the LLP was designed to provide an up-to-date legal framework for certain professions and referred to "recent developments" in other jurisdictions such as USA and Jersey.[44] In reality, however, this proposal was a response to pressure for limited liability within a partnership relationship, if not framework, from professional firms and a threat to move offshore if it was not forthcoming.[45] This plea for limited liability was not new, although originally linked to "sleeping" partners. In 1854 the House of Commons unanimously passed a resolution

> that the law of Partnership, which renders every Person, who, though not being an ostensible Partner, shares the profits of a Trading Concern, liable to the whole of the Debts, is unsatisfactory, and should be so far modified as to permit Persons to contribute to the Capital of such Concerns on Terms of sharing their Profits, without incurring Liability

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41 See Judith Freedman, "Limited Liability: Large Company Theory and Small Firms" (2000) 63 MLR 317. The Company Legislation and Regulatory Framework Committee in Singapore has recommended in its 2002 Final Report, *supra*, n 12, that that country adopts the Delaware model of LLP (which is based on the partnership model) as opposed to the UK model (which is based on the corporate model; and requires financial disclosure accordingly). The Law Reform and Revision Division of the Attorney General's Chambers in Singapore has also published a consultation paper on LLPs (LRRD 3/2002, March 2002) suggesting their implementation into Singapore and inviting consideration of a mixture of UK and Delaware provisions, together with an interesting solution to the disclosure issue (para 4H-12).

42 Austin Mitchell MP, Hansard, HC 23 May 2000.

43 DTI Response to the HC Select Committee on Trade and Industry, Fourth Report, HC 59 annex, June 16 1999, para 26.

44 *Limited Liability Partnership – A new form of Business Association for Professions*, DTI, London, February 1997.

45 HC Select Committee Report HC 59, para 26. But see Judith Freedman and Vanessa Finch, "Limited Liability Partnerships: Have Accountants Sewn up the 'Deep Pockets Debate'" [1997] JBL 387. The apparent threat from overseas LLPs came not only from those in the US but also one specifically designed for the accountancy firms in Jersey. See (1997) 60 MLR 538 for an account of the Jersey LLP, which requires, *inter alia*, a £5m bond to be deposited by the members. Whether a move offshore would have been feasible for tax reasons was never finally settled but the Revenue took the view that a Jersey LLP would be taxed as a company in the UK. See *R* v *IRC, ex parte Bishopp* [1999] STC 531.

beyond a limited amount.[46]

The DTI published the responses to the consultation paper and, despite a change in Government, the matter was then remitted to the House of Commons Select Committee on Trade and Industry in 1999 for what proved to be the only general pre-legislative consideration of the proposals.[47] Originally the Law Commissions were invited to look at the width of availability of the LLP but never its introduction as such.[48] In fact they never examined the LLP at all, simply noting, without explaining why, that the vast majority of partnerships would be unaffected by its introduction.[49] The Select Committee were somewhat ambivalent as to the need for an LLP, stating that there was a failure by the DTI to set out a convincing case for its introduction[50] but also noting the "very real possibility" of firms registering offshore.[51]

The Select Committee made one very significant change, however, to the proposals in that they successfully recommended that the LLP be made available to all and not just the regulated professions.[52] The drawback to this, however, is that the LLP was originally conceived as a vehicle for those professions and many of its provisions still bear the imprint of that original purpose.[53] The DTI continued onwards, publishing a draft bill and regulations in September 1998[54] and again in July 1999[55]. At that stage they considered the Bill to be a final draft although consultation on the regulations went on until May 2000.[56] The end result was the Limited Partnerships Act 2000 and the Limited Liability Partnership Regulations 2000.[57] The former is a short framework Act, the latter sets out the details,

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46 Hansard 1854, 764, 800. That particular plea was answered in 1907 by the introduction of the limited partnership. But, by then, the ability to invest in companies on such terms and the linkage of limited liability with non-interference in management of the firm made them obsolete as general commercial vehicles almost before they started.

47 The HC Select Committee Report 59 referred to in note 45, *supra*.

48 *Partnership Law Initial Consultation Document*, Law Commission, February 1997.

49 *Partnership Law Consultation Paper*, *supra*, n 11 at para 1.15.

50 HC 59, *supra*, n 45 at para 6.

51 *Ibid* para 26.

52 *Ibid* para 43. This was accepted by the DTI, HC 59 annex, para 27. The LLP is limited to businesses on formation but seems to allow for a subsequent change to a non-business form: the LLP Act 2000 s 2(1)(a) requires a business at the time of incorporation, but not thereafter. The tax authorities have certainly proceeded on the basis that an investment LLP is a real possibility: see Inland Revenue Tax Bulletin, December 2000: Geoffrey Morse, Paul Davies, David Milman, Ian Fletcher, Richard Morris, *Palmer's Limited Liability Partnership Law* (London: Sweet and Maxwell, 2001) at paras A1.85-A1.104.

53 *Eg*, the lack of any formal requirement for an internal regulatory agreement (see, *infra*, note 87 and the fact that the LLP is to be treated as a partnership for direct tax purposes.

54 URN 98/874. The LLP (Scotland) Regulations 2000 were not part of this process.

55 URN 99/1025.

56 A summary of responses was published then: URN 00/866. Again there was no consultation on the Scottish regulations.

57 SI 2001 No 1090 (London: HMSO). For Scotland parts of those Regulations are replaced

the majority of which simply incorporate by reference substantial parts of the Companies Act 1985, the Insolvency Act 1986 and the Company Directors Disqualification Act 1986, as modified by the regulations. There are some new additions but very few in number. The Partnership Act 1890 is conspicuous by its absence from this list.

There is therefore no easily accessible corpus of legislation available to potential users of the LLP although commercial texts, including one prepared by the author, have attempted to produce a comprehensive if unauthorised version.[58] The DTI thought that that would be the best solution when this rather obvious defect was raised both by the Select Committee[59] and also by some of us during the consultation period—the result being outsourcing of legislation taken to its extreme.[60] There are many criticisms which can be made as to the legislative format adopted, not least its opaqueness—for example the modifications in the regulations provide that the word "company" in the host section is to include and so is not necessarily replaced by, the words LLP[61]—thus making the sections relating to schemes of arrangement involving say both companies and LLPs interesting reading and an intellectual puzzle[62]—but business legislation should not be apparent only as a result of such an exercise. The end result is also cumbersome and requires subsequent changes to LLP law by additional regulations whenever the "host" corporate law section is altered,[63] which can only add to the opaqueness of the legislation.

What then is an LLP? In essence it is a body corporate with limited liability in the sense that its members are not personally liable for its debts beyond their financial interests in the LLP itself, but with unlimited capacity.[64] It is incorporated by registration with an incorporation document fulfilling the role of the memorandum of association[65] and subject to many of the accounting and disclosure requirements and other controls applicable

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by (and, due to the vagaries of devolution, other parts are duplicated by) the LLP (Scotland) Regulations 2001, SI 2001 no 128.

58 *Palmer's LLP Law*, *supra*, n 52 at Part C.

59 HC 59 para 82.

60 The previous attempt at such legislative techniques by the DTI in the Insolvent Partnerships Order 1992 was such a disaster that it had to be replaced within 2 years: see SI 1994 No 2421 (London: HMSO).

61 See the LLP Regs, *supra*, n 54 at regs 3(2)(a), 4(1)(a), 5(2)(a) and 6(2)(a).

62 See *Palmer's LLP Law*, *supra*, n 52 at Chap 10 and para C1-120.

63 See *eg* the Limited Liability Partnerships (Particulars of Usual Residential Address) (Confidentiality Orders) Regulations 2002 SI 2002 No 915; the Limited Liability Partnerships (Competent Authority) (Fees) Regulations 2002, SI 2002 No 503; and the Limited Liability Partnerships (No 2) Regulations 2002, SI 2002 No 913 (all London: HMSO). All these were required to mirror changes to the Companies Act to protect directors of companies in sensitive business such as animal research from attacks on their private addresses.

64 LLP Act ss 1(3) and (4).

65 *Ibid* s 2.

to companies.[66] But it has no shareholders or share capital, no directors and no specific requirements as to meetings or resolutions. For insolvency purposes it is also treated as a company and is not only subject to all the controls and liabilities imposed on insolvent companies but also to its own additional clawback provision[67]. Externally therefore the LLP is a company but internally it may be run as the members wish—there is no formal legal requirement in the legislation for any written agreement. It was originally assumed that the professional firms for whom the form was initially intended would draft their own; at a late stage it was realised that this might not be the case with smaller enterprises and so there are a number of, rather hastily thought through, default terms in the regulations based on some of those in the Partnership Act[68]—the only obvious direct application of partnership law to LLPs, apart from direct taxation where an LLP is also to be treated as a partnership (another relic of its origins—as is the fact that changing from a partnership to an LLP is tax neutral whereas changing from a company to an LLP is not).[69]

The LLP is therefore a hybrid creature but based substantially on the corporate model—one possible reason being that unlike, say the position in Delaware, English partnership law does not currently confer legal personality on a partnership (this is, however, one of the issues raised by the Law Commissions in connection with their review of partnership law in general—see below). Thus, once it was decided to create the LLP as a separate legal person the corporate model was the obvious solution. There is one limit to the application of the corporate model, however, in that, given the absurdity of a one person partnership of any form, it is not possible to have a single member LLP. Since it appears that otherwise there is no legal reason why a single member LLP should not exist, the resulting paradox in itself reprises the basic conflict in using company law to regulate what is called a partnership.

The questions which now arise are: first, will the LLP be used and, second, will it work? At first sight it looks an attractive vehicle both for large firms, preserving internal flexibility with the advantages of limited liability (albeit at the price of disclosure) and for small start up businesses given its lack of internal regulations when compared with the private company—there can, for example, be no question of worrying about the esoteric rules concerning financial assistance for the acquisition of shares or the registration of special resolutions. For tax reasons it is not, however, an attractive vehicle for existing companies to move into, although existing

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66 Including most of Part VII of the 1985 Act on accounting and audit, a much modified annual return provision, the auditor controls and registration requirements of that Act.

67 New s 214A of the Insolvency Act 1986 as applied to LLPs. See note 108, below.

68 LLP Regs 7 and 8. For the consultation process involved see URN 00/617 and 00/865. DTI (London: HMSO). The internal agreement is the subject of s 5(1) of the LLP Act.

69 See *Palmer's LLP Law*, *supra*, n 52 at para A1.90 and the UK Inland Revenue Tax Bulletin December 2000 (available on www.inlandrevenue.gov.uk).

reliefs would apply to an LLP converting into a company and changes between a partnership and an LLP are tax neutral.

Some commentators have suggested that it will be widely used whereas others have a very different opinion. In their recent article, *The Limited Liability Partnership: Pick and Mix or Mix-up?*,[70] Vanessa Finch and Judith Freedman have no doubts:

> The desires of large partnerships have not been met, since they continue to seek the revision of joint and several liability laws. The requirements of small businesses are now, in any event, being met by steps currently being designed to improve laws relating to partnerships and limited liability companies. The financiers of business may see the LLP as a higher cost, higher risk entity than the limited liability company and this may discourage use of the LLP. The LLP is not so much a potentially popular vehicle of sophisticated design as one produced under pressure to a flawed plan.

In particular Finch and Freedman argue that there are simply too many uncertainties in the areas of law, accounting and taxation for the LLP for it to work. In terms of numbers the take up so far has been modest but there is a steadily rising curve (up to July 2002, 2877 LLPs have been registered although not all of these may be active[71]) but it is still early days. It is necessary therefore to examine some questions to see if they are real and/or solvable so as to peer a little more closely into the crystal ball to see whether in time the LLP will blossom or whether it will be a mere footnote in the history of UK business law.

IV. Will the LLP Provide Effective Limited Liability for the Professions?

Section 1(4) of the LLP Act provides that: "The members of a limited liability partnership have such liability to contribute to its assets in the event of its being wound up as is provided by this Act." It has nothing else to say about the personal liability of individual members in connection with the activities of the LLP.[72] When the LLP was first mooted as being a form of protection for partners against their joint and several liability for the

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[70] [2002] JBL 475 ("Finch and Freedman").

[71] In the first year LLPs were available, to March 2002, 1941 LLPs were registered. In the next four months a further 936 were registered, a definite increase on a month by month basis. Only 124 of these in total have been registered in Scotland.

[72] Since s 6 of the LLP Act provides that all the members of an LLP are agents of it, contractual liability will usually rest with the LLP. Section 6 is in fact based on the partnership concept of agency rather than the corporate model but modified to take account of the LLP's legal personality. This may have some relevance to the reform of partnership law generally: see note 183, below.

negligence of one partner with whom they had little practical connection, it was suggested that this would not affect the personal liability of the negligent partner concerned—those actually responsible for say a negligent audit would remain personally liable, as would the LLP itself, but not the other members as such. This would preserve the professional ethos of personal responsibility.[73] That balance between limited liability and personal responsibility appears to have been achieved by the Jersey LLP where the statute makes it clear that personal liability for a partner's own negligence is unaffected by the existence of an LLP.[74] Further, in many US LLPs personal liability applies both to the individual concerned and others supervising him or her.[75] But there is no such provision under the UK statute and in fact the Government expressly rejected the idea of including one.[76]

The question of personal liability, unless it is resolved by the professional bodies themselves, is therefore a matter for the courts.[77] In effect the issue resolves itself into whether, assuming that contractual liability lies solely with the LLP as the contracting party, the courts will regard the personal liability in tort of a member of an LLP as being in any way different from that of a director of a company. Both after all are bodies corporate and the LLP is directly based on the corporate rather than the partnership model. In the case of most torts there will be no problem since normal principles of liability may well make both the member involved and the LLP liable, either vicariously or as joint tortfeasors,[78] but the position is more complex in connection with the tort of negligent misstatement, which is the one most likely to concern professional firms. This is because, unlike, say, the tort of deceit, liability depends upon there being a special relationship between the parties based on an assumption of responsibility by the tortfeasor.[79] So whereas a director of a company will be personally liable in deceit if he or she makes a deliberate or dishonest deception[80] there

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73 See *eg* the Explanatory Notes to the LLP Bill as originally introduced into the House of Lords on 23 November 1999 (HL Bill 6) para 10.

74 See the Limited Liability Partnerships (Jersey) Law 1997 article 5.

75 See *Finch and Freedman, supra*, n 70 at note 61.

76 The Government refused to accept an amendment to this effect during the debate in the House of Lords—amendment No 28, HL debates 24 January 2000, col 1381 (London: HMSO)

77 The Government has openly accepted that this is the position: see the explanatory notes to the LLP Act paras 15 and 16.

78 See *eg Daido Asia Japan Co Ltd* v *Ines Charlotte Rothen* 24/7/01 (Ch), distinguishing *Standard Chartered Bank* v *Pakistan National Shipping Corporation* [2000] 1 Lloyd's Rep 218.

79 This has been the position ever since the landmark decision creating the tort of negligent misstatement in *Hedley Byrne & Co Ltd* v *Heller and Partners Ltd* [1964] AC 465. The purpose of the statement and the nature of the transaction are important in this context: see *Caparo plc* v *Dickman* [1990] 2 AC 605.

80 See *eg Credit Suisse First Boston Corporation* v *Faris Al Rawi* [2002] EWHC 222 (Comm), 21 February 2002.

will be no liability for negligent misstatements unless the director has assumed a position of special responsibility to the client. In *Williams v Natural Life Health Foods Ltd*[81] the House of Lords, overturning the Court of Appeal, held that on the facts the director had not assumed any such responsibility. But inherent in that decision was the principle that merely acting as a director of the company was not enough to give rise to such an assumption of responsibility and this has been followed in other cases since then.[82]

This is, however, what has been referred to as a "developing" area of company law.[83] But for present purposes the question is not where that law is going but whether the courts would take a different attitude to the personal liability of a member of an LLP for, say, a negligent report prepared for a client of the LLP than it does if the report had been prepared by a director for a client of the company. Under the general law of partnership, a negligent partner would of course always be personally liable under the principle of joint and several liability.

I cannot see why the courts should distinguish between an LLP and a company on this point. Finch and Freedman regard that proposition as being unacceptable on the basis that the LLP must be intended to diverge from company law in some respects if it is to be justified, as it was, on the basis of preserving the partnership ethos.[84] But that seems to confuse what the LLP started out as and what it became. It is a business form which, like a company, is open to all and is based squarely for external purposes on the corporate model. If there is to be a distinction in this developing area, which is possible, between those acting for an incorporated and those for an unincorporated business[85] (which is a different question) then that distinction must apply as between members of an LLP and partners in a partnership. After all, section 1(5) of the LLP Act expressly provides that: "Except as far as otherwise provided by this Act or any other enactment, the law relating to partnerships does not apply to a limited liability partnership."

The problem therefore is not one which derives from the LLP form itself—it is in the possible distinction between incorporated and unincorporated businesses. Interestingly, if I am correct, then the LLP form gives members more immunity from liability for negligent misstatements

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81 [1998] 1 WLR 830 (HL) overruling [1997] 1 BCLC 131 (CA).

82 *Noel* v *Poland* [2001] 2 BCLC 645. See also John Armour, *Corporate personality and the assumption of responsibility* (1999) Lloyd's Maritime and Commercial Law Quarterly 246; Ross Grantham and Charles Rickett, *Directors' Tortious Liability: Contract, Tort or Company law?* (1999) 62 MLR 133.

83 See *eg Partco Group Ltd* v *Wragg*, unreported, 1 May 2002, giving leave to proceed to a full hearing on the question as to whether two directors of a target company owed a duty of care to the bidder on the basis of personal assurances *etc*.

84 *Finch and Freedman, supra*, n 70 at 486.

85 See *Merrett* v *Babb* [2001] 3 WLR 1. In that case an employee of a sole trader was held liable for negligent misstatement but the circumstances were very different.

than they originally sought from Jersey. Barring special circumstances, not only is there no joint and several liability on the members there is also no individual liability on any member for a negligent misstatement. Yet the professions it seems are still seeking reform of the joint and several liability principle in partnership law.[86] It may well be that they are simply wary of the alleged uncertainty of the position of LLPs in this respect, but if they are rejecting the LLP it seems to be unlikely that this is because of the limited liability point—it must, on any interpretation, give far more protection than a partnership.

V. How Will the LLP Work Internally?

As we have seen, one of the main characteristics of the LLP is that although it is subject to most of the company law rules relating to its external relations, virtually none of the rules relating to the internal relationships apply (there is one apparently anomalous exception which is considered below). Originally this distinction was made because the LLP was promulgated as leaving the professional firms free to regulate their own internal affairs by agreement just as they had done as partners.[87] Internal regulation was not required as part of the price of limited liability. When the LLP metamorphosed into a business form available to all, it was realised that not all such businesses would have such express agreements so a number of default clauses were added at the eleventh hour.[88] These, as set out in regulations 7 and 8 of the LLP Regulations, are closely modelled on the relevant parts of sections 24, 25, 28, 29 and 30 of the Partnership Act.[89] Since the default provisions are taken from the partnership model (and section 5(1)(b) of the LLP Act expressly provides that they are derived from that source) the question is to what extent that model will be applied generally to the internal relationships between the members. That in turn divides into two linked issues: first, will the courts consistently apply partnership law concepts in the construction of all LLP agreements, express or implied, even if the larger LLPs adopt corporate type constitutions; and, second, will they apply either a general or limited fiduciary relationship as between the members *inter se* as distinct from any such relationship

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86 This was made clear in responses to the Company Law Review—see the response of the ICAEW, July 2000. The Review also considered various ways of limiting the liability of auditors see *eg* the Final report paras 5.34-5.36, 8.140-8.142. The climate may well have changed since then, however, and the government in its White Paper, *Modernising Company Law*, *supra*, n 16, says at para 4.47 that it is considering the whole question of audit and auditors, post-Enron, and will come forward with its proposals in due course.

87 The 1997 consultation paper from the DTI, URN 97/597, made this clear at para 2.2.

88 DTI Consultation Paper: *LLPs: Regulatory Default Provisions*, URN 00/617 (London: HMSO).

89 The internal provisions of the Partnership Act applying to partnership property could not be transposed for LLPs since the LLP may well be the owner of the LLP property whereas partners individually own partnership property.

between each member and the LLP.

With regard to the first issue, Finch and Freedman are concerned that the courts may operate a two-tier approach and that the burden of litigation in this area will fall primarily on the smaller LLPs who rely on the default clauses, which are by no means fully comprehensive (*eg* they say nothing about financial matters).[90] There is a very real issue here because the overarching supremacy of the corporate model is breached by the fact that internal affairs are entirely a matter for agreement and that if there is no agreement on certain matters then partnership solutions are provided. It is therefore possible, they argue, that the courts will construe some LLP agreements as if they were articles/shareholder agreements and some as if the were partnership deeds.

The LLP legislation is itself somewhat schizophrenic on this point. There is a default clause to the effect that there is no implied power of expulsion in an LLP,[91] but of course that, on the partnership model, can be overridden by express agreement.[92] At the same time the unfairly prejudicial remedy in section 459 of the Companies Act 1985 has been applied to all LLPs by the regulations subject to it being ousted by express agreement.[93] Thus the courts may have to relate the partnership concept of expulsion exercised in good faith, with the corporate concept of unfairly prejudicial conduct.[94] Although its presence is somewhat anomalous, in the sense of incorporating a company law concept into an internal partnership model, section 459 may well, however, provide at least one form of exit procedure for the smaller and less formal LLPs.

There are of course no answers to these questions of interpretation just yet. But it appears that the more immediate perceived practical problem is rather that there is no model LLP agreement for small businesses to use.[95]

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90 *Finch and Freedman*, *supra*, n 70 at 490.

91 See reg 8 of the LLP Regs.

92 This is often the situation in practice. There is some doubt as to the exact procedure and standards expected of partners exercising such a power, but the need for basic good faith is not in doubt: See *Lindley & Banks*, *supra*, n 1 at paras 10.110 and 10.120-10.129; Morse, *supra*, n 1 at 165-169. The Law Commissions in their *Joint Consultation Paper on Partnership Law*, *supra*, n 11 have suggested, at para 13.7, that there should continue to be no default power of expulsion.

93 Sub-s (1A) to this effect was added to s 459 in its application to LLPs by Part I of Sched 2 to the LLP Regs.

94 The meaning of that phrase was defined by Lord Hoffman in *O'Neill* v *Phillips* [1999] 1 WLR 1092 so that it requires some breach of the terms of the articles or other agreement which the complainant expressly or impliedly agreed that the affairs of the company should be conducted. In certain cases this could include equitable considerations. The test is whether the exercise of the power or other act in question is contrary to what the parties by words or conduct have agreed. As so put there seems no inherent problem in applying that to LLPs.

95 The Company Law Review proposed such a model constitution for small companies in Chapter 17 of its Final Report. This recommendation has been accepted by the Government and even been applied by them to public companies in such a way that companies will have to expressly opt out of the relevant model and/or each individual

The Government refused to provide one but then there is no official partnership deed either and that has not inhibited the use of partnerships.[96] The legal and business formation professions could clearly devise a number of different model LLP agreements just as they have model articles and partnership deeds. It will just take time. As to the question of interpretation of internal agreements it seems to me conceivable and perfectly rational for the courts to adopt a variable approach, sometimes adopting the articles/shareholder agreement model and sometimes the partnership deed model, depending upon whether the relationship between the members is in reality one of partnership or not. Company law after all has made that distinction, based on the existence or otherwise of so called partnership qualities of mutual trust and management participation, ever since the landmark decision of the House of Lords in *Ebrahimi v Westbourne Galleries Ltd*[97] and this has been carried forward into the current formulation of unfairly prejudicial conduct.[98] To argue that such an approach to LLPs would be flawed on the basis of uncertainty is merely to argue that the LLP is new and will evolve its own jurisprudence, which in any event may not be all that new. Further such criticism sits ill with the criticism that an LLP is not sufficiently separate from existing forms of business entity.

An *Ebrahimi* form of distinction may also provide the answer to the second question as to whether, and in what circumstances, there is a fiduciary relationship between the members *inter se*. It is assumed that, given the corporate bias, it is likely that there will be an obvious or presumptive one as between the members and the LLP.[99] Consistent with its pro-corporate approach, the Government rejected any idea of providing for an express duty of good faith as between the members,[100] so that the matter has been left to be decided either by the LLP agreement or the courts. But one of the default clauses applies section 28 of the Partnership Act thus requiring any member to render true accounts and full information of all things affecting the LLP to any member or his legal representative.[101] Thus

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provision: *Modernising Company Law*, *supra*, n 16 at para 2.5 and draft clause 11.

96 The Law Commissions have provisionally suggested that there should be no such model agreement for partnerships: Law Commissions' *Joint Consultation Paper on Partnership Law*, *supra*, n 11 at para 16.8.

97 [1970] AC 360. See *Gower*, *supra*, n 6 at 749-751.

98 By Lord Hoffman in *O'Neill* v *Phillips*, *supra* n 94.

99 This can be predicated simply on the basis of the agency relationship between a member and the LLP. *Quaere* whether any or all of the statutory statement as to the fiduciary duties of directors to their companies proposed in the White Paper, *supra*, n 16 at clause 19 and Schedule 2 to the draft bill, will be applied to members of an LLP? If so it is to be hoped that they are rather more readily understandable to the layman (and perhaps less naïve) than the present draft.

100 The DTI expressly stated that it had no wish to go much beyond the relationship which exists between a director and a company: DTI, S*ummary of responses: LLPs*, URN 00/865 at 8.

101 Reg 7, LLP Regs. On the operation of s 28 in the partnership context see *Lindley & Banks*,

there can be a limited fiduciary relationship by default between the members (although the other fiduciary duties of good faith and non-competition, when implied as default clauses, are stated as being owed only to the LLP, which mitigates against any general fiduciary relationship between the members). In my view the courts are more than capable of solving this issue—they are well versed in exploring the limits of fiduciary relationships—even the potential conflict between the duty of full disclosure owed by one member to another and the duty to the LLP to act in the best interests of the LLP as a whole. Such duties might well provoke a conflict if the member seeking the information intends to damage the LLP as a result of obtaining it. In this context it should be noted that it has been held in Canada that a partner can have access to a confidential document prepared by a lawyer for the other partners as to how to remove him since it was prepared whilst he was still a partner.[102]

The courts have after all had to decide the circumstances in which, in the corporate context, directors can owe fiduciary duties to individual shareholders as well as to the company and those could easily be applied by analogy to members of an LLP.[103] The most recent explanation in the corporate context was given by Mummery LJ in *Peskin v Anderson*.[104] If one substitutes LLP for company and members for directors/shareholders the solution to the fiduciary issue may well be as follows:

> The fiduciary duties owed to the [LLP] arise from the legal relationship between the [members] and the [LLP] directed and controlled by them. The fiduciary duties owed to the [other members] do not arise from the legal relationship. They are dependent on establishing a special factual relationship between [the members] in the particular case. Events may take place which bring [some members] of the [LLP] into direct and close contact with [other members] in a manner capable of generating fiduciary obligations, such as a duty of disclosure of material facts to the [other members], or an obligation to use confidential information and valuable commercial and financial opportunities, which have been acquired by the [members concerned] for the benefit of the [other members] and not to prefer and promote their own interests at the expense of the [other members] …
>
> Those [fiduciary] duties are, in general, attracted by and attached to a person who undertakes, or who, depending on all the circumstances, is treated as having assumed, responsibility to act on behalf of, or for the benefit of another person. That other person may have entrusted or, depending on all the circumstances, may be treated as having entrusted,

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supra, n 1 at paras 16.02-16.09; Morse, *supra*, n 1 at 143-4.

[102] *Dockrill* v *Coopers & Lybrand Chartered Accountants* (1994) 111 DLR (4th) 62.

[103] See *eg Percival* v *Wright* [1902] 2 Ch 421; *Re Chez Nico Restaurants Ltd* [1991] BCC 736; *Munro* v *Bogie* [1994] 1 BCLC 415; *Platt* v *Platt* [1999] 2 BCLC 745.

[104] [2001] 1 BCLC 372 at 379.

> the care of his property, affairs, transactions or interests to him.[105]

On that analysis there will be LLPs where such duties attach and those where they do not. That does not seem to me to be any more of a problem than it is for companies or partnerships.[106] It certainly shouldn't put anyone off an LLP.

VI. Is the Creditor/Member Balance Precise Enough to Encourage the Use of LLPs as Against Companies?

Another of Finch and Freedman's arguments is that the creditor protection provisions in LLP law may create sufficient uncertainty in the minds of the banks and other lenders for them to advise their business customers against the use of the LLP as against the company. This argument is mainly predicated on the fact that, in addition to the application to LLPs of the wrongful trading, fraudulent preference and transactions at an undervalue provisions applicable to companies, the additional creditor protection section (new 214A of the Insolvency Act 1986 applicable only to LLPs) coupled with a rewording of section 74 of that Act as it applies to LLPs may have the reverse effect from that intended by making the LLP less creditor-friendly.[107]

Section 214A provides for the court, on the application of the liquidator, to order any member to repay any withdrawals made by him or her from the LLP within two years prior to the commencement of its winding up, if the member either knew or had reasonable grounds for believing that the LLP was unable to pay its debts at that time or would be so unable as a result of that and other contemporaneous withdrawals, and that the member either knew or ought to have known (based on his skill, knowledge and experience and those of a person carrying out the same functions as the member) at that time that there was no reasonable prospect that the LLP would avoid going into insolvent liquidation.[108] Some of these phrases are clearly derived from

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[105] Wilson J in the Supreme Court of Canada case *Frame* v *Smith* [1987] 2 SCR 99, at 136, identified the 3 general characteristics of a fiduciary relationship as being: (1) the fiduciary has scope for the exercise of some discretion or power; (2) the fiduciary can unilaterally exercise that power or discretion so as to affect the beneficiary's legal or practical interests; (3) the beneficiary is peculiarly vulnerable to or at the mercy of the fiduciary holding the discretion or power. This need for vulnerability has been debated in subsequent Canadian cases but the criteria have been applied both to decide on the existence of a new fiduciary relationship and the limits to existing presumptive ones such as a partnership. The cases were thus discussed by Costigan J in *Prothroe* v *Adams* [1997] 10 WWR 101 in the context of the limits of one partner's duties of good faith to his fellow partners, but they could be equally applied to establish the duties of members of LLPs *inter se*.

[106] See *eg Prothroe* v *Adams*, *supra*, n 105.

[107] *Finch and Freedman*, *supra*, n 70 at 509.

[108] The exact wording of s 214A is set out in Sched 3 to the LLP Regs. See also *Palmer's LLP Law*, *supra*, n 52 at para A9.40; Morse, *supra*, n 1 at 247-249.

wrongful trading[109] but others (such as the two year limit) reflect rather more the preference and undervalue provisions.[110]

Finch and Freedman, having conducted a detailed analysis of the wording of section 214A, argue that it is possible that the courts may take either a lenient or a severe approach to members' liability under that section. In favour of the lenient approach, they argue is the fact that there may be evidential difficulties for liquidators seeking to recover monies under section 214A and that subjective criteria may creep in.[111] In addition liquidators may face funding difficulties in bringing actions under section 214A.[112] If that is the case then section 214A will not assist creditors to any marked degree. On the other hand if the courts take a hard line approach[113] then members may be tempted to take their money out before the two year period[114] which will have an adverse effect on creditors. On any interpretation, from the point of view of the members they have nothing to gain from section 214A and much to lose—it simply does not apply to companies. Finally Finch and Freedman argue[115] that since section 74, as modified in its application to LLPs, allows members' claims to rank alongside those of creditors in a winding up (as opposed to being subordinated to them as in a corporate insolvency[116]) and for members' agreements to settle contributions to the LLP in such circumstances, that again may prejudice the creditors, although it hardly seems to prejudice the members in their choice between an LLP and a company.

In reality, however, the wrongful trading provisions have been little used in the corporate sphere (due at least in part to funding problems for

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[109] Thus the requirement "of no reasonable prospect that the LLP would avoid going into insolvent liquidation" in s 214A(5) and the subjective/objective criteria to decide a member's awareness in s 214A(6) are derived directly from sub-ss 214(2)(b) and (4). The time factors are, however, different as between the two and there is no equivalent in s 214A to the defence in s 214(3) of the director taking every step to minimise loss.

[110] See s 240 of the IA 1986 applying the relevant time for both transactions at an undervalue and preferences. These provisions also apply to LLPs by virtue of reg 5 of the LLP Regs.

[111] Finch and Freedman, *supra*, n 70 at 503 *et seq*. In particular it is argued that the omission of the words "ought to have concluded" from s 214A in relation to awareness of the LLP's insolvency and the similarity in scope between s 214A and the preference sections may have a bearing on this.

[112] See *Palmer's Company Law*, *supra*, n 9 at para 15.461.1; *Re Oasis Merchandising Services Ltd* [1997] BCC 282 (CA).

[113] Actually withdrawing money from an LLP may be regarded by the courts as more heinous than simply carrying on business in a misguided attempt to save the company/LLP. Similarly whilst careful monitoring, or lack of it, of the financial position may well be regarded as negating wrongful trading it may, conversely, be regarded as an aggravating factor if a member, knowing of the situation, withdraws money from the LLP. See *eg Re Produce Marketing Consortium (No 2)* [1989] BCLC 520; *Re Purpoint Ltd* [1991] BCLC 491; *Re Sherborne Associates Ltd* [1995] BCC 40; and *Re Brian D Pierson (Contractors) Ltd* [1999] BCC 26.

[114] Even taking a salary is potentially included in s 214A by sub-s 214A(2)(a).

[115] Finch and Freedman, *supra*, n 70 at 510.

[116] As to what amounts to a members' claim see *Soden* v *British & Commonwealth Holdings plc* [1998] AC 298.

liquidators but also due to the courts' attitude against using hindsight as foresight[117]) and for similar reasons[118] it may be that s 214A will not play much of a role in the LLP sphere. The major creditors will protect themselves by a floating charge in either case.[119] From the point of view of the banks therefore the only question is whether unsecured overdrafts will be more expensive for an LLP than for a company and the only reason why that may be is if section 214A precipitates headlong rushes for the exit by members prior to the two year deadline—everything else is the same. If that seems unlikely (since it requires a number of assumptions to be made such as a draconian approach by the courts and a sudden absence of funding problems for liquidators) it may seem even more so if one considers the application of the Company Directors Disqualification Act to members of an LLP.[120] Disqualifications under section 6 of that Act have proved far more effective than wrongful trading in establishing behavioural norms for directors of sinking ships of all sizes.[121] There is no reason why it should not do the same for members of an LLP. Deliberate attempts to avoid section 214A may well constitute grounds for unfitness within section 6. There seems therefore to be no overwhelming reason why the creditor/member balance should influence a choice as between a company and an LLP.

Before we leave creditor protection it is worth noting that as opposed to the traditional partnership the LLP is more friendly to members in providing some limited liability whilst at the same time not altogether unfriendly to the major creditors who may take a much better security in the form of a floating charge—not available in partnership law.[122]

VII. Other Residual Checks on Forming an LLP

In addition to the problems of accessibility of the legislation, the liability of individual members, the uncertainty regarding internal relationships and the creditor/member balance, there are of course other teething problems with

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[117] See *eg Re Sherborne Associates Ltd* [1995] BCC 40.

[118] Although the courts may take a harsher view of s 214A. See, *supra*, n 113. But there are other problems, *eg* of evidence, which may make s 214A more of a threat than a reality.

[119] This will also protect them against the vagaries of the modified s 74 of the IA 1986. See *supra*, n 115.

[120] The 1986 CDDA is applied, as modified to LLPs, by reg 4 of the LLP Regs. Disqualification may work either way so that a director can be disqualified from being a member of an LLP and a member of an LLP from being a director. See *Palmer's LLP Law*, *supra*, n 52 at para A1.72 and Chap 11.

[121] See *eg Re Continental Assurance Co of London plc* [1996] BCC 888; *Re Kaytech International plc* [1999] 2 BCLC 351 (CA); *Official Receiver* v *Vass* [1999] BCC 516; *Re Barings plc (No 5)* [1999] 1 BCLC 433.

[122] The Law Commissions' provisional recommendation is that this should continue to be the case, unless a category of registered partnerships is to be introduced: Law Commissions' *Joint Consultation Paper: Partnership Law*, *supra*, n 11 at Chap 22.

the LLP. Two of these, raised by Finch and Freedman,[123] relate to taxation and accountancy.[124] Being specialist issues, this is not the place to go into either of these problems in any detail. Nevertheless one or two observations may be made. Tax considerations are important but, as Finch and Freedman point out, they clearly vary from business to business.[125] It is true that the Revenue still regards the LLP as an alternative device to a partnership (having either deliberately or inadvertently missed its sea change to a modified company) and needs to consider the LLP in the corporation tax context—particularly in allowing for conversion from a company to an LLP and vice versa to be tax neutral.[126]

With regard to accounting controls, seen as a *quid pro quo* for limited liability, there are obvious tensions in applying corporate accounting rules to an entity which may be run internally on a partnership basis and is taxed as such. That is a matter for the accountancy profession and the DTI to sort out and the former has, over a year after the introduction of LLPs, finally produced a Statement of Recommended Practice on Accounting by LLPs[127] and surely technical solutions can be found for technical problems so as not to frustrate the LLP's development.

VIII. Reforming the General Law of Partnership

Whatever the future of the LLP may be, it is clear that partnerships as such are very much here to stay[128]—there will be no further additional small business form in the foreseeable future[129] and limited liability is not necessarily seen as crucial by those who engage in such business.[130] The Law Commissions have as yet only produced their joint consultation paper on partnership law reform and not their final recommendations. The following therefore are comments on that consultation paper only. The LLP does have some relevance to this process, however, since, as we have seen, there are some aspects of partnership law attached to it, principally in the area of internal relationships[131] but also the application of agency law to

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123 *Supra*, n 70.

124 *Ibid* at 491 and 493.

125 *Ibid* at 491.

126 See generally *Palmer's LLP Law*, *supra*, n 52 at paras A1.85-A1.104 and sources cited there.

127 *Accounting by limited liability partnerships*, published by the Consultative Committee of Accountancy Bodies on 29 May 2002, available on www.ccab.org.uk. See also generally *Palmer's LLP Law*, *supra*, n 52, Chap 4.

128 See the Law Commissions' *Joint Consultation Paper on Partnership Law*, *supra*, n 11, Chap 1 ("Law Com").

129 See the *Final Report* from the Company Law Review Steering Group, *supra*, n 37 at para 7, and the subsequent White Paper, *Modernising Company Law*, *supra*, n 16 at para.1.6.

130 See Law Com, *supra*, n 11 at para 1.11.

131 LLP Act s 5. See note 89 above; and *Palmer's LLP Law*, *supra*, n 52, Chap 5; Morse, *supra*, n 1 at 259-264.

LLPs.[132]

The adaptation of these partnership concepts to LLPs is significant for partnership law reform generally in two ways: first the LLP has legal personality on formation and so the adaptation of traditional partnership fiduciary duties and agency relationship as between the partners (devised in English law for a situation where there is no actual firm as a legal person) to the member/LLP scenario is of relevance to the similar problems which will arise if the traditional partnership is also to become a legal person, which is put forward as a possibility by the Law Commissions.[133] Second, in adapting the partnership agency model to LLPs, at least one significant change has been made to the borrowed statutory provision which could be applied to all partnerships.[134]

IX. Acceptance of General Themes

It seems to me that there are three general themes in the proposals which are to be welcomed. The first is the introduction of legal personality for all partnerships, which will accord with public perception of a firm as an entity.[135] There might be thought to be problems with the concept of an informally created legal person (*ie* no one might realise that it does actually exist or when it came into effect since it can arise simply by an association of persons carrying on a business with a view of profit),[136] but in practice since such matters as insurance and ownership of assets could be dealt with by the law of trusts and problems of theft *etc* by a partner from the unknown firm covered by the need to show dishonesty, any such problems are outweighed by the advantages, not least the assimilation of partnerships into modern regulatory law.[137] The schizophrenic attitude of the tax regime whereby partnerships are regarded as transparent for direct taxes but as an entity for indirect taxes will, however, continue.[138]

The proposal that all partnerships should have legal personality[139] with

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[132] LLP Act s 6. See *Palmer's LLP Law*, *supra*, note 52, Chap 7; Morse, *supra*, n 1 at 256-258.

[133] Law Com, *supra*, n 11 at para 4.17

[134] See Morse, *supra*, n 1 at 257.

[135] See *supra*, n 133.

[136] This causes some problems with "contemplated partnerships" discussed below. The introduction of legal personality would not, unless the registered partnership is to be introduced, which seems unlikely, require any formalities for the formation of a partnership. That would still occur whenever the factual situation required by s 1 of the PA 1890 is fulfilled. The Law Commissions suggest minor amendments to s 1 but not to that basic principle: Law Com, *supra*, n 11 at para 5.26.

[137] See Morse, *supra*, n 1 at 88-91.

[138] This is also the position with regard to LLPs.

[139] Partnerships do have legal personality in Scotland under s 4(2) of the PA 1890. This is not necessarily the same concept as that being proposed by the Law Commissions, however, and has exercised the Commissions in their consultation document. See *eg* Law Com, *supra* n 11 at para 4.33 and *Major* v *Brodie* [1998] STC 491, where the English court

the added provision that such personality should survive a change in the partners unless they provide otherwise (*ie* an opt-out model rather than an opt-in model as is suggested in the document) seems the most workable.[140] An alternative possibility of only giving such personality to a new form of registered partnerships[141] would defeat the object of the exercise and would I think have a very limited effect, since those firms which might register would probably either be those which would draft a constitution so as to take full benefit from automatic legal personality or incorporate as LLPs anyway. To introduce another costly and bureaucratic process is unnecessary.

One of the advantages of continuing legal personality is in fact the second theme of the proposals.[142] This is that the association is to survive so far as possible after a change in the membership of the firm. Thus where one partner leaves the firm for whatever reason the existing relationship between the remaining partners is presumed to continue. Thus there would only be a dissolution as between the exiting partner and the other partners and not as between all the partners (which is technically the current position in the UK).[143] So, for example, a partner will only be able to withdraw from a partnership at will by notice rather than dissolve it[144] (thus avoiding the potential doomsday scenario nearly brought about by the activities of Mr Bingham chronicled in *Walters* v *Bingham*).[145]

The third theme which is to be welcomed is the new approach to dissolution and winding up. In line with the second theme, dissolution *per se* would be limited to situations where the whole firm was to be dissolved (either voluntarily or compulsorily).[146] There are also the proposals for the winding up of a solvent partnership under court supervision with an independent officer having powers to act vigorously.[147] The current problems of partnership disputes consequent on a winding up are well documented in the report.[148]

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struggled with the parameters of the legal personality of a Scottish partnership—not least because it had contradictory expert evidence on the point.

140 *Cf* Law Com, *supra*, n 11 at para 4.32.

141 *Ibid* para 4.21 and Chap 20.

142 *Ibid* para 4.32.

143 See Morse, *supra*, n 1 at 192. For the potential consequences see *eg Hadlee* v *Commissioner of Inland Revenue* [1993] AC 524 (PC). See also *Chiam Heng Chow* v *Mitre Hotel (Proprietors)* [1993] 3 SLR 547 at 555C (CA) for a similar statement as to the position in Singapore.

144 Law Com, *supra*, n 11 at para 6.19.

145 [1988] FTLR 260. See *Lindley & Banks*, *supra* n 1 at paras 24.21 *et seq*; Morse, *supra*, n 1 at 47.

146 Law Com, *supra*, n 11 at paras 6.4; 6.7; 6.15; 6.25. In para 6.15 the Commissions suggest that there should be a general policy "to give the maximum duration to partnerships which is consistent with the wishes or presumed wishes of the partners".

147 *Ibid*. Para 8.60; summarised in Morse, *supra*, n 1 at 205.

148 *Ibid*. Paras 8.29 *et seq*.

X. Proposals to be Welcomed as They Stand

The document makes a substantial number of detailed proposals and options for reform of specific provisions of partnership law. It is impossible in the space allocated to go through each of them but I would first like to mention a few of those which seem to me to be both sensible and timely before commenting on some areas which might require further thoughts and on others which appear to have been ignored in the consultation document.

Thus I welcome the proposed changes to the definition of a partnership in section 1 of the 1890 Act (*eg* it should be an *association* based on agreement to carry on a business through the firm with a view of profit but without necessarily having an agreed division of profits)[149] and the proposed abolition of sections 2 and 3 of the 1890 Act which provide a number of sometimes confusing evidential presumptions against the existence of a partnership.[150] These sections today only cause problems rather than provide solutions as to the existence of a partnership and have served their purpose. To some extent modern case law suggests that the courts have already come to this conclusion and use section 1 as the key section.[151] I also (with almost everyone else) welcome both the Commissions' and the DTI's proposals to abolish the numerical limit of 20 on partnerships.[152] The present system is both outdated and cumbersome and a strange way of regulating certain professions by means of exemptions from a numerical limit.[153]

I also welcome the proposals to rectify the anomaly in section 9 of the Act as to joint and several liability as between a living and a deceased partner, and to provide for primary and subsidiary liability where the firm has legal personality;[154] the proposals to modernise the references to payments of interest in the Act;[155] and the technical amendments to take into account legal personality.[156]

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149 Law Com, *supra*, n 1 at para 5.26. The question as to whether there is a need for a division of profits under the existing wording of s 1 is discussed in *Lindley & Banks*, *supra*, n 1 at para 2.10 and Morse, *supra*, n 1 at 21.

150 Law Com, *supra*, n 1 at paras 5.43 and 5.50.

151 See, *eg Vekaria* v *Dabasia* 1 December 1998 (CA) in England and *Lek Bong Hua* v *Lek Boon Chye* [1999] 1 SLR 523 in Singapore.

152 Law Com, *supra*, n 1 at para 5.51. Having produced a consultation paper on the issue and having received very favourable responses the DTI has drafted the final version of a statutory instrument to remove the limit. This is available on the DTI website: www.dti.gov.uk/cld. The original reason for the limit, difficulty in bringing claims, has long since disappeared.

153 This is because the exceptions to the limit are often couched in terms of membership of a professional or regulatory body, *eg* the Chartered Institute of Loss Adjusters. See *Lindley & Banks*, *supra*, n 1 at para 4.29 *et seq*.

154 Law Com, *supra*, n 11 at para 10.12. See Morse, *supra*, n 1 at 125; *Lindley & Banks*, *supra*, n 1 at paras 13.05 *et seq*.

155 Law Com, *supra*, n 1 at para 7.26(b).

156 *Ibid*. *Eg* at para 5.26.

XI. Areas Requiring Further Thought

There are a number of proposals in the report which do require perhaps some second or further thoughts. To take a few of these:

A. *Contemplated Partnerships*

It is sometimes difficult to establish exactly when a partnership association has actually begun—there is, as yet, no registration procedure.[157] Thus it is necessary to decide when the partnership obligations arise and, if legal personality is to be introduced, exactly when the firm itself comes into existence. In particular when does an agreement to set up a partnership actually evolve into the creation of a partnership? Following the decision of the Court of Appeal in *Khan* v *Miah*[158] that arranging premises for a proposed restaurant, advertising the new venture *etc* did not amount to a partnership since the actual business of running the restaurant never got off the ground, the Law Commissions recommend that it should be sufficient for a partnership to exist if the actual carrying on of the business was an object rather than a reality.[159] But the House of Lords in that case[160] subsequently decided that there was no need for actual trading to begin for a partnership to exist. What is needed is a business activity carried on in common and the fact that assets had been so acquired and liabilities so incurred jointly was sufficient for that. It seems to me that that is a better criterion for establishing a partnership than merely having the object of actually carrying on a business where nothing may actually have been and might never be done.[161] On the other hand the editor of the latest edition of *Lindley and Banks on Partnership Law* regards the decision in *Khan* v *Miah* as giving rise to great uncertainty.[162] But his argument seems to be predicated simply on the basis that the facts will be different in each case.

B. *Acceptance of repudiatory breach by one partner*

The House of Lords in *Hurst* v *Bryk*[163] suggested that acceptance by the other partners of a repudiatory breach of the partnership agreement by one partner which would end the *agreement* should not amount to an automatic dissolution of the partnership *relationship* (since the partners had subjected themselves to equitable considerations which could override the common

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[157] It is unlikely that the system of registered partnerships canvassed by the Law Commissions, *supra*, n 11, Chap 22, will receive much support.
[158] [1998] 1 WLR 477.
[159] Law Com, *supra*, n 11 at para 5.22.
[160] [2000] 1 WLR 2123.
[161] See Morse, *supra*, n 1 at 12-13.
[162] *Supra*, n 1 at para 2.03.
[163] [2000] 2 BCLC 117.

law doctrine of repudiation). This view could apply equally to the cases of frustration and rescission of the agreement.[164] As the Law Commissions pointed out this would mean that the relationship would survive, but only as a partnership at will which could be ended at any time by notice, or even by the acceptance of the repudiatory breach itself. Their suggested reform is to provide that acceptance of a repudiatory breach would end neither the contract nor the association. To effect that, an application would have to be made to the court for a dissolution—although they asked for views as to whether there should be an exception where a partner is locked out of the management of the firm for some time as a result.[165]

With respect I do not see how, consistently with the idea that a partnership is dependent upon an agreement, that association can remain intact on acceptance of a repudiatory breach of that agreement. There is also the considerable practical difficulty, as *Lindley and Banks* points out, of tying all the by now disenchanted partners into the firm pending a court dissolution. This would expose a partner who has, say been wrongly excluded from participation, to full joint and several liability during that period, for which a subsequent indemnity might, at best, be cumbersome.[166] A better course would be to provide that such acceptance provides for an immediate withdrawal from the association by the person concerned, with continuity for the other partners, rather than a possible future dissolution, albeit partial (since other proposals would give the court that option), eventually coming from the courts. This would avoid problems of tying in all the partners, and logically fit with the general theme of providing for withdrawals rather than dissolutions[167] and also with the law of contract.

C. *Rights of outgoing partner to share in the profits pending final settlement of accounts*

Section 42 of the Partnership Act 1890, currently provides that an outgoing partner (including a deceased partner) has a choice when the other partners continue the business pending the settlement of a final account. This is a choice as between a share of the profits attributable to the outgoing partner's share in the partnership assets or to interest on that share of the assets (currently 5% but to be altered to cover fluctuating rates).[168] The Commissions have suggested that the profits share option should be removed on the basis of practicalities of ascertaining how much of those subsequent profits is due to the outgoing partner's share and how much to

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[164] See Morse, *supra*, n 1 at 202-205; *Lindley & Banks*, *supra*, n 1 at paras 24.05 *et seq*.
[165] Law Com, *supra*, n 11 at paras 6.32, 6.33.
[166] *Supra*, n 1 at para 24.07.
[167] See Law Com, *supra*, n 11 at para 6.15.
[168] On s 42 generally, see *Lindley & Banks*, *supra*, n 1 at paras 25.25-25.37; Morse, *supra*, n 1 at 222-228.

the personal efforts of the remaining partners.[169] But in the light of the decision and comments of the Court of Appeal of Victoria in *Fry v Oddy*[170] perhaps this should be reconsidered. In that case the question arose as to ascertaining the share of the profits attributable to the share of the assets of an outgoing partner in a firm of solicitors. The Court considered that in a modern legal practice profits were more and more attributable to the assets of the firm as opposed to the personal skills of each member of the firm. If that is correct and in times of low interest rates it would seem harsh to remove the profits share option from section 42. In any event there is an argument that the continuing partners might be construed as holding that amount as constructive trustees for the outgoing partner.[171]

D. *Competing or complimentary fiduciary duties*

The Law Commissions raise the issue as to the application of the current fiduciary duties owed by each partner to the other partners to a situation where there the firm has its own separate legal personality and it carries on the business. This poses the question as to what duties should be owed by each partner to the firm and whether there should be any such duties still owed as between the members *inter se*. The Commissions have put forward three options: (i) that all duties should be owed only to the firm; (ii) that some duties should be specified as being owed to the firm (duty to account for profits, duty not to compete, duty to act *bona fide* for the benefit of the firm) and others as between the members (duty to give full information and accounts and duty of good faith in partnership relations); and (iii) that the duties of care and skill, account and non-competition should be owed both to the firm and the other partners.[172]

The Commissions are concerned that if the duties are only owed to the firm then there will be a problem for a minority partner having any redress against the majority for breach. One rather cumbersome answer to that is that it would be possible for a procedure to be devised to allow one partner to bring an action for a breach of duty owed to the firm subject to the majority being able to disclaim it if they are acting in good faith (as is suggested by the Commissions).[173] More realistically, consideration should be given to adopting some form of default exit or resolution dispute

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[169] Law Com, *supra*, n 11 at para 7.26. The option has no application in any event to the partner's share of the capital appreciation of the partnership assets: *Barclays Bank Trust* v *Bluff* [1981] 3 All ER 232.

[170] [1999] 1 VR 542.

[171] Insofar as they are derived from assets, which could include goodwill, still partially owned by the outgoing partner. The Law Commissions' proposals should also be considered in the light of art.1 to the First Protocol to the European Convention on Human Rights.

[172] Law Com, *supra*, n 11 at para 15.21.

[173] *Ibid*. *Quaere* as to whether there is any concept of the derivative action in partnership law as it stands: see the Canadian case of *Watson* v *Imperial Financial Services Ltd* (1994) 111 DLR (4th) 643; Morse, *supra*, n 1 at 90.

procedure, though not necessarily based on section 459 of the Companies Act as has been applied to LLPs.[174] This could take the form of a modified no-fault exit procedure if the partnership ethos of mutual trust *etc* is broken. If such a default procedure is excluded by agreement then the parties will surely have addressed their minds to exit procedures and provided accordingly. There is always the just and equitable winding up provision in section 35 of the Act as a final back up, which, if amended as the Commissions suggest, will allow the courts to allow for a withdrawal and not a full dissolution.[175]

It follows that I cannot see any reason why the duties should not be stated as being owed to the firm and exceptions where they may be owed between the partners could be left to the courts. It is clear that as controllers and agents for the firm the partners will owe fiduciary duties to it. To provide for additional express categorised fiduciary duties as between the members runs the risk of having competing duties; *ie* where a partner's duties to the firm and to another partner might actually conflict, as is a possibility with LLPs.[176] If the answer to that is that it could be sorted out by the courts then why not leave the question of duties as between the partners to the courts in the first place.

There is, as we have seen, a similar problem with regard to the internal relationships of members of LLPs. I can see no reason why the same basic solution as I have suggested for LLPs should not equally apply to partnerships; *ie* that the duties should be owed to the firm and only, additionally, to each other where there is a special factual relationship on the analysis of Mummery LJ in *Peskin* v *Anderson*.[177]

Members of an LLP are not partners, however, and it could be argued that the partnership ethos requires an automatic fiduciary relationship as between the partners[178] but I would suggest that to provide that all fiduciary duties are owed to the firm as arising from the legal relationship of direction and control between them and leaving the courts to apply fiduciary duties as between the partners on the factual relationship basis, *ie* where one partner has undertaken or is treated as having assumed responsibility to act for the other's benefit, allied to an exit procedure, will prove just as effective a protection for individual partners.

XII. AREAS NOT ADDRESSED BY THE LAW COMMISSIONS

There are two areas of difficulty in partnership law which, if they were

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174 See *supra*, n 93 and n 94.

175 Law Com, *supra*, n 11 at para 6.42.

176 See *supra*, n 101.

177 [2000] 1 BCLC 173. See *supra*, n 104.

178 As has always been the case. See *eg Const* v *Harris* (1824) Turn & R 496 *per* Lord Eldon: "In all partnerships, whether it be expressed in the deed or not, the partners are bound to be true and faithful to each other."

considered, have not been addressed in the Law Commissions' document. The accusation that these are academic difficulties only could only be addressed to the first of these and even there it has led to recent litigation in Australia and given that we only review partnership law every hundred years it might have been thought worthy of mention. The other area is very much before the courts in the UK.

A. *Section 5 and the doctrine of the undisclosed principal*

The Law Commissions are of the opinion that section 5 of the 1890 Act, which sets out the circumstances where one partner may bind the others to a contract, is "generally satisfactory".[179] But that section has a proviso whereby the other partners will not be bound, even if the partner concerned is acting in the ordinary course of business of the firm, if either the person dealing with him knows that he has no authority (unexceptional) or does not know or believe him to be a partner. The latter appears to negative the doctrine of the undisclosed principal (*ie* where an agent is acting for an undisclosed principal, the third party may enforce the contract against the principal), despite some suggestions in case law to the contrary[180] and has led to academic debate as to when exactly the third party is unaware that the person he is dealing with is a partner (*eg* with whom).[181] Some consideration should be given as to whether the proviso should be maintained in its present form, including the trustee solution adopted in Australia (*ie* that the apparently unconnected partner is contracting as a trustee for the benefit of the firm rather than as an agent).[182] At the very least the amendment to the wording of the proviso in section 6 of the LLP Act, which imports section 5 of the PA into LLP law might be considered. There the restriction only applies if the person dealing with the member does not know that he/she is a member of *the* LLP rather than *an* LLP. Given that partnerships may have legal personality,[183] such a limited restriction, *ie* that the third party did not know that the partner was a member of the firm involved, would at least reduce the potential for confusion.

B. *Liability for breaches of express and constructive trusts by one partner*

The Partnership Act has three sections which apply to non-contractual

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179 Law Com, *supra*, n 11 at para 9.5.

180 *Watteau* v *Fenwick* [1893] 1 QB 346, *cf Construction Engineering (Aus) Pty Ltd* v *Hexyl Pty Ltd* (1985) 155 CLR 541.

181 See J L Montrose: *Liability of principal for acts exceeding actual and apparent authority* (1939) 17 Can Bar Rev 693; J C Thomas*: Playing word games with Professor Montrose* (1977) 6 VUWLR 1. See Morse, *supra*, n 1 at 105-109.

182 *Construction Engineering (Aus) Pty Ltd* v *Hexyl Pty Ltd*, *supra*, n 179.

183 See *supra*, n 133.

partnership liability. Section 10 provides joint and several liability for all wrongs committed by a partner in the ordinary course of business of the firm or with the authority of his co-partners;[184] section 11 for the misapplication of property either received by a partner within his authority as such and misapplied by him or brought into the firm in the ordinary course of its business and misapplied whilst in the firm's custody;[185] and section 13 which provides that no partner without notice is liable if a partner, being a trustee, improperly employs trust property in the business or on behalf of the firm in breach of trust.[186] The Commissions have not recommended any changes of substance to these three sections,[187] but this does seem to ignore recent problems which have arisen with regard to their application to the vicarious liability of partners for breaches of an express trust by one partner and, more importantly, their vicarious liability for what is known as accessory liability of one partner under the laws of trusts and restitution.

Such accessory liability is based on a person either knowingly assisting in a breach of trust (knowing assistance—based on dishonesty)[188] or knowingly receiving trust property taken in breach of trust by another (knowing receipt—based on conscience).[189] If one partner is so liable, in what circumstances will the other innocent partners be vicariously liable if there is a partnership connection so as to bring sections 10 or 11 into play—they will of course be each individually liable if they have the requisite knowledge *etc*.

The Court of Appeal in *Dubai Aluminium Company Ltd* v *Salaam*,[190] held that section 10 liability applies to liability for the knowing assistance of one partner—liability for wrongs can include that, so that if the knowing assistance is done within the ordinary business of the partnership (*ie* it is an improper way or carrying out an activity of the firm) the other partners will

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[184] Section 10 reads: "Where, by any wrongful act or omission of any partner acting in the ordinary course of the business of the firm, or with the authority of his co-partners, loss or injury is caused to any person not being a partner in the firm, or any penalty is incurred, the firm is liable therefor to the same extent as the partner so acting or omitting to act". See *Lindley & Banks*, *supra*, n 1 at paras 12.83-12.110; Morse, *supra*, n 1 at 110-116.

[185] Section 11 reads: "In the following cases: namely – (a) where one partner acting within the scope of his apparent authority receives the money or property of a third person and misapplies it; and (b) where the firm in the course of its business receives money or property of a third person, and the money or property so received is misapplied by one or more the partners whilst it is in the custody of the firm; the firm is liable to make good the loss". See *Lindley & Banks*, *supra*, n 1 at paras 12.111-12.140; Morse, *supra*, n 1 at 116-119.

[186] See *Lindley & Banks*, *supra*, n 1 at paras 12.141-12.152; Morse, *supra*, n 1 at 119-125.

[187] Law Com, *supra*, n 11, paras 10.26, 10.30.

[188] The most recent formulation of this liability is by the House of Lords in *Twinsectra Ltd* v *Yardley* [2002] 2 All ER 377 (Lord Millet dissenting).

[189] The exact parameters of this liability are not yet certain: see *eg Bank of Credit and Commerce International (Overseas) Ltd* v *Akindele* [2000] 4 All ER 221.

[190] [2000] 2 Lloyd's Rep 412.

be liable vicariously as they are for torts. This reversed previous cases to the contrary which limited section 10 to torts and crimes and potentially opened up section 10 to cover all forms of liability.[191] But what about knowing receipt? It could be argued that section 10 vicarious liability should also apply if the receipt is also within the ordinary business of the firm or authority of a partner—it is also a wrong. But because this, unlike knowing assistance, involves the property being received by a partner or the firm, it also involves sections 11 and 13.

The difference between sections 11 and 13 was explained by Millet LJ in *Bass Brewers Ltd* v *Appleby*[192]:

> Section 11 deals with money which is properly received by the firm (or by one of the partners acting within the scope of his authority) for and on behalf of the third party but which is subsequently misapplied. The firm is liable to make good the loss [*ie* vicarious liability]. Section 13 is concerned with money held by a partner in some other capacity, such as a trustee, which is misapplied by him and then improperly and in breach of trust employed by him in the partnership business. His partners can be made liable only in accordance with the ordinary principles of knowing receipt [*ie* personal liability].

The question therefore ought to be whether a partner's knowing receipt can also be construed as a proper or business receipt by the firm within section 11 (or even section 10?) or whether it is an improper or non-business receipt by the firm and so within section 13, thus negating vicarious liability.

But a different Court of Appeal in *Walker* v *Stones*[193] decided that partners could not be liable at all for a breach of an express trust by one partner under section 10 since otherwise it would contradict section 13. This was because if section 10 applied it would presuppose that individual trusteeships which a partner may undertake are in the ordinary course of business of a firm and would cover the exact situation described in section 13. That case was not concerned with knowing receipt and *Lindley and Banks*, somewhat optimistically perhaps, does not consider that it has any relevance to it[194] but in so far as it says that all express breaches of trust by a partner are outside section 10 it would seem to be wrong. Section 13 only applies to one specific fact situation—*ie* money taken in breach of trust and subsequently introduced into the firm by one partner. It could not apply where money is held by the firm, one partner becomes a trustee of it and

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[191] The application of s 10 to knowing assistance cases seems also to have been tacitly assumed in *Agip (Africa) Ltd* v *Jackson* [1991] Ch 547. *Lindley & Banks*, *supra*, n 1 at para 12.110 appears underwhelmed by these decisions.

[192] [1997] 2 BCLC 700 at 711.

[193] [2000] 4 All ER 412.

[194] Para 12.145.

then breaches his trust. That should be dealt with under sections 10 or 11. There are also problems with the parameters of section 13 as to the meaning of notice.

Although both these decisions of the Court of Appeal have been referred to the House of Lords, the result of all this is that there is some confusion as to the parameters of section 10 and the interface between the three sections and this surely merits some discussion in a reform document. The reality is that those sections predate modern developments in accessory liability and restitutionary concepts. There are several possibilities: one would be to separate vicarious liability for torts and crimes on the one hand and for trusts and accessory liability on the other; another would be to consider whether vicarious liability is appropriate at all for accessory liability, or alternatively whether restitutionary principles should be applied without any requirement of fault; or more radically to repeal sections 11 and 13—leaving section 10 to deal with all questions of vicarious liability (*ie* was the wrong, of whatever type, done in the ordinary course of the firm's business or within the authority of a partner). This would preserve the exclusion of liability in the factual situation of section 13[195]—because the breach of trust there envisaged takes place outside the firm, but would include those currently within section 11—misapplication within the authority of a partner[196] or whilst in the firm's custody). General principles would continue to establish any direct personal liability of the other partners as an accessory.

XIII. CONCLUSION

The process of law creation and reform is always a fascinating subject for study. There is no doubt that many of the structural and operational rules applicable to companies (especially private companies) will change within the next few years. The same may well be true of partnerships. In both cases, however, the basic norms will remain recognisable. The LLP is something of an ugly duckling and it is not clear whether it will ever be a swan. For the present it will, however, be the only new business structure, albeit one which has developed independently and been largely ignored by both contemporaneous law reform projects. Ironically, perhaps, many of the changes which will eventually come out of the company law review in particular, will have to be replicated in a modified way in the derivative corporate law applied to LLPs, even though those changes today are still being formulated without any reference to LLPs. In fact, with hindsight, it would clearly been much better to have considered LLPs after the reform of

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[195] But leaving tracing available as now: see *Lindley & Banks, supra*, n 1 at para 12.152.

[196] Assuming that the concept of authority in s 10 is wide enough, or made wide enough, to encompass a partner's apparent authority as currently stated in s 11(a). See *eg Allied Pharmaceutical Distributors Ltd* v *Walsh* [1991] 2 IR 8.

partnership law so that the possibility of the partnership model with legal personality being available might have provided a realistic and better alternative to the use of the corporate model for LLPs. As it is, the paper chase is on.