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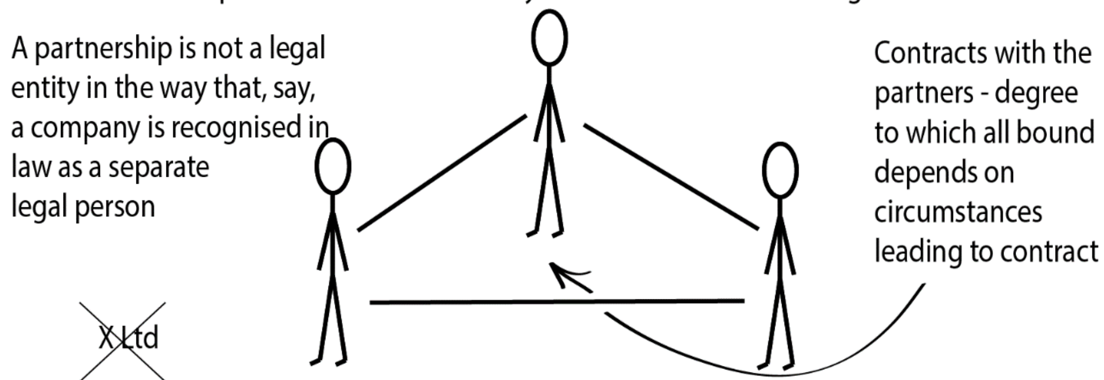
Guide 4 – Partnership



Throughout this Guide an imaginary scenario will be used to illustrate matters. The scenario involves Ian Brown who is considering setting up a business, selling food stuff from a retail unit in a converted barn. He is considering setting up the business with 2 colleagues – Sandra Green and David Pinkerton.

If more than one person decides that they want to set up in business together then, as mentioned in Guide 3, they do not have the option to set up as a sole trader. Two or more people, who want to own a business, cannot set up as a **sole** trader.

However, if two or more people do want to set up in business together then they have the option to set up as a partnership or as a company or as a Limited Liability Partnership.

This Guide focuses on partnerships. It considers the process for setting up a partnership and also the advantages and disadvantages of partnerships; when compared to a sole trader, company or Limited Liability Partnership.

4.1 How to set up a partnership

Before starting trading as a partnership, the individual partners (to be) should make sure that they reach an agreement as to the core terms of the partnership. So, if Ian Brown, Sandra Green and David Pinkerton decide to set up a partnership together it is important to establish the exact terms of their agreement at the outset; terms such as how profits are to be split between the partners, how new partners are to be appointed, how much money each partner can draw from the partnership each

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month and so on. A full list of matters that should be agreed on between the partners is given in this Guide at 4.3.

A partnership agreement can be verbal but the problem with verbal agreements is that people can misremember stuff (deliberately or not) and, when it comes to disagreements, it can be difficult to find out precisely what was intended. Sometimes prior conduct (i.e. what the partners have actually done in the past) can help as a source of evidence as to intention; so if, say, Ian, Sandra and David had formed a partnership (but with no written agreement) but their prior conduct was that they had always shared the income profits 30%, 30% and 40% respectively, then that would be good historical evidence that this was what the partners intended, in terms of the arrangement for the distribution of income profits. However, rather than rely on past conduct evidence and oral evidence it is best to have a written partnership agreement in place from the outset.

The advantage of a written partnership agreement is that there is much less chance of "agreed" terms being open to interpretation. Ian, Sandra and David might get on particularly well at the moment in time that they set up in partnership together but this could change over time. Although, in law, there is no specific law that says that the terms of a partnership agreement must be written down it is recommended that a written partnership agreement is drafted and signed by all the partners.

Tip: If considering entering a partnership ensure that the terms of the agreement are put in writing and signed by all the partners (either as a deed or as a simple contract – see differences between contract and deed below).

Tip: In business there are numerous written agreements that may (or may not) be relevant to a sole trader, partnership, company or Limited Liability Partnership. For example, a sale of goods contract, a partnership agreement, a shareholders' agreement, a franchise agreement, an agreement to transfer land and so on (details of these types of agreements are dealt with in this and in other Guides of this Guide). You may see some documents that are described as being "By way of deed" and that are "Signed as a deed…" The differences between a document that is signed as a deed and one that is not are as follows:

1. Signing a document as a deed requires the document to be referred to as being "By way of a deed" and additionally for specific formalities (in regard to the signing of the document) to be followed. The formalities for signing a document as a deed will depend on whether the document is being signed by an individual as a sole trader, individuals as partners in a partnership, by directors on behalf of a company or by members on behalf of an LLP. Examples of how deeds should be signed (and how contracts should be signed) are given in Figure 4.1 below.

2. The law requires certain documents such as those that transfer the legal title in land to be made by way of deed (albeit with limited exceptions such as leases for 3 years or less).

3. A document signed by way of deed does not require "consideration" in order for it to be binding (for details of what is meant by consideration see Guide 16).

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4. If a document is made by way of deed then the time limit for a party to the deed to make a claim for any breach is 12 years (compare this with 6 years for an ordinary agreement (contract) that is not made by way of deed).

Contract	**Contract**	**Contract**	**Contract**
Signed by sole trader and no need for witness	Signed by [name of partner authorised to sign contract] **for and on behalf** of [Name of partnership]	Signed by [name of director authorised to sign contract] **for and on behalf of** [Name of company]	Signed by [name of member authorised to sign contract] **for and on behalf of** [Name of LLP]
Deed signed by sole trader	**Deed** signed by partnership - all partners sign unless power of attorney has been given to one to sign on behalf of all	**Deed** signed by company (various options for signing deeds e.g. :	**Deed** signed by LLP (various options for signing deeds) e.g. :
Signed as a deed by [Name inserted] in the presence of:	Signed as a deed by [Name inserted] in the presence of:	Signed as a deed by [Name of Company] acting by [Name of director] a director, in the presence of:	Signed by [Name of LLP] acting by [Name of member] a member, in the presence of:
Witness signature, name and address	Witness signature, name and address	Witness signature, name and address	Witness signature, name and address

Figure 4.1

4.2 Legal Definition of Partnership

What is a partnership?

The legal definition of a partnership can be found in the Partnership Act 1890. Partnership law in parts of the UK, such as Scotland, do not follow the precise laws of England and Wales. The following is a discussion of the law of partnership that applies to England and Wales.

Under section 1(1) of the Partnership Act 1890 a partnership is defined as:

"***the relation which subsists between persons carrying on a business in common with a view of profit***".

So, in situations in which **<u>two or more persons</u>** get together and **<u>work together with a view to profiting</u>** from their work **<u>this results in a partnership</u>**; even if those people did not necessarily realise that this was the outcome of their actions.

Tip: Sometime people working together do not realise that technically they are in partnership with others; especially in family business scenarios. The fact is

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that if the elements mentioned above are in place then a partnership may well result. This could have tax and other implications.

A partnership is an association of persons (by law “persons” can include companies as well as individuals - as mentioned previously, a company is actually a legal “person”) **but** the entity of the partnership itself does not have a legal personality.

To many this might seem confusing, especially given that sometimes partnerships use business names ending in wording such as “*& Co”*, and possibly in doing so giving the impression that the partnership is a separate legal entity. But note that a name ending in “& Co” does not mean the entity is a company; only if the business entity’s name ends in Ltd (or Limited) or plc (or public limited company) will the entity be a company. (Albeit do note that there are also other less common types of company).

The fact is that a partnership is not a separate legal entity in itself, but rather it is an association of individuals. Compare that with a Limited Liability Partnership or a company or even a sole trader; each of which is considered to be a separate legal entity in its own right (or his/her right in the case of a sole trader).

As mentioned before it is recommended that the terms of a partnership be agreed and evidenced in written form, signed by all the partners. However, any such agreement does not need to be submitted to any government body (or other body for that matter) such as Companies House.

4.3 What terms should be in a Partnership Agreement?

The following is a list of the type of information that should be included in a partnership agreement. The list does not cover every detail of every element that should be included. However, the information referred to below is the minimum that you would expect to see in a partnership agreement. Appointing a legal representative could save time and money when it comes to drafting a partnership agreement.

Tip: Firms of solicitors are required to follow the Solicitors Regulation Authority Code of Conduct. This contains rules on how a solicitor should deal with clients including rules on matters such as conflict. If prospective partners in a partnership do not have any conflict or potential conflict issues then a solicitor could act for all of the partners. However, if there is potential conflict or actual conflict between the partners then the solicitor would have to ask the partners to seek separate legal representation; although the firm could potentially act for one of the partners, if there were no confidentiality issues. An example of conflict would be if, say, the prospective partners could not agree on the profit-sharing arrangements.

Here are the main items that should be included in a partnership agreement:

(1) Full names and addresses of the partners.

(2) The nature of the existing business.

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(3) The business trading name, if one is to be used.

(4) The date on which the agreement is due to start. It is worth bearing in mind that **if** the specific conditions that are required to set up a partnership are already in place (i.e. two or more people working in business with a view to profit) then specifying a future date on which an agreement is due to start can, in those circumstances, be meaningless, as technically the partnership would have already started.

(5) The address of the place of business.

(6) Details of the partnership's bankers and accountants.

(7) The length of time for which the partnership is due to last. It may be, say, for a fixed term of X years or it may be for an unlimited period or it may be just while a specific project Y lasts.

(8) Income profit percentage shares. So, for example, if the partnership (Ian, Sandra and David as partners) sells organic meat pies and makes £90,000 profit during the year how is that income profit to be distributed between the partners? Is it to be equally distributed or is it to be some other share, such as 40%, 40% and 20%?

(9) Initial capital – details of how much each partner will put into the business at the outset (as cash or as a cash equivalent (a cash equivalent might be an asset such as a car)). So, for example if Ian, Sandra and David contribute £5,000 (cash), £2,000 (cash) and £6,000 (cash) respectively then this should be clearly detailed in the partnership agreement. Without contrary intention it is implied that, in the event of the partnership coming to an end, each partner will be able to withdraw their initial contributions (assuming there is still sufficient capital in the business to do so).

(10) Capital profits – how are these profits going to be distributed? Invariably partners focus on "*Income profits"* and how these are to be distributed and, in fact, they might not even be aware of "*Capital profits*".

Capital profits are the added value that will build up in a business over the years (assuming it is a successful business). In the event that the partnership then closes or if, say, a partner wishes to leave, how precisely will the increased value in the business be split between the partners? In order to make the arrangements clear to all the partners the Capital profits percentage figures should be agreed in writing in a partnership agreement.

So, say Ian, Sandra and David started in business as partners and put in cash to the value of that quoted in (9) above and the business, at the beginning, is worth £13,000 (i.e. £5,000 + £2,000 + £6,000 = £13,000). A few years later the business might be worth say £50,000. Much of this increase might be due to (a) the goodwill associated with the business increasing in consequence of the large number of customers who now use the business or (b) perhaps the business might have bought lots of business equipment and other assets or (c) perhaps it's a combination of both.

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The goodwill is seen as an asset (although not one that is generally speaking recorded on accounts; however, goodwill is a figure that buyers often have to pay for when buying a business). Goodwill reflects, to an extent, the value that a business has in consequence of it having a customer base. It is an “intangible asset” i.e. it cannot be physically touched.

Imagine that the business has gone up in value. The question is, in the event that the partnership comes to an end, how precisely will the £37,000 (being the difference between the current value of £50,000 and the initial £13,000 value of the partnership) be distributed? Should it be distributed equally or should it be distributed in accordance with the capital contributions that were made in the first place e.g. If Ian contributed £5,000 out of the initial £13,000 might it be that he should benefit from a percentage equating to £5,000 (his initial contribution) divided by £13,000; i.e. approximately 38% or should the capital profits be split equally i.e. 33.3%.

Precisely how the capital profits are to be split is down to negotiation between the prospective partners but if nothing is agreed then there are default rules under the Partnership Act 1890 - for more of which see below.

(11) Specify which assets are to be **owned** by the partnership and which are simply to be **used** by the partnership (“used”, in this context, means without being absorbed into the partnership asset pool). Over the years various cases have come to court in which, when a partnership ends (or “dissolves”, as it is technically referred to as), the partners are unable to agree the status of certain assets. Partner X might argue that the asset that (s)he brought into the partnership was never intended to be a partnership asset but was only essentially being used by the partnership under licence and that now the partnership is to end (s)he, Partner X, is entitled to receive the asset back without any splitting of its value amongst the other partners. Partner Y may argue to the contrary. In order to prevent this conflict arising the written partnership agreement should specify which category each asset falls under; either (a) business asset **<u>or</u>** (b) non-business asset (i.e. not owned by the partnership). By way of example in the case of Ian Brown and his colleagues Ian might argue that the fridge freezer that he brought to the farm unit (from his house), and that the business has been using since the first day of trading, is actually his and does not belong to the business and that he never intended it to be owned by the business. Such disputes can be taken care of by accurately detailing the start-up arrangements in a written agreement.

(12) Drawings – these specify the amounts that partners may draw out of the business on account of profits each month/week etc. It is important to ensure that drawings are not excessive and that they do not exceed the profits. So, for example, if Ian, Sandra and David estimate that profits for the year will be £90,000 then they should insert a figure for drawings which allows up to that amount to be drawn over the year by the partners, but not more (or if there are excessive drawings the agreement should specify how that is remedied).

(13) Cheques - how many partners are required to sign any cheques? Must Ian, Sandra and David all sign the cheques or is some other combination acceptable?

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(14) Accounting date - the business' accountant can advise as to what the partnership accounting date should be. This is the date to which the accounts are drawn up at the end of each accounting year.

(15) Powers and duties of the partners in regard to management matters. For example, the agreement should lay down rules such as whether new employees may be appointed by a majority of the partners or by unanimous vote. Which other decisions should be made by way of majority vote/unanimous vote?

(16) Are there to be any restrictions on the activities of the partners in terms of carrying on any other businesses?

(17) Specify rules as to what process should be followed in the event that a partner wishes to retire ("retire" being the technical name for leaving the partnership; rather than stopping working at a certain age). Are the continuing partners allowed to have the option to buy out the share of the outgoing partner? Over what period will the payment be made for the partnership share?

(18) Are there any situations in which a partner can be expelled? Is the power to expel to be by majority or by unanimous vote? Which events will justify expulsion of a partner? e.g. bankruptcy. What happens when a partner is expelled? For example, when a partner retires, he or she would normally be paid an amount representing their capital plus any capital profit share plus any income share, for the period up to the point when they leave. Sometimes a partnership will pay a yearly amount (known as an annuity) to the outgoing partner. However, in the event that the partner has been made bankrupt or left for reasons of, say, gross misconduct, then it may be that it is not appropriate to pay them in the same way as would have been done in the event of a "normal" retirement.

(19) Don't forget to deal with how losses (either income or capital losses) are to be divided. The business might not perform as well as Ian, Sandra and David hope it will. Perhaps losses will be split in the same way that profits are split (if income and capital profits are the same – but they don't have to be) or maybe using another percentage split.

(20) Consider inserting clauses to clarify what power each partner has to bind the whole of a partnership to enter into a contract. e.g. "*No partner may enter into a contract with a third party to buy goods in excess of £1,000*". Having said that sometimes all of the partners in a partnership can find themselves bound to a contract by the actions of one partner, irrespective of what is stated in the partnership agreement.

This can happen if it is reasonable for the person who is dealing with a partner to assume that the partner had authority to enter into the contract on behalf of the other partners and the contract concerned goods or services that would normally be associated with the business in question. So, for example, it would be more difficult for a supplier to argue that a contract, in regard to a supply of electronic computer games (to Ian, Sandra and David's food retail partnership), was binding if the supplier had only entered into a contract with **one** of the partners. In this case it should be obvious to the supplier that this is not the type of goods that you would

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expect Ian, Sandra and David to be selling from their farm unit. However, if a supplier had similarly entered into a contract with Ian alone for say £2,000 worth of chocolates (without Sandra and David being aware of this) then it is unlikely that Sandra and David would be able to argue that the partnership is not bound to the contract; given the product is a food and their business deals with the sale of food.

I previously mentioned the Partnership Act 1890 and, as well as defining what a partnership is, the Partnership Act 1890 also has a role to play in the event that a particular term of the partnership agreement is not dealt with expressly (or in situations where a term cannot be inferred from previous dealings). In this situation the Partnership Act 1890 can fill in the gaps.

Effectively the Partnership Act 1890 lays down the default positions for various terms and conditions of a partnership agreement. So, for example, if a situation existed in which there was both (a) no provisions in an express written (or verbal) agreement and (b) no evidence available concerning what had happened in the past (past dealings) then income profits (I am using income profits just for the purpose of illustrating the defalut provisions) under the default provisions of the Partnership Act 1890, would be split equally. That is because section 24 of the Partnership Act says that:

"*subject to any agreement express or implied between the partners… All the partners are entitled to share equally in the… profits of the business*."

There are some provisions in the Partnership Act which it is not possible to override, even by way of express agreement. For example, in regard to arrangements such as dealings with third parties.

The Partnership Act 1890 can be found at the legislation.gov.uk website.

4.4 Advantages of a Partnership

The fact that, to a great extent, the partners are allowed to negotiate and agree on most of the terms of their partnership agreement, without having to comply with any rules or regulations, means that there is a great deal of flexibility in terms of how the partners are able to manage their business. More so than for a private company, as is further described in Guide 5. The partners are effectively both the owners and the managers of the partnership, in the same way that a sole trader is both owner and manager of the sole trader business.

Partnerships do have a possible advantage over companies and Limited Liability Partnerships (for those who do not want their financial details to be available to the public) in that annual accounts (and other information) does not have to be made available to the public in the same way that companies and Limited Liability Partnerships must do (Companies and Limited Liability Partnerships must lodge financial information at Companies House). The Companies House website has the accounts and other information on any Limited Liability Partnership or company. You cannot find information for a partnership (or for a sole trader) at Companies House.

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4.5 Disadvantages of a Partnership

As with a sole trader the partners in a partnership have unlimited liability and so, if a claim is made against the partners in a partnership (assuming that any business insurance that Ian, Sandra and David had in place was insufficient to cover the claim) any claimant (if successful in their claim) could seek payment from the personal assets of the partners as well as the business assets of the partnership.

Imagine that a customer, Mr Smith, buys a sandwich from Ian, Sandra and David's business (which is being run as a partnership). If it is the case that he contracted salmonella, and his illness and associated losses were found to be caused by those working in Ian, Sandra and David's business, and that the damage was reasonably foreseeable then he could sue the partners for his personal injury. Hopefully, the partners will have taken out insurance at the same time as starting the business and so the insurer would pay on their behalf. Of course, even if they had taken out insurance the consequences for the business may well be that there will be increased premiums, when it comes to renewing the insurance. As has been seen with Covid claims there is no guarantee that all types of claim that were thought to be covered are actually covered and that is where it becomes even more important to read the fine print.

So, what happens if no insurance has been taken out or the claim is not covered by the insurance policy? The answer is that the wronged party, Mr Smith, will have not just the business assets but also the personal assets of each of the individuals to potentially claim against should his claim be successful. i.e. If Mr Smith's claim resulted in a court judgment of say £50,000 in his favour, but the business assets were only worth £30,000 then Mr Smith could seek to enforce the judgment against the personal assets of Ian, Sandra and David. This is the same as we saw in the sole trader scenario.

To answer the question of whether being a partner in a partnership is an advantage or disadvantage, in terms of tax efficiency (as compared with other business vehicles, such as companies), consider the tax matters and National Insurance Contributions matters raised in Guide 3.7. i.e. which business vehicle is best will require a careful assessment by a financial adviser, taking into account the individual owner's personal financial circumstances and projected profits.

You might see some partners described as "salaried partners". The "salary" paid to a salaried partner is usually limited to a fixed amount, payable out of the partnership's net profits. This means that a salaried partner does take the risk that he/she will not be paid in the event that the partnership does not have sufficient net profits from which the "salary" is paid.

4.6 Business Names Rules

The same rules that apply to a sole trader also apply to a partnership. So, if a partnership trades under a business name that consists of the surnames of the individual partners or the surnames with "permitted additions" (such as their initials or forenames) then there are no disclosure requirements that need to be made in terms of disclosing the full names of the partners on invoices, letters etc. The detail of

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these provisions are detailed in the Companies Act Part 41 (section 1192). Note that there are some disclosure exemptions for a partnership that has more than 20 partners but this isn't going to be relevant to most start-up businesses.

As mentioned previously, it might seem odd that rules relating to individuals and partnerships (i.e. entities with nothing to do with companies) are found in the Companies Act 2006 but is the reality.

Tip: Ian Brown, Sandra Green and David Pinkerton set up in partnership together. If they decide to trade as "Brown Green and Pinkerton" then there are no disclosure requirements to be made on their invoices, letters etc. That is because they are using their surnames.

Tip: Ian Brown, Sandra Green and David Pinkerton set up in partnership together. They decide to trade as "Topfoodydoody". In this case they will need to disclose their full names on any business letters, written orders for goods or services to be supplied to the business, invoices and receipts issued in the course of business and written demands for payment of debts arising in the course of business. Additionally, they would need to state, in a notice at their trading premises, their full names and the full address of their trading premises. That is because they are trading under a name that does not consist of their surnames (plus any permitted additions such as forenames or initials).

Ian, Sandra and David should also take care to make sure that in the event that their trading name contains a word which implies a link to HM Government, local authorities or public bodies that they should seek the consent of the Secretary of State before trading under that name.

Again, as with the business name of a sole trader, partners must also consider the rules in the Statutory Instrument that is called: The Company, Limited Liability Partnership and Business Names (Sensitive Words and Expressions) Regulations 2014. This Statutory Instrument can be found at http://www.legislation.gov.uk As mentioned previously, in Guide 3, this Statutory Instrument lays down various rules prohibiting the business from using certain specified words unless previous consent is obtained from specified government departments.

Tip: The start-up procedures for a partnership are minimal. However, it is a good idea to get a written partnership agreement drafted. Also, don't forget the business name rules if you intend trading under a name that is different to the names of the partners. In that event the law expects the partnership to give full names and an address for service i.e. if someone does want to sue the partnership then they need to know who to send their claim documents to and to which address. So, for example, if we consider the scenario mentioned above, in which the customer wants to sue the business for a poorly prepared food product then it is important for the customer to know the names of the individuals that (s)he will be suing and to have an address to send any claim form to. That is the reason why the disclosure rules are in place. If Ian, Sandra and David trade under a name that is not their actual names (with "permitted additions" such as forenames and initials) then it would not be possible for the

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customer to know precisely who to make a claim against. That is essentially the reason why the disclosure rules are in place. i.e. to ensure that the real names behind the trading name are revealed.

Also don't forget to seek consent to use words in the trading name which are "sensitive" or that imply are linked to the government etc.

4.7 Table on Advantages and Disadvantages of Partnership

Figure 4.2	
Advantages of Partnership	**Disadvantages of Partnership**
No specific start-up provisions for partnership vehicle itself but must comply with rules which apply to the trading name. (Though, good idea to have **written** partnership agreement).	Unlimited liability for partners. Successful claimant can seek contribution from partner's personal as well as business assets.
The only specific "rules" on partnership management are limited rules in the Partnership Act 1890, and most of the rules can be overridden by express or implied agreement between the partners.	Difficult for lenders to take security (charges) over assets such as stock in the same way as described for sole trader.
Flexible management structure due to limited number of rules.	
No need to make accounts and other information public (compare this with companies and LLPs).	
Tax advantages/disadvantages in setting up in partnership when compared to company and other structures should be assessed by a financial adviser. Each situation will differ on the facts and guidance from a financial adviser should be sought.	

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